TAX INCREASE PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

VARIOUS PENDING TAX INCREASE PROPOSALS

JUNE 5, 6, 10, AND 11, 1974

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JUNE 10 AND 11, 1974

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(Parts One and Two)

TAX INCREASE PROPOSALS

MONDAY, JUNE 10, 1974

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

The committee met, pursuant to recess, at 10:05 a.m., in room 2221, Dirksen Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senator Long, Hartke, Bennett, Curtis, Dole, and Packwood.

The CHAIRMAN. This hearing will come to order.

We are pleased to have with us this morning the senior Senator from Massachusetts, Hon. Edward M. Kennedy. We would be pleased to know your views with regard to these various tax matters under discussion for the last several days.

STATEMENT OF HON. EDWARD M. KENNEDY, A U.S. SENATOR FROM MASSACHUSETTS

Senator KENNEDY. Thank you very much, Mr. Chairman. I appreciate very much the opportunity to take a few moments of the committee's time this morning to address my attention to some of the particular tax reforms that I favor and also to review very briefly some of the steps that you and I and Senator Mondale are taking to provide at least some stimulation to the economy and some relief in the form of tax equity to those that have been the hardest hit by inflation, especially the increased cost of energy and food across this country. I think all of us who are concerned about tax reform and tax equity are very much in your debt for the leadership you provided in the work bonus provision which you successfully sponsored on the floor of the Senate last fall, and which is now a central part of our tax relief proposal.

So I am pleased to join in these hearings this morning as a timely symbol and demonstration of the commitment of many of us in the Senate to tax reform.

Mr. Chairman, I would like to ask that my full statement be printed in the record. I will refer to it and summarize it.

The CHAIRMAN. Without objection, it will be printed, and I will be very pleased to study the entire statement. It deserves it and it will certainly have that attention.

TAX REFORM NEEDED

Senator KENNEDY. We have a crisis over taxation today, since countless ordinary men and women now realize that their taxes are too large because others pay too little. Year after year, Congress after

Congress, we have allowed the loopholes and the special benefits in the tax laws to accumulate, virtually without end.

As a result, we allow tens of billions of dollars of income and profits to escape taxation every year. Those loophole losses have to be made up somehow, and we know they are made up by higher taxes for every ordinary citizen. To paraphrase a famous aphorism, our tax laws in their majestic quality allow the poor as well as the rich to invest in State and local bonds, to reap long-term capital gains, to drill for oil, to enjoy the fantastic benefits of owning real estate, and to hire lawyers and accountants skilled in the latest techniques of tax shelters and tax avoidance.

The time has come to end all that. The time has come for Congress to take the lead this session. There is still enough time to guarantee that one of the major landmarks of the 93d Congress is legislation on comprehensive tax reform.

I see a three-part strategy.

First, we need immediate tax relief for every citizen. Congress should act now to provide an across-the-board antirecession tax cut for every citizen. Through such tax relief, we can provide an urgently needed shot in the arm to prevent the economy from sinking deeper into the current recession, and to prevent unemployment from soaring higher than its present level of 5.2 percent.

Now about to come before the Senate is a proposal that I have joined in introducing with you, Mr. Chairman, and with Senator Mondale, to provide $6.5 billion in antirecession tax relief. My hope is that Congress will act quickly to adopt it. The health of the American economy for the remainder of 1974 into 1975 may well hang on the outcome of our action.

Second, both as a down payment on comprehensive tax reform this year and as an offset to the revenue loss from tax relief, we need to enact some basic tax reforms. With Senator Bayh and five other Senators, I have joined in proposing four reforms which we think are capable of immediate enactment, either on the forthcoming tariff bill or the debt ceiling act. Briefly, the reforms would accomplish the following: Repeal the oil depletion allowance, repeal the asset depreciation range system of accelerated depreciation, repeal the domestic international sales corporation system of tax subsidies for exports, and strengthen the minimum tax by reducing the current exclusion from $30,000 to $10,000 and by eliminating the current deduction for taxes paid.

These four proposed reforms will generate new revenues totaling $4 billion in 1974 and $7 billion by 1978.

Third, we must work for final action in this Congress on comprehensive tax reform. In addition to the four immediate reforms I have already proposed, the highlights of my own agenda go as follows:

Increasing Proliferation of Tax Shelter Transactions

First and most important, and an area to which I would like to devote my principal emphasis this morning, we must call a halt to the increasing proliferation of tax shelter transactions now being packaged and marketed around the country on a massive assembly line basis for the benefit of wealthy individuals anxious to keep their taxes low.

These packaged tax shelters have now become one of the most notorious abuses in our tax history, a flagrant vehicle by which high bracket taxpayers eliminate their taxes altogether or reduce them to levels that are unacceptably low. At present, such transactions are costing the American taxpayer over $1 billion a year, and the revenue loss is obviously escalating as the techniques become more familiar and more widely used. If Congress is serious about tax reform, immediate action is required.

But that is not the only cause. A far higher price is being paid in terms of the loss of confidence that people have in the tax laws. Tax shelter transactions now run through our entire economy. The ingenuity of wealthy tax avoiders and their advisers knows no bounds. What I might call the older generation of tax shelters are those in real estate and oil and gas, the two types of shelters still most widely used today.

More recently, newer generations of shelters have sprung up in areas like cattle farming and orange and apple orchards, movie production, jet airplanes, railroad cars, river barges and oil tankers—even including tankers that by virtue of their size cannot dock in U.S. ports. And there are other shelters in more exotic areas, such as rose and azalea bushes, almonds, and pistachio nuts, thoroughbred racing stables, or masterpiece-in-the home clubs for famous works of art, and even in chinchilla farms and pornographic films.

Whatever the arguments for Federal tax subsidies for building homes and drilling for oil or raising cattle, it can hardly be contended that investments in pornographic films, chinchillas, azalea bushes, or exotic fruits and nuts constitute a national priority worthy of encouragement by our tax laws. And even in those areas like real estate and oil exploration and cattle ranching, where some form of tax subsidy may be appropriate, I have grave doubts about the propriety of allowing the tax laws to be distorted in a way that serves a purely tax-avoidance purpose of a handful of wealthy citizens.

Vast amounts of funds are flowing into these activities today—not because the Nation wants them, not because Congress or State or local governments want them, but because the richest 1 percentile of the Nation wants them for their tax avoidance value.

The sudden proliferation of tax shelters in recent years is indicated by the rising workload of the SEC. In February of 1972, for the first time in its history, the SEC was obliged to create a specialized branch to handle public offerings of tax shelter transactions. But the SEC sees only the tip of the iceberg, the roof of the shelter. It deals only with shelters whose registration is required under the securities laws—in effect, those involving public offerings sold across State lines.

A more accurate measure of the proliferation of tax shelters can be found in the figures of the National Association of Securities Dealers. These figures cover tax shelters sold by members of the association, whether the shelters are interstate or intrastate transactions.

And as the table accompanying my testimony indicates, the number of offerings of tax shelters nearly quadrupled between 1970 and 1972. The dollar value of the offerings more than tripled, reaching the astonishing level of $3.2 billion in 1972.

Even the NASD figures, however, fail to tell the whole story. The association estimates that its figures cover only about one-tenth of the dollar volume of all tax shelters offered, and an even smaller fraction of the number of shelters offered, since the vast majority are sold through private placement and not through securities dealers.

The best estimate, therefore, is that in 1972, upward of $30 billion in tax shelters were sold around the country.

Enormous waste is involved in the nationwide syndication of tax shelters that is taking place today. A significant portion of the benefits are siphoned off in fees for the promoters, underwriters, lawyers, salesmen and accountants whose business is the sale of those Federal tax advantages.

These transactions also have serious and undesirable economic side effects. They often constitute artifical and unfair competition for legitimate business operations. They encourage high risk and extremely speculative adventures that will not stand up to serious economic analysis. They spawn bad business practices that plague the legitimate farmer or the professional oilman, or the ordinary real estate developer.

Investors in tax shelters do not need to make an economic profit on their shelters. They do not have to meet a payroll or feed a child or clothe a family or make a monthly mortgage payment out of the income from their operations.

The only thing these wealthy investors want is the large deductions and other tax advantages that the shelters can produce for high bracket lawyers, physicians, dentists, investment bankers, corporate executives and the like.

There is a very simple approach that Congress could now take to meet this problem. It would deal with shelters through their leverage aspect. It would effectively end the syndication and mass marketing of such shelters, and thereby eliminate most of the worst abuses.

The essence of the reform is to limit the tax benefits of a shelter to an investor's own personal stake in the project, the actual amount of his own investment. I am today introducing an amendment to H.R. 8217, the tariff bill now on the Senate calendar, to carry out this reform.

If a partner is not liable for all of the debts and other obligations of a partnership, he should not enjoy all of the tax advantages that the partnership produces.

It is as simple as that. By itself, this amendment should succeed in ending the insidious practice of syndicated tax shelters without any substantial effect on legitimate business operations. It is extremely unlikely that the busy doctors, lawyers, corporate presidents, and others who enjoy the benefits of such tax shelters will want to be involved in the active operations of the businesses in which they have invested to the extent of becoming personally liable for the transactions of the shelters. They only want their passive investments and handsome tax deductions, not the headaches and liabilities of the acutal operations.

The more we learn about these tax shelter transactions, the more concerned we are. The practice is destroying the integrity of our tax laws. In no other area is the Revenue Code so dangerously eroded or the vitality of our self-assessment tax system so seriously threatened. Indeed, some experts have already predicted that such tax shelters will become the Achilles heel of the Federal income tax if Congress does not bring them under control.

So far, we have been too slow in awakening to the abuses that have sprung up in these dark but heavily sheltered recesses of the Revenue Code. Now is the time for Congress to tackle the issue and end the unfair tactics being used to subvert the tax laws and distort the American economy.

Tax Credits Instead of Tax Deductions

Another major area of comprehensive tax reform that I favor is one that cuts across many other subjects, the need to overhaul the relationship between tax credits and tax deductions. In the past, as part of overall tax reform, I have urged Congress to allow credits instead of deductions in a number of major areas, including the personal exemption, the homeowner's mortgage interest deduction, the deduction for medical expenses, and the deductions for State and local income and property taxes.

Our tax laws are clearly out of joint today, and nowhere is the disparity clearer than in the case of some of the most popular tax deductions:

It makes no sense to me that, because of the rate structure of our present revenue laws, the $750 personal exemption means that a child in a wealthy family is worth a tax saving of $525 to his parents, while a ghetto child is worth a savings of only $105.

It makes no sense to me that the tax law saves the wealthy family 70 cents on every dollar in mortgage interest payments on its Scarsdale home, but only 14 cents on the dollar for the family home in Harlem.

It makes no sense to me that, through the tax laws, the U.S. Treasury pays 70 percent of the cost of a wealthy citizen's visit to his Beverly Hills physician, but only 14 percent of the medical bills for the family in East Los Angeles.

By allowing the use of credits instead of deductions in these and other areas of the tax laws, either on an optional or on a mandatory basis, we can make the income tax system far more progressive and provide a substantial new measure of equity for millions of our taxpayers.

In addition, I also favor a number of reforms in specific areas of the tax laws. In an appendix to my testimony, I have introduced a more detailed summary of the proposals.

Capital Gains Reform Needed

Before closing, however, there is one area that I would like to deal with briefly. In any legislation worthy of the name tax reform, we have to come to grips with capital gains. Today, such gains represent one of the most sifignificant preferences in the tax laws, and yet they are available almost exclusively to the Nation's richest individuals.

According to recent statistics, the top 3 percent of taxpayers enjoy 55 percent of all capital gains, and the top one-tenth of 1 percent of all taxpayers enjoy 30 percent of all capital gains. The enormous tax advantages that now apply to capital gains are thus the special province of an extremely wealthy elite among the Nation's taxpayers.

I do not support efforts to close the gap altogether between the tax on ordinary income and the tax on capital gains, but we must go part way. The changes I propose in capital gains would not substantially impair the flow of capital in the Nation. A major tax preference would still exist for capital gains in the Revenue Code. And by ending the major current loophole involving capital gains at death, Congress would actually free up billions of future dollars for investment, dollars that would otherwise be frozen because of the tax advantages that now occur when property is held until death.

At the same time, I believe that Congress should resist the proposals being circulated to relax even further the current low rate of tax on capital gains, depending on the length of time a capital asset is held. Such a change would seriously increase the existing lock-in effect of the capital gains tax, since it would encourage investors to hold assets for longer periods of time in order to obtain the progressively more favorable tax rates that would become available. To me, the answer to the problem of the sagging stock market is a sound economy, not a further dose of special tax preferences for the wealthy few who have the wherewithal to enjoy capital gains.

In closing, let me repeat that in the coming weeks Congress should make its intention clear to give tax reform the same high priority already reserved for other basic issues. Only in this way can we bring real tax justice to every citizen, and end the unjust reign of "King Loophole" in our revenue laws. Whatever the final outcome of the debate over President Nixon's tax returns, the most important lesson of the disclosure of the President's tax data is that tax reform must move back to center stage as an issue for Congress and the American people.

Just as Watergate helped to generate important new legislative momentum in Congress for comprehensive reform of the Nation's election laws, including the landmark bill for public financing of elections that passed the Senate earlier this year, so the President's tax disclosure should generate a similar momentum in Congress for comprehensive reform of the Nation's tax laws. Tax reform belongs at the top of our agenda for 1974. It is up to us in Congress to meet our obligations as representatives of millions of ordinary taxpayers. If we succeed, then in the years to come the 93d Congress will be remembered as the Congress that at last brought tax justice to America.

The CHAIRMAN. Thank you for your statement, Senator.

Senator Hartke?

SOCIAL SECURITY TAXES—REGRESSIVE TAXATION

Senator HARTKE. Senator Kennedy, I share with you your concern for closing the loopholes, and also I am personally in favor of increasing the exemption. I would increase it to $1,000, which I feel would be more appropriate in view of the increase in the cost of living.

Of deeper concern is the mounting increase in social security taxes, and I wonder what opinion you have on that?

Senator KENNEDY. Well, first of all, I recognize that you have been one of the real leaders in efforts to increase the personal exemption and to reduce the burden of the payroll tax. We have tried to accommodate both approaches in our tax relief package—an increase in the personal exemption from $750 to $825 to provide across-the-board relief, the Mondale provision for an optional tax credit to aid low- and medium-income groups, and the work bonus provision of Senator Long to provide payroll tax relief.

I am extremely sympathetic to the ever-increasing burden of social security tax increases. That is why I favor supplementing social security taxes with general tax revenues.

Senator HARTKE. I agree with that. What would be the total cost of the Kennedy-Mondale-Long package?

Senator KENNEDY. $6.5 billion.

Senator HARTKE. $6.5 billion?

Would we not be better off—I am not as worried about the recovery.

Senator KENNEDY. I am sure Senator Bennett does.

Senator HARTKE. I am interested in paying the bills, but I am more interested in tax equity. The solution should be to aid the people who are hit hardest. The most regressive taxation that we have today is the social security tax. It is recognized even by the Social Security Advisory Board as being regressive, and as much as I am in favor of the increase in the exemption, if I had to make my choice I would rather that the problem of a retrogressive social securtiy tax be solved first.

The employer can write his share of the tax off as a business expense. But the poor little guy working in the filling station cannot take anything off. He is getting hit so hard that in many cases his social security tax is higher than his income tax.

I was wondering whether the Senator would be interested in providing relief where it is most needed. If you are going to give a $6.5 billion tax relief, why not increase the $6.5 billion in the employee's contribution and take this from the general fund, and then go ahead with paying for it by plugging tax loopholes.

Senator KENNEDY. Frankly, I prefer the more balanced package we have proposed. It is always possible to pour all the tax relief into one class of the population, but I believe that tax relief should be more broadly based. Also, as you know, any proposal for such a far-reaching change in the payroll tax is controversial and difficult to enact. I doubt that Congress could deal with it in time to provide the antirecession impact we feel is needed.

In any event. the overwhelming impact of our package is on the group the Senator is concerned about. Eighty percent of the relief goes to persons earning $15,000 a year or less.

Of course, an argument can be made that these groups do not need the resources as much as the poor elderly on social security.

But I do think that this formula that has been devised, both in terms of economic stimulation and in terms of equity, is defensible.

Senator HARTKE. Just so I do not misunderstand you, I am not talking about the elderly now. I am talking about the paying employee, and as far as the middle-income group is concerned, he is going to be under $15,000——

Senator KENNEDY. I thought your point was——

Senator HARTKE. My proposal is that the general revenue taxation which is now assessed one-half against employee and one-half against employer, be reduced for the employee's contribution to the amount of $6.5 billion.

There is a total revenue of about $60 billion anticipated in the social security fund, $30 billion coming from the employee. So that means that the employees contribution has been reduced by one-fifth. For person who earns less than $15,000; he will get a tax break on his social security tax. I would reduce his contribution by one-fifth to the social security fund. This one-fifth would then be paid from the general revenue fund.

This would provide a stimulus to the economy and aid those who need it most by correcting a very undemocratic and regressive tax.

Senator KENNEDY. If you have got the figures there, I would be glad to review them with you. But I feel that our balanced package is a more realistic form of tax relief that is capable of prompt enactment. We can't overhaul the system of social security financing as a rider on the Debt Ceiling Act. But I would be glad to review the figures.

Senator HARTKE. I will be glad to review those.

Senator KENNEDY. The basic point which you make about the regressive nature of the payroll tax is something that I too am concerned about.

Senator HARTKE. I will prepare a chart for you and I will show you how the benefits are better off for a person under $15,000 to do this than they are the other way around.

Senator KENNEDY. I would be glad to examine it.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. Mr. Chairman, I am sure Senator Kennedy realizes that neither he nor I will convince the other of our position. I am looking at the fact that there are eight more witnesses.

Senator KENNEDY. That is right.

Senator BENNETT. And I think they are entitled to an opportunity, so I will contribute my time to them.

Senator KENNEDY. We will have a chance to develop this on the floor.

Senator BENNETT. Yes, on the floor.

Senator KENNEDY. Where we enjoy such exchanges.

The CHAIRMAN. Senator, I want you to know that it is not my fault that we have never had the pleasure of having a Kennedy serve on the Senate Finance Committee. I went to your brother, the late John Kennedy, and urged him to apply for membership on this committee, and was unsuccessful in doing so. He explained to me why he did not think he should apply for it, and if you want the benefit of his advice I will be glad to impart that to you sometime.

But I would urge some of you who bear your family name to reconsider, because I think you could make a contribution on the committee. I have recruited a number of Senators whose thinking is pretty close to your thinking on this matter, enough so that we have some votes for your tax cut proposal, but not enough to recommend it out to the Senate. But we did keep the faith in reporting out a measure to which it can be offered.

CHOOSING A VEHICLE FOR TAX REFORM AMENDMENTS

Now, let me ask you this: Just looking at the possibility that time may run out on us before this Congress is over, and we may be pressed with some other urgent matters that no one could have anticipated when this Congress started, if we are going to have these amendments offered on the debt limit bill anyway, do you think it serves any purpose for us to debate these items once on this minor tariff bill than is out there on the Senate calendar, and then again on the debt limit?

I assume these amendments will be offered on the debt limit bill. This is because those who favor the tax measures would feel that they would like to offer them on a bill that the President would be very reluctant to veto. That way they would have the maximum persuasive power directed toward the White House to try to convince the President that he ought to go along and forgo his doubts about some of these measures that you have advocated, and some of which I strongly subscribe to, in signing a bill. Now, if he would veto a debt limit bill that might contain these amendments, he would assuredly veto a minor tariff bill that contained them.

Might I just have your views on this? Do you think that we might be better advised to postpone this debate until the debt limit bill is before the Senate, or do you think that we ought to go ahead and face a prospect of debating and covering this ground twice?

Senator KENNEDY. Well, I have seen a debt limit bill filibustered, too, as the chairman of this committee remembers very well, during the final hours of last session, when we amended it to include public financing of campaigns.

The CHAIRMAN. Well, I have to be tolerant of filibusters. Before I became a committee chairman, I also filibustered bills when I did not think the thing would go the way I thought it should have gone.

Senator KENNEDY. That is right.

The CHAIRMAN. So I cannot complain too bitterly about somebody waging a filibuster.

Senator KENNEDY. That is right. But as a means or a technique of pushing through legislation it has some vulnerability as well, even though it may be close to veto-proof.

I want to indicate also that this committee and the chairman kept complete faith in some of us who offered tax relief and tax reform amendments in the early part of this year. The bill was recommitted then, and there was an impasse over other legislation.

The chairman of this committee gave assurance that a vehicle would be brought to the floor to let the debate proceed. This committee and you, Mr. Chairman, kept faith with that commitment.

I for one would be willing to have the debate on the tariff bill. But the Debt Ceiling Act is an obvious alternative. We have seen two or three occasions where the debt ceiling has been used as a recent vehicle for other important measures. One was on the social security benefit increase; another was on the end-the-war amendment; a third was on campaign financing.

Basically, the debt ceiling approach is not the best way to legislate, and I would hope that we could take up the other measure and move ahead on that.

I will have a chance to talk with some of my colleagues. Your floor advice is valuable, as a Senator who is a recognized tactician and who is supporting some of these provisions, and who has a legitimate concern about others. I think it would be very important and very influential in the way we proceed.

The CHAIRMAN. Well, I am concerned about the fact that we will, of course, have to act on a debt limit bill regardless of who prevails on these amendments. I think we should also act on a major trade bill coming out of this committee this Congress, and I would hope very much that we will act in the health area to make progress in that area, for better or for worse, and with the spirit of compromise that seems to be suggested by you and the administration, maybe you can get together on something. I am not adamant on my views on the health area.

Then there are going to be a number of other measures that we will have to act on; for example, we did have a big social security bill that should not be permitted to die. We have passed this bill but the House has not conferred with us. We will have to either send more social security legislation to them or else we will have to find some way to press them into conference with us on that measure.

So I recognize that we are going to have a heavy workload this year. I just wondered if we might try to reach some understanding that we will offer the tax amendments on one bill or on two bills, but that we are not going to keep fighting the same amendments over and over again in the whole Congress.

Senator KENNEDY. I would be more than glad to cooperate in every way. I know the feelings that you have, particularly on some of these measures, and I think it might be wise, in saving the Senate's time and in permitting the discussion that we try to develop a sensible schedule. I would be glad to cooperate in any way.

The CHAIRMAN. Well, I appreciate your appearance, Senator Kennedy, and I would like to discuss in greater detail with you at this point your suggestion. But you and I know that we will have the opportunity to discuss these matters on the Senate floor with one another, and that is not true of these witnesses who come along behind you. So that I want to express the thanks of the committee for your appearance here today.

Senator KENNEDY. Thank you very much, Mr. Chairman.

The CHAIRMAN. I welcome your suggestion on the bill as reported.

[The prepared statement of Senator Kennedy follows:]

from the office of

Senator Edward M. Kennedy

of Massachusetts

SENATOR KENNEDY URGES TAX RELIEF AND TAX REFORM, INCLUDING END TO SYNDICATED TAX SHELTERS

FOR IMMEDIATE RELEASE
JUNE 10, 1974

Senator Edward M. Kennedy today called on Congress to end th syndicated tax shelters now widely used by wealthy individuals to pyrami tax loopholes and escape their fair share of taxes. The proposal was ma by Kennedy in the course of testimony before the Senate Finance Committe on tax reform.

Citing the mushrooming use of such syndicated shelters, amou ing to as much as $30 billion in tax shelter assets in 1972, Kennedy sai the practice was destroying the integrity of the tax laws and was becomi the Achilles heel of the Internal Revenue Code.

Kennedy noted that upwards of $1 billion a year in excessive tax relief is conferred on high bracket taxpayers, such as wealthy inves doctors and dentists, lawyers, investment bankers, and others. The Sena said they are enjoying unjustified tax benefits by investing not only in traditional tax shelters like real estate and oil and gas, but also in areas like cattle farming, orange and apple orchards, movie productions, jet airplanes, railroad cars, river barges, and deepwater oil tankers, as well as in exotic areas like rose and azalea bushes, pistachio nuts, thoroughbread racing stables, masterpiece-in-the-home clubs for famous works of art, and even in chinchilla farms, cattle sperm banks, and pornographic films.

Such shelters confer their tax advantages through a variety of techniques, Kennedy said, but one of the principal devices is the "leverage" through so-called limited partnerships, under which an invest receives deductions based on the partnership's total operating funds, ev though his own investment is extremely small, and he has no further pers liability for the operation. In real estate shelters, for example, said Kennedy, it would not be unusual for an investor to receive in tax deductions a year, even though his own actual investment was only $100,000.

Kennedy said that these tax shelters cause a revenue loss of over a billion dollars a year. "This loss has to be made up somewhere," he said, "and it is being made up out of the hard-earned dollars of the eighty million ordinary taxpayers in the nation, whose taxes are too high because others' are too low. The rich are entitled to their playgrounds, but it's time the average taxpayer stopped paying for their toys."

Kennedy proposed to close the syndicated tax shelter loophole by limiting the tax advantages to each taxpayer's own investment in the project. Kennedy said he would offer a Senate floor amendment to close the loophole during the forthcoming Senate floor debate on tax reform.

In other parts of his testimony, Kennedy repeated his call for a tax cut for low and middle income citizens, coupled with tax reforms to offset any revenue loss. Kennedy is a principal sponsor in the Senate of a pending $6.5 billion tax cut, as well as a $4 billion four-part tax reform package to repeal the oil depletion allowance, the DISC export subsidy and the ADR accelerated depreciation allowance, as well as to strengthen the minimum tax enacted by Congress in 1969 as a special 10% tax on income that is otherwise untaxed.

In his testimony, he also called for additional tax reforms, including reforms in capital gains and other aspects of oil taxation.

The full text of Senator Kennedy's testimony is attached.

from the office of

Senator Edward M. Kennedy

of Massachusetts

TESTIMONY OF SENATOR EDWARD M. KENNEDY HEARINGS ON TAX REFORM

SENATE COMMITTEE ON FINANCE

For Immediate Release
June 11, 1974

I am pleased to join in these hearings this morning as a timely symbol and demonstration of the commitment of many of us in the Senate to tax reform.

We have a crisis over taxation today, since countless ordinary men and women now realize that their taxes are too large because others pay too little.

Year after year, Congress after Congress, we have allowed the loopholes and special benefits in the tax laws to accumulate, virtually without end. As a result, we allow tens of billions of dollars of income and profits to escape taxation every year. Those "loophole losses" have to be made up somehow, and we know the way they are made up -- by higher taxes for every ordinary citizen.

In fact, the Internal Revenue Code is America's biggest welfare bill of all. But it is the sort of welfare that only Alice in Wonderland can understand, because the greatest benefits of tax welfare go entirely to the richest individuals and the nation's largest corporations.

Only those of substantial means are able to play the loopholes well. Middle and lower income Americans simply cannot afford the substantial sums that are necessary to take advantage of the tax shelters that now exist. According to many estimates, the threshold level of income for effective use of tax shelters is in the neighborhood of $50,000 a year, far beyond the reach of any ordinary citizen.

To paraphrase a famous aphorism, our tax laws in their majestic equality allow the poor as well as the rich to invest in State and local bonds, to reap long-term capital gains, to drill for oil, to enjoy the fantastic benefits of owning real estate, and to hire lawyers and accountants skilled at the latest techniques of tax shelters and tax avoidance.

Wherever we look, we find the tax base being eroded by unjustified deductions and exemptions, by windfall subsidies, by questionable incentives for various industries, by benefits that have long since outlived whatever justification they had when first enacted, and even by loopholes quietly written into law for the benefit of particular individuals or corporations -- "tax fingerprints" that dot the Revenue Code in silent tribute to the political muscle of the wealthy and the powerful in the nation.

And meanwhile, the taxes paid by ordinary citizens are always on the rise.

The time has come to end all that. The time has come for Congress to take the lead. We can act this session. There is still enough time to guarantee that one of the major landmarks of the 93rd Congress is legislation on comprehensive tax reform.

I see a three-part strategy:

IMMEDIATE TAX RELIEF

First, we need immediate tax relief for every citizen. Congress should act now to provide an across-the-board anti-recession tax cut for every citizen. Through such tax relief, we can provide an urgently needed shot-in-the-arm to prevent the economy from sinking deeper into the current recession, and to prevent unemployment form soaring higher.

Such tax relief would also provide a welcome and well-deserved respite from the continuing burden that inflation and high interest rates now impoe on every citizen.

Now about to come before the Senate is a proposal that I have joined in introducing with Senator Long and Senator Mondale, to provide $6.5 billion in anti-recession tax relief. The proposal contains three principal provisions:

--It will raise the personal exemption for individuals under the Federal income tax laws from its current level of $750 to a new level of $825.

--It will provide an optional tax credit of $190 in lieu of the exemption.

--It will refund a portion of the Social Security payroll taxes paid by low-income workers with children, through a refundable tax credit -- Senator Long's "work bonus" -- equal to 10% of wages up to $4,000 in income. For incomes over $4,000, the credit is phased out at the rate of 25¢ per dollar, so that the credit disappears when income reaches $5,600. Because the credit is refundable, it will be paid as an income tax refund, even if the recipient has no income tax liability.

This tax relief proposal is now awaiting action by the full Senate on either the Vessel Repair Tariff Act or the Debt Ceiling Act.

My hope is that Congress will act quickly to adopt it. The health of the American economy for the remainder of 1974 and on into 1975 may well hang on the outcome of our action.

DOWN PAYMENT ON TAX REFORM

Second, both as a downpayment on comprehensive tax reform this year and as an offset to the revenue loss from tax relief, we need to enact some basic tax reforms on the tariff bill or the Debt Ceiling Act. With Senator Bayh and five other Senators, I have joined in proposing four reforms which we think are capable of immediate enactment. I am attaching a detailed explanation of each of these reforms. Briefly, they would accomplish the following:

--Repeal the oil depletion allowance, effective January 1, 1974 ($2.0 billion revenue gain in first year; $2.6 billion in third year; $3.3 billion in fifth year).

--Repeal the Asset Depreciation Range (ADR) system of accelerated depreciation, effective for plant and equipment placed in service as of May 8, the date our amendment was proposed ($250 million revenue gain in first year; $1.5 billion in third year; $2.0 billion in fifth year).

--Repeal the Domestic International Sales Corporation (DISC) system of tax incentives for exports, effective January 1, 1974 ($815 million revenue gain).

--Strengthen the minimum tax by reducing the current exclusion from $30,000 to $10,000, and by eliminating the current deduction for taxes paid, effective January 1, 1974. This provision was passed 47-32 by the Senate on January 24, 1974, ($860 million revenue gain).

These four proposed reforms will generate new revenues totaling $4 billion in 1974, and $7 billion by 1978.

Again and again in recent years, the Senate has considered and debated and voted on these proposals. The time for final action has come. The people of America are fed up with rising taxes for themselves, soaring profits out of oil, and gaping loopholes for many others among the favored few. It is time for Congress to begin to redeem its pledge of equal tax justice for every citizen under the Internal Revenue Code. The place to start is here, with the four most flagrant loopholes in the law -- oil depletion, ADR, DISC, and the minimum tax.

COMPREHENSIVE TAX REFORM

Third, we must work for final action in this Congress on comprehensive tax reform. The vehicle is in sight -- the pending measure now being considered in the Ways and Means Committee in the House. Clearly, the goal of enacting such reform before adjournment is within our reach, and I urge both this committee and the Ways and Means Committee to give it the high priority it deserves.

My own view is that Congress ought to be able to enact loophole-closing tax reforms amounting to net revenue savings of at least $10 billion a year.

The list of areas that need reform is long, but there is growing agreement on what some of the major elements should be. In addition to the four immediate reforms I have already proposed, the highlights of my own agenda go as follows:

PACKAGED TAX SHELTERS

First, and most important, is a reform which, like the minimum tax, cuts across many specific areas and which will eliminate some of the worst abuses of the tax laws. We must call a halt to the increasing proliferation of tax shelter transactions now being packaged and marketed around the country on a massive assembly-line basis for the benefit of wealthy individuals anxious to keep their taxes low.

These packaged tax shelters have now become one of the most notorious abuses in our tax history, a flagrant vehicle by which high bracket taxpayers eliminate their taxes altogether or reduce them to levels that are unacceptably low. At present, such transactions are costing the American taxpayer over $1 billion a year, and the revenue loss is obviously escalating as the techniques become more familiar and more widely used. If Congress is serious about tax reform, immediate action is required.

Tax shelter transactions now run through our entire economy. The ingenuity of wealthy tax avoiders and their advisers knows no bounds. What I might call the Victorian generation of tax shelters are those widely used in real estate, and oil and gas -- the two types of shelters still most widely used today.

More recently, newer generations of shelters have sprung up in areas like cattle farming, orange and apple orchards, movie production, and in jet airplanes and railroad cars and river barges and oil tankers -- even including tankers that by virtue of their size cannot dock in U.S. ports.

There are also shelters in more exotic areas, such as rose and azalea bushes, pistachio nuts, thoroughbred racing stables, or masterpieces-in-the-home clubs for famous works of art, and even in chinchilla farms and cattle sperm banks and pornographic films.

Whatever the arguments for federal tax subsidies for building homes or drilling for oil or raising cattle, it can hardly be contented that investments in pornography,, chinchillas, azalea bushes, and exotic fruits and nuts constitute a national priority worthy of encouragement by our tax laws.

And even in those areas like real estate and oil exploration and cattle ranching, where some form of tax subsidy may be an appropriate national priority, I have grave doubts about the propriety of allowing the tax laws to be distorted in a way that serves a purely tax-avoidance purpose of a handful of wealthy citizens.

Vast amounts of funds are flowing into these activities today -- not because the nation wants them; not because Congress or State or local governments want them, but because the richest percentile of the nation wants them for their tax avoidance value.

The sudden proliferation of these and other tax shelters in recent years is indicated by the rising workload of the S.E.C. In February 1972, for the first time in its history, the S.E.C. was obliged to create a specialized branch, to handle public offerings of tax shelter transactions. In July 1973, a second special branch was added in the S.E.C. Today there are three S.E.C. branches working essentially full time on tax shelters: one branch on oil and gas, a second branch on condominiums and cattle and agriculture, and a third branch on real estate and other shelters.

But the S.E.C. sees only the tip of the iceberg, the roof of the shelter. It deals only with shelters whose registration is required under the securities laws -- in effect, those involving publi offerings sold across state lines.

A more accurate measure of the proliferation of tax shelters can be found in the figures of the National Association of Securities Dealers. These figures cover tax shelters sold by members of the Association, whether the shelters are interstate or intrastate transactions.

As the accompanying table indicates, the number of offerings of tax shelters nearly quadrupled between 1970 and 1972, and the dollar value of the offerings more than tripled, reaching the astonishing level of $3.2 billion in 1972. Although the figures for 1973 have been cut in half, the reduction is obviously caused by the nosedive of the national economy in general and the plunging stock market in particular. No one doubts that the tax shelter entrepreneurs are waiting in the wings, their vast wares ready for the first hint that the economy is coming back to health.

TAX SHELTERS OFFERED BY N.A.S.D. BROKER DEALERS 1970-73

NUMBER OF FILINGS AND GROSS DOLLAR AMOUNT OF FILINGS */

	1970		1971	
	NO.	AMOUNT	NO.	AMOUNT
Oil and Gas	62	$664,337,000	155	$740,094,000
Real Estate	54	256,485,000	139	523,534,000
Vintage and Farming	3	10,742,000	7	30,266,000
Cattle Farming and Breeding	13	26,764,000	22	244,636,000
Miscellaneous	13	26,336,000	11	29,915,000
	145	$984,664,000	334	$1,568,405,000

	1972		1973	
	NO.	AMOUNT	NO.	AMOUNT
Oil and Gas	226	$1,027,500,000	120	$514,000,000
Real Estate	243	1,910,000,000	74	467,564,000
Vintage and Farming	21	43,284,000	5	13,950,000
Cattle Farming and Breeding	30	192,012,000	22	181,167,000
Miscellaneous	19	55,256,000	14	143,815,000
	539	$3,228,667,000	235	$1,320,340,000

*/ Items may not add to totals because of rounding.

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Even the NASD figures, however, fail to tell the whole story. The Association estimates that its figures cover only about one-tenth of the dollar volume of all the tax shelters offered and an even smaller fraction of the number of shelters offered, since the vast majority are sold through private placement and not through securities dealers. The best estimate therefore, is that in 1972, upwc of $30 billion in tax shelters werepackaged and sold around the country.

Enormous waste is involved in the nationwide syndication of these tax shelters that is taking place today.

A significant portion of the benefits are siphoned off in fees for the promoters, underwriters, lawyers, and accountants whose business is the sale of these federal tax advantages.

These transactions also constitute artificial and unfair competition for legitimate business operations. They encourage high risk and extremely speculative adventures that will not stand up to serious economic analysis. They spawn bad business practices that plague the legitimate farmer, the professional oilman, and the ordinary real estate developer. Investors in tax shelters don't need to make an economic profit on their shelters. They don't have to meet a payroll or feed a child or clothe a family or make a monthly mortgage payment out of the income from their operations. The only thing these wealthy investors want is the large deductions and other tax advantages that the shelters can produce for high bracket lawyers, physicians, investment bankers, corporate executives, and the like.

The principles of a tax shelter are fairly simple. There are a handful of basic elements that may exist alone or in overlapping combinations:

--<u>Deferral</u> of current tax, which allows income to be realized in a year chosen by the taxpayer;

--<u>Leverage</u>, which allows borrowed funds to be used to create tax benefits far in excess of the taxpayer's own personal stake in the property;

--<u>The shelter</u> itself, which allows deductions from one activity to offset income from another; and,

--<u>The capital gain</u> available on disposition of the property, even though the shelter has provided deductions against ordinary income in the past.

Different tax shelters use these elements in different ways. It may be appropriate as Congress studies the problem more intently to establish rules to deal with each transaction.

It is also possible, however, to fashion an overall approach. The Administration, for example, has proposed a "Limitation on Artifical Accounting Losses," the so-called LAAL method, which would deal with shelters through their deferral aspects, by matching deductions with the income generated by the shelter project. The LAAL approach, however, is extremely complicated, and would impose heavy burdens of accounting and record-keeping on such operations. Many tax experts who havestudied LAAL believe that it may well be unworkable in practice.

There is, however, one very simple approach that Congress could now take. It would deal with shelters through the leverage aspect. It would effectively end the syndication and mass marketing of such shelters, thereby eliminating most of the worst abuses.

The essence of the reform is to limit the tax advantages of a shelter to an investor's own personal stake in the project, the actual amount of his own investment. This purpose would be accomplished by requiring that limited partnerships, the most widespread form of syndicated tax shelters, must be taxed in accord with the pass-through rules now applicable to Subchapter S corporations. I am today introducing an amendment to H.R. 8217, the tariff bill now on the Senate calendar, to carry out this reform.

Under Subchapter S in present law, certain corporations are entitled to be taxed as partnerships in some respects. For present purposes, the central point is that shareholders are entitled to deductions generated by the corporation only to the extent of their actual stock investment in the corporation. The amendment I propose would apply this same principle to limited partnerships.

The effect of this amendment, as applied to a real estate transaction or other leveraged shelter, would be as follows: (1) Assume that ten wealthy individuals put up $100,000 each for a limited partnership -- limited in the sense that their liability is limited to their $1 million investment, so that the partners themselves are not individually liable for the debts, work claims, negligence or other tort obligations, or other charges against the partnership;

(2) Assume also that the partnership borrows $9,000,000 to develop a luxury apartment complex, thereby producing a total capitalization of $10 million for the partnership.

(3) Assume further that the project generages $2.1 million in accelerated depreciation interest, operating expenses, and other deductions in the first year.

On these facts, under present law, each individual partner would receive a deduction of $210,000, based on his share of the $2.1 million deduction generated by the full $10 million in operating funds available to the partnership. Thus, a $210,000 deduction would be available to each partner, even though his own individual liability on the project is limited to his actual $100,000 investment.

The proposed amendment, by contrast, would allow each partner a deduction of only $100,000. The remaining $110,000 of his $210,000 share of the partnership deduction would go into his "suspense" account, to be available only as an offset against future income from the project; it would not be available as a current deduction from his other income.

By itself, this amendment should succeed in ending the insidious practice of syndicated tax shelters, without any substantial effect on legitimate business operations. It is extremely unlikely that the busy doctors, lawyers, corporate presidents, and others who enjoy the benefits of such shelters will want to be involved in the active operations of the businesses in which they have invested, even to the extent of becoming personally liable for the transactions of the shelters. They only want their passive investments and handsome tax deductions, not the headaches and liabilities of the actual operations.

The more we learn about these syndicated tax shelter transactions, the more concerned we are. The practice is destroying the integrity of our tax laws. In no other area is the revenue code so dangerously eroded or the vitality of our self-assessment tax system so seriously threatened. Indeed, some tax experts have already predicted that such tax shelters will become the Achilles heel of the Federal income tax if Congress does not bring them under control.

So far, we have been too slow in awakening to the abuses that have sprung up in these dark but heavily sheltered recesses of the Revenue Code. Now is the time for Congress to tackle the issue, and end the unfair tactics being used to subvert the tax laws and distort the American economy.

TAX CREDITS VERSUS TAX DEDUCTIONS

The second major area of comprehensive tax reform I favor is also one that cuts across many other areas --- the need to overhaul the relationship between tax credits and tax deductions. In the past, as part of overall tax reform, I have urged Congress to allow credits instead of deductions in a number of major areas, including the personal exemption, the homeowner's mortgage interest deduction, the deduction for medical expenses, and the deductions for State and local income and property taxes.

Our tax laws are clearly out of joint today, and nowhere is the disparity clearer than in the case of some of the most popular tax deductions:

--- It makes no sense to me that, because of the rate structure of our revenue laws, the $750 personal exemption means a child in a wealthy family is worth a tax saving of $525 to his parents, while a ghetto child is worth a saving of only $105.

--- It makes no sense to me that the tax law saves the wealthy family 70 cents on every dollar in mortgage interest payments on its Scarsdale home, but only 14 cents on the dollar for the family home in Harlem.

--- It makes no sense to me that, through the tax laws, the United States Treasury pays 70% of the cost of a wealthy citizen's visit to his Beverly Hills physician, but only 14% of the medical bills for the family in East Los Angeles.

By allowing the use of credits instead of deductions in these and other areas of the tax laws, either on an optional or mandatory basis, we can make the income tax system far more progressive, and provide a substantial new measure of equity for millions of our taxpayers.

TAX SIMPLIFICATION

The third broad area in the drive for tax reform is the subject of tax simplification. Above and beyond the effort to close unjustified loopholes, we must also reduce the needless complexity and paperwork that now plague the ordinary taxpayer. Too often, tax reform bills become a type of public service employment for lawyers and accountantsand well-meaning reforms become lost in the fog of contortions and complexities in the Code, beyond the comprehension of the average citizen.

OTHER SPECIFIC REFORMS

In addition, I also favor a number of reforms in specific areas of the tax laws. In an appendix to this statement, I have provided a more detailed summary of some of these proposals. In brief, they are as follows:

CAPITAL GAINS. In the area of capital gains, I would propose four changes:

-- (1) increase the inclusion percentage from 50% to 60%.
-- (2) repeal the 25% alternative rate for the first $50,000 of capital gains;
-- (3) Increase the holding period for capital gains from six months to one year; and
-- (4) tax the accrued gain on transfers at death or by gift.

At the present time, capital gains represent one of the most significant preferences in the tax laws, yet they are available almost exclusively to the nation's richest individuals. According to recent statistics, the top three percent of taxpayers enjoy 55 percent of all capital gains, and the top one-tenth of one percent of al l taxpayers enjoy 30% of all capital gains. The enormous tax advantages that now apply to capital gains are thus the special province of an extremely wealthy elite among the nation's taxpayers.

I do not support efforts to close the gap altogether between the tax on ordinary income and the tax on capital gains, but we must go part way. The changes I propose in capital gains would not substantially impair the flow of capital in the nation. A major tax preference would still exist for capital gains in the Revenue Code. And by ending the major current loophole involving capital gains at death, Congress would actually free up billions of future dollars for investment, dollars that would otherwise be frozen because of the tax advantage that now occurs when property is held until death.

At the same time, I believe that Congress should resist proposals now being circulated to relax even further the current low rate of tax on capital gains, depending on the length of time a capital asset is held. Such a change would seriously increase the existing "lock-in" effect of the capital gains tax, since it would encourage investors to hold assets for longer periods of time in order to obtain the progressively more favorable tax rates that would become available. To me, the answer to the problem of the sagging stock market is a sound economy, not a further dose of special tax preferences for the wealthy few who have the wherewithal to enjoy capital gains.

OIL. In the area of oil, in addition to the repeal of percentage depletion for both foreign and domestic production described above, Congress should take two other steps to deal with the excessive tax advantages now available for foreign oil operations:

-- First, we should repeal the deduction currently allowed for intangible drilling costs on foreign wells. In virtually every other industry, taxpayers are required to recover these expenses through annual depreciation over the lifetime of the asset; only in the case of oil is an immediate deduction allowed for the full amount of this intangible expense, such as labor, equipment rentals, fuel and similar costs, which make up about 75% of the investment in a well.

-- Second, we should repeal the foreign tax credit for oil operations, and thereby end the current travesty of our tax laws, which allows foreign royalties to be treated as foreign taxes for the purpose of the credit. Under this reform, the expenses will be taken as a tax deduction, as they should; they will no longer be available as a credit against U.S. taxes.

These oil reforms are especially appropriate in these times of focus on America's energy independence. For too long our tax laws ave subsidizedexploration and drilling and development overseas for oil. It is time to close this loophole and bring our far flung oil corporations back to American soil.

STATE AND LOCAL BONDS. In the area of state and local bonds, we should provide an optional federal subsidy for taxable bonds issued by state and local governments, equal to 50% of the interest on the bonds.

INTEREST. On the interest deduction, we should do four things. (1) We should strengthen the present limitation on the deduction of investment interest by eliminating the $25,000 exemption, which serves to exempt, at present interest rates, the interest on as much as $300,000 of debt. (2) We should apply the limitation to corporations. (3) We should require net investment income to be computed on the same basis as taxable income; that is, by using accelerated depreciation, percentage depletion and other similar preferences. (4) And, the current deductions for interest on property should be limited to the taxpayer's principal residence, and should not be available for interest paid on vacation homes and similar property.

PERSONAL DEDUCTIONS. On personal deductions, we should require the allocation of personal itemized deductions between taxable and taxexempt income. Obviously, an individual makes these expenditure out of both types of income, and the tax benefit of the deduction should be limited to the proportion of his total income that is taxed.

INVESTMENT CREDIT. On the investment credit, a number of changes are desirable. The credit should be allowed only for increased investment over an average base-period level. In addition, the amount of the credit should be included in the income of the taxpayer; the credit should be limited to the actual user of the property for which the credit is granted; and the credit should be made refundable, so that a positive tax refund can be given to a taxpayer who has no other tax liability.

OTHER FOREIGN INCOME. Finally, in the area of other foreign income, we should repeal the $25,000 exemption for income earned abroad. We should repeal the Western Hemisphere Trade Corporation provisions. We should repeal the provision that allows double-counting of the foreign tax credit in the case of U.S. subsidiaries. And, we should repeal the tax deferral provisions by which the United States encourages multi-national corporations to build plants in foreign lands, in order to enjoy the benefits of such "tax havens".

In closing, let me repeat my hope that in the coming weeks, Congress will make its intention clear to give tax reform the same high priority already reserved for other basic issues. Only in this way can we bring real tax justice to every citizen, and end the unjust reign of King Loophole in our revenue laws.

Whatever the final outcome of the debate over President Nixon's tax returns, the most important lesson of the disclosure of the President's tax data is that tax reform must move back to center stage as an issue for Congress and the American people.

The picture that emerges from the voluminous recent disclosures of the Joint Committee on Internal Revenue Taxation is not a pretty one, because it demonstrates the extraordinary ease with which wealthy individuals maneuver their financial affairs to avoid their fair share of taxes and take advantage of our loophole-ridden revenue laws.

Just as Watergate helped to generate important new legislative momentum in Congress for comprehensive reform of the nation's election laws, including the landmark bill for public financing of elections that passed the Senate earlier this year, so the President's tax disclosures should generate a similar momentum in Congress for comprehensive reform of the nation's tax laws.

Tax reform belongs at the top of our agenda for 1974. The country needed a spark to ignite the fire of tax reform, and the President's disclosures have provided it. It is up to us in Congress to meet the challenge, to meet our obligation as representatives of every ordinary taxpayer. And if we succeed, then in years to come, the 93rd Congress will be remembered as the Congress that at last brought tax justice to America.

DETAILED EXPLANATION OF CERTAIN TAX REFORM PROPOSALS

STATE AND LOCAL BONDS

PROPOSAL: Provide a federal subsidy for taxable bonds issued by state and local governments, equal to 50% of the interest on the bonds.

PROBLEM: Interest on bonds issued by state and local governments is currently exempt from the Federal income tax. This exemption creates an obvious tax inequity and is a favorite loophole of wealthy individuals and corporations.

In addition, it has been demonstrated that the exemption is a highly inefficient means of providing federal financial aid to state and local governments. The federal revenue loss under the exemption is currently extimated at $2.8 billion per year, but this federal expenditure results in only a $1.8 billion interest saving to state and local governments. The other $1 billion ends up as a kind of "commission" in the hands of high bracket individuals and corporate investors in the bonds.

For example, assume that a 70% bracket individual invests $ in a taxable bond at an interest rate of 9%. The individual would pay a tax of $6.30, leaving a net gain of $2.70. Instead, if this 70% bracket taxpayer invested in a tax-exempt bond paying 6% interest, he would have a net gain of $3.30 (the difference between the $2.70 after-tax yield on the taxable bonds and the $6.00 tax exempt interest). The state and local government has saved $3.00, the difference between $9.00 and $6.00, but the Federal Government has lost, in revenue, $3.30. In other words, the Treasury has paid the 70% bracket individual $3.30, so that a state or city could save $3.00.

REASONS FOR PROPOSAL: The proposal will eliminate the wastage in the present system of providing federal financial aid to state and local governments. The state and local governments, at their option, can issue taxable bonds and the Treasury will provide an automatic 50% subsidy for the interest payable on such bonds. Thus, if a local government issues a taxable bond bearing 10% interest, the federal government will pay 5% of the interest. Since most bond investors are high bracket taxpayers, the Treasury will not suffer any revenue loss, because it will be collecting taxes on the interest received by the investors. As a result, the "commissions" currently paid to high bracket taxpayers will be eliminated, and all of the Federal expenditure will go to intended beneficiaries, state and local governments.

This proposal has now been approved by the National League of Cities, the National Governors Conference, the National Association of Counties, the Municipal Finance Officers Association, and the U.S. Conference of Mayors.

CAPITAL GAINS

PROPOSALS:

1. Increase the inclusion percentage from 50% to 60%.
2. Repeal 25% rate for first $50,000 of capital gain.
3. Increase the holding period from six months to one year.
4. Tax accrued gain on transfers at death or by gift.

PROBLEMS: Present tax rules provide several important benefits for income that is denominated as "capital gain" income.

First, the tax on the accrued gain each year is deferred, and is not required to be paid until the taxpayer disposes of the property by a taxable sale or exchange. If the individual dies, present tax rules completely exempt the gain from tax.

Second, even when gains are realized, only one-half of those gains are subject to tax. At the present time, these tax benefits represent $9 billion in Federal subsidies each year. One half of the $9 billion in tax benefits goes to only 200,000 of the 80 million taxpayers, or less than three-tenths of one percent of the taxpayers in the country. In effect, this constitutes a Federal subsidy of $22,500 per year per family to the richest families in the country.

Third, the failure to tax gains at death permits wealthy individuals to pass on to their heirs the entire appreciation in value of their assets, free of income tax. By contrast, a wage earner who has his funds in a savings account, can pass on his estate to his heirs only after having paid income taxes in full on the amount that the heirs receive.

Fourth, even assuming that a favorable tax rate should be given to capital gains, the holding period to qualify for capital gains should be lengthened in order to distinguish speculation from true investment. Under the present six-month holding period, one who invests in stock can turn over his "inventory" twice a year at capital gains rates. By contrast, the furniture dealer who turns over his inventory twice a year must pay tax at the full rates applicable to ordinary income.

RECOMMENDED SOLUTIONS:

1. The 50% exclusion accorded capital gains should be reduced to 40%, i.e., 60% of the gains would be subject to tax. This would mean that the tax rate paid on capital gains by 70% bracket taxpayers would be increased from the present 35% to 42%. This increase may be compared to that of 1969 when the tax rate on capital gains was increased from 25% to 35%. No deterrent to investment has resulted from the increase in capital gains rates in 1969.

2. The holding period would be lengthened to one year to insure that the favorable capital gains rate is given to persons who have invested, rather than to those who are speculating.

3. Taxation of accrued capital gains at death or by gift will insure that the property of the wealthiest passes on to their heirs after paying income taxes, just as is true in the case of the wage earner. Appropriate exemptions can be provided to phase in the change and to provide for transfers to a wife, transfers to charity, transfers to orphaned children, etc. A special program of Federal financial assistance can be provided to those estates which are composed of assets hot easily marketed, notably farms and small businesses.

INTEREST-DEDUCTION

PROPOSALS:

1. Strengthen the present limitation on the deduction of investment interest.

2. The current deductions for interest should be limited to the taxpayer's principal residence and not be available for interest and taxes incurred on vacation homes and the like.

PROBLEMS:

In 1969, Congress imposed a limitation on the interest deduction, where the interest was incurred to invest in assets that would only be taxed at capital gains rates. The difficulty existed because taxpayers borrowed money to invest in capital assets; the interest deduction would offset ordinary income in full; but when the property was sold, only one half of the gain would be included in the tax base. In 1969, Congress moved to limit the obvious inequity that resulted from this situation, by providing that one half of the interest in excess of $25,000 plus the taxpayer's investment income would be disallowed until such future year as the taxpayer had additional investment income which was taxable in full. The theory of the Congressional action was that if the gain on the property was only going to be taxed to the extent of one half, then the interest deduction incurred to carry that property should be allowed only to the extent of one half.

2. The deduction for interest on home mortgages is presumably intended as a federal program to provide financial assistance in encouraging home ownership. However, the federal program was never intended to provide financial assistance to persons who wish to buy second or even third homes as vacation homes. Nonetheless, present rules permit the deduction of interest on mortgages incurred to purchase these homes.

RECOMMENDATIONS:

1. The present investment interest limitation should be strengthened by eliminating the $25,000 exemption (which serves to exempt, at present interest rates, interest on as much as $250,000 of debt); by applying the limitation to corporations; and by requiring that net investment income should be computed on the same basis as taxable income, i.e., by using accelerated depreciation and percentage depletion.

2. To prevent the use of the interest deduction to help finance vacation homes, the deduction for interest should be limited to the taxpayer's principal residence.

PERSONAL DEDUCTIONS

PROPOSAL: Require allocation of personal itemized deductions between taxable and tax-exempt income.

PROBLEM: Present tax rules permit special deductions for certain personal expenditures --- medical expenses, charitable contributions, interest, taxes, casualty losses, child care expenses, and contributions to political campaigns. Despite the fact that an individual can pay these expenditures out of either taxable or tax-exempt income, present rules permit the deductions to be taken in full agains taxable income. In other words, present tax rules unrealistically assume that all of the itemized personal expenditures are paid out of taxable income. Tax-exempt income --- notably the excluded one-half of capital gains, interest on state and local bonds, and income from percentage depletion, from accelerated depreciation, and from intangible drilling and development expenses --- is equally available to pay these personal expenditures. Therefore, the much fairer and more logical rule is to allocate the itemized personal expenditures between taxable and tax-exempt income.

OPERATION OF PROPOSAL: The proposed rule would require that itemized personal deductions be allocated between the taxpayer's taxable and tax-exempt income. Thus, if an individual had $50,000 of taxable income and $50,000 of tax-exempt income, and spent $20,000 for interest and medical expenses, only $10,000 of the expenditures would be allowed as deductions against the taxable one half of the individual's income. Presumably, the other $10,000 in expenses could have been paid out of the individual's tax-exempt income, and it is appropriate to disallow the deduction, since the income is not included in the tax base. This proposal was adopted by the House of Representatives in the 1969 Tax Reform Act, but was dropped by the Senate.

INVESTMENT CREDIT

PROPOSAL: (1) The amount of the investment credit should be included in the income of the taxpayer; it should be limited to the actual user of the property for which the credit is granted; and the credit should be made refundable, i.e., a positive tax refund can be given to a taxpayer who has no tax liability.

(2) The credit should be allowed only for increased investment over an average base-period investment level.

PROBLEM:

(1) Under present rules the taxpayer who invests $100 in equipment and machinery gets a $7 credit for that investment. However, the taxpayer is permitted to depreciate the property on the full $100, although the out-of-pocket cost is only $93. Normal rules permit a taxpayer to depreciate only its own net cost in an asset. This double tax benefit from the investment credit is unwarranted. The amount of the credit itself should be included in income, and then the taxpayer can deduct depreciation on the full $100 of investment.

The credit should also be limited to the actual user of the property. Failure to so restrict the credit at the present time has resulted in tax shelter operations in which the investment credit is used by a "lessor", notably banks. As a result of these tax shelter operations, large banks have now reduced their U.S. income tax liability to near zero, thus completely negating the reforms of 1969 that were intended to place banks more on a parity with other corporations.

Finally, the investment credit is of no benefit to a taxpayer that has no tax liability. Thus, railroads, airlines, and other industries that have no tax liability cannot use the investment credit unless they engage in tax shelter operations. Making the credit available only to the user, and making the credit refundable, would enable the government, through the investment credit, to provide assistance to taxpayers who make investments in new machinery and equipment regardless of whether these taxpayers show a federal tax liability or not. Thus, Penn Central could either lease or purchase railroad cars and it would get the benefits of the credit under this proposal, even though it might not have any positive tax liability.

Adoption of this proposal would also make it possible to provide the credit, if it is so desired, to tax-exempt institutions. For example, the credit could be made available to hospitals which are required to invest in very costly equipment. However, since hospitals are tax-exempt, the present investment credit is of no benefit or incentive to them to invest in modern hospital equipment.

(2) There is substantial agreement that the present investment credit simply constitutes a windfall to certain corporations for making investments that they planned to make in any event. As such, it is simply a cost-sharing by the federal government in situations in which no cost-sharing is required.

Presumably the credit was intended to operate as an incentive for industry to make investments in new plant machinery and equipment, which they would have been unable to make in the absence of federal financial aid. To insure that the credit achieves the desired purpose, and does not operate as a windfall, the credit should be restructured so that it is available only for increased investments over a taxpayer's average base period.

Thus, for example, if the taxpayer's investment in new plant machinery and equipment had averaged $10 million per year over the preceding five years, the credit would be available only for investment in plant machinery and equipment in the current year in excess of ten million dollars. Such a change would greatly improve the equities of the investment credit and would target the federal financial assistance to situations where it is most needed.

OTHER FOREIGN INCOME

PROPOSALS:

1. Repeal earned income exemption.

2. Repeal Western Hemisphere trade corporation provisions.

3. Repeal the deferral provisions that encourage foreign tax havens.

4. Repeal the provision that allows double-counting of the foreign tax credit in the case of U.S. subsidiaries.

5. Revise the loss carry-over aspect of the foreign tax credit.

PROBLEMS:

1. Present rules provide an exemption of $20,000 a year for a person who is living abroad for at least a year ($25,000 for a three-year resident). Presumably, the exemption is intended to reduce the costs for U.S. employers where they utilize U.S. employees in foreign businesses. There is no justification for the rule, since the foreign tax credit is entirely adequate to prevent double taxation.

2. Present tax laws provide a special 34% tax rate for Western Hemisphere Trade Corporations, instead of the normal 48% tax paid by U.S. companies. Again, companies simply set up subsidiaries to do their exporting in the Western Hemisphere, exporting products that the parent companies would have exported in any event. The Treasury has never been able to find that the special rate has produced any increased exports.

3. Various provisions permit U.S. corporations to set up wholly-owned foreign subsidiaries and defer the tax on profits earned by those subsidiaries until the profits are returned to the U.S. If the profits are continually re-invested overseas, the tax is avoided indefinitely.

This benefit produces a marked incentive for U.S. companies to invest in foreign activity, as opposed to domestic activity, and is one of the principal "foreign tax haven" provisions in the Internal Revenue Code. There is no reason for the U.S. to subsidize multi-national corporations in their decisions to build plants overseas. The tax system should be neutral between a businessman's decision to invest abroad or in the United States, rather than provide tax preferences to export U.S. jobs. This reform is one of the principal tax provisions of the Hartke-Burke trade bill.

4. Under present rules, a parent corporation with a subsidiary in a less developed country is not required to include in income ("gross up") the foreign tax on dividends paid by the subsidiary to the U.S. parent. As a result, the parent gets a double tax benefit. The foreign tax counts both as a deduction for the subsidiary in calculating the dividend reported to the parent, and as a credit for the parent against its own taxes.

In 1962, Congress ended this unjustified benefit for such subsidiaries in developed nations by requiring that the foreign tax be counted in the dividends paid by the subsidiary to the U.S. parent. In other words, the parent is required to "gross up" the dividends it receives from its foreign subsidiaries.

However, the change was not applied to subsidiaries in less developed countries. Although the present treatment is defended on the theory that it assists less developed countries, there is no evidence to indicate that the present tax windfall encourages investment in less developed countries. The rule should be made the same for all foreign subsidiaries, regardless of where they are located.

5. The foreign tax credit should also be revised to correct some technical defects. One notable problem has to do with losses incurred by a company in a foreign country which are deducted currently against U.S. income. In subsequent years, when foreign activity produces income, a foreign tax credit is allowed in full for the taxes paid on such income, because many foreign countries do not allow an operating loss carryover, as does the U.S. The result is to obtain a double tax benefit, which primarily operates to provide a financial windfall to companies involved in the natural resources area. This defect should be cured by providing that the foreign tax credit in the subsequent year should be computed as if the loss had been allowed as a deduction in the foreign country. Such a provision was approved by the House in the Tax Reform Act of 1969.

BACKGROUND OF THE ASSET DEPRECIATION RANGE SYSTEM

The ADR system permits a corporate taxpayer to depreciate capital assets within a range of up to 20% faster than the useful lives of these assets as defined by Treasury guidelines on useful lives in 1971. Many people believed that the Treasury was exceeding its statutory authority in administratively changing the depreciation system. In part due to public and Congressional protest, the Administration submitted a modified version of ADR to Congress in the Revenue Act of 1971. On November 12, 1971, the Senate came within two votes of rejecting ADR.

ADR abandons a concept which had been an integral part of the tax laws for 40 years -- namely , that deductions for depreciation of capital assets must be based on the actual useful life of the asset. Once we depart from this concept and allow tax depreciation to exceed economic depreciation, the owners of property producing taxable income are in effect receiving subsidy payments from the Treasury. There is no mathematical difference between giving an individual or business a direct handout and forgiving him a like amount in taxes due.

In announcing the ADR in January of 1971, President Nixon stated that "a liberalization of depreciation allowances is essentially a change in the timing of a tax liability." This statement is mistaken and represents a confusion between the consequences of a "liberalization" in depreciation allowances for a single asset or assets of a single year or even a limited number of years and the permanent "liberalization" established by ADR. Experts in this field have estimated that by 1980 the ADR system will have resulted in up to a $30 billion <u>permanent</u> revenue loss to the Treasury. Thus ADR is not simply a change in the timing of tax payments or reducing payments now in return for a tax liability in the future. It represents a repeating and accumulating loss in tax revenues year after year, a loss which will ultimately grow along with the general rate of growth of the economy and in particular the rate of growth in equipment subject to the tax depreciation.

The major rationale which has been put forward to justify ADR is that it will stimulate investment and therefore the economy generally. Many experts in this area, however, do not agree that this is the case. Professor Robert Eisner of Northwestern University who has spent many years studying the subject of asset depreciation earlier this year testified before the House Ways and Means Committee that "there is little evidence that 'liberalization' of depreciation allowances of this type will have much effect on investment." He went on to note that "if the objective were to increase investment spending, economic analysis makes clear that a far more effective device, dollar for dollar of tax loss to the Treasury, would be some form of direct investment subsidy or tax credit." It should be noted that an investment tax credit to stimulate capital investment was also adopted as part of the Revenue Act of 1971 providing ample tax relief and investment incentives for corporations.

The other argument of the ADR proponents revolved around the competitive position of U.S. producers. As nearly all economists will agree, this is a spurious argument. There is no empirical evidence that those countries with the lowest taxes on capital have higher rates of economic growth. In fact, among the major industrial countries the converse appears to be true. If the goal were to stimulate capital formation, ADR is a very ineffective and costly stimulus. In part, this is reflected by the current data which show that business has moved very slowly in adopting ADR. If ADR has a strong investment incentive, why have firms not moved more quickly to adopt the new proposals? Its complexity also appears to be discriminating against the smaller business firms. The current Treasury data indicate that the system is being adopted by the large conglomerates but not the smaller proprietorships and partnerships. Apparently the complex provisions can only be interpreted by the larger firms. Major improvements in the U.S. balance of payments has come from the devaluation of the dollar rather than tax giveaways to business. The future history of ADR is likely to follow that of accelerated depreciation after 1954 -- a very gradual adoption with no noticeable investment stimuli, but considerable hidden long-run revenue costs.

Estimated revenue loss due to ADR		Estimated revenue gains if ADR is repealed	
1971	$300 million	1974	$400 million
1972	$900 million	1975	$1.0 billion
1973	$1.2 billion	1976	$1.5 billion
1974	$1.4 billion	1977	$1.7 billion
		1978	$2.0 billion

FACT SHEET ON DISC

DISC provisions of the Tax Code allow specially organized export corporations to defer indefinitely the tax on one-half of their income. There is no evidence that DISC provisions provide an extra stimulus to exports. But they will cost the U.S. Treasury $740 million in 1974, primarily in the form of subsidies to large corporations. Our ~~amendment would~~ terminate the unjustified DISC subsidy.

How DISC Provisions Work

Under existing law, a corporation may elect to be a DISC (a Domestic International Sales Corporation) if at least 95% of its gross receipts, and at least 95% of its assets, are export-related. DISCs are completely free from normal income taxes. Shareholders, however, are taxable on one-half of the DISC's income each year, or the amount distributed as dividends, whichever is greater. Thus, DISCs in effect allow indefinite tax deferral on one-half of export income.

In practice, DISCs are most often paper corporations established by other large corporations merely for the purpose of receiving tax benefits for exports. A DISC need not satisfy normal requirements of corporate capitalization, but need have only $2500 in assets. In 1972, 22% of the income received by all DISCs was earned by eight DISCs with gross receipts over $100 million, and over 80% of the 2,249 DISCs were owned by corporations with assets of over $100 million. These large corporations can channel their exports, on either a sale or commission basis, through DISCs they have created, and thus receive substantial tax benefits.

Revenue Gain From Termination of DISC Benefits

Terminating DISC benefits under our amendment would gain an estimated $815 million in 1974. $740 million of this amount comes from revenue which would otherwise have been lost in 1974 under the DISC provisions. And $75 million comes from the estimated tax revenue which would be payable in 1974 on DISC income deferred in prior years.

DISC Provisions Have Had No Demonstrable Effect on Increasing Our Export Trade

The U.S. in 1973 enjoyed a $700 million trade surplus, with an unprecedented $70 billion in exports. But when the DISC provisions were originally enacted in 1971, the nation was facing a serious balance of payments deficit, including for the first time in recent years a deficit in trade of goods and services. According to the International Economic Report of the President, the turn-around in the U.S. trade balance was caused primarily by increased world-wide demand for our agricultural and manufactured exports, and the 15% devaluation of the dollar over the past two years. During 1971 and the first half of 1972 our demand for foreign products was strong, and economic slowdowns abroad reduced demand for our exports, producing a negative trade balance. Since then, however, export demand has increased, the prices of our exports have become more competitive, and higher relative prices abroad have reduced our demand for imports.

There is no evidence that any part of this trade turn-around is due to the tax benefits provided under DISC. In fact, the GAO has reported that DISC "is not considered to have had much influence toward increasing U.S. exports to date. Neither has it resulted in exporters lowering their prices to meet competition." And a recent Treasury Department report prepared pursuant to the DISC statute gives no convincing evidence that the tax subsidy under DISC is having an effect on our exports or balance of trade. Although the Treasury analysis, which covers data from calendar year 1972, shows that selected firms utilizing DISCs increased their exports 14.1%, slightly more than the total U.S. export growth by 12.4% in that year, the Treasury makes no claim that these figures are statistically significant and admits that their conclusion is "highly tentative." The Treasury Report did show, however, that the 15% profit rate for exporters using DISCs has been about twice the 8% rate of return for those industries in which DISCs predominate, and that the revenue loss has been much higher than Congress expected when it enacted DISC in 1971. The revenue loss was an estimated $250 million in 1972 and $500 million in 1973, instead of the originally predicted $100 million in 1972 and $170 million in 1973.

Effective Date

Our amendment would make DISC benefits unavailable for any taxable year beginning after December 31, 1973. Since DISCs are largely an accounting device, utilized by corporations at the end of their taxable years when export receipts, assets, and income are accounted for, terminating the DISC provisions as of this tax year would work no unfairness. Taxes on income previously deferred would be payable in equal assessments over ten years.

\# \# \# \#

Relationship to the Ways and Means Bill

The Ways and Means bill repeals depletion in gradual steps from 1975 through 1978. Its provision on depletion would have virtually no effect in 1974. Our proposal would return significant revenues to the public treasury from balooning oil profits beginning this year. Oil industry profits in 1973 rose some 55 percent over 1972, according to Business Week. Company reports for the first quarter of 1974 indicate another very large jump for this year. After their accountants had done everything possible to minimize below-the-line profits, Texaco reported after-tax earnings up again by 123 percent; SoCal, 92 percent; Standard of Indiana, 81 percent; Gulf, 76 percent; Mobile, 66 percent; Shell, 51 percent; and Exxon, 39 percent.

This proposal separates the repeal of percentage depletion from the other provisions of the Ways and Means Energy Tax Package, because depletion has been the subject of hearings and public debate for many years and the issue is familiar to everyone. Action should be taken now to close this major loophole as the first step toward satisfying public demand for fair taxation of oil income. The other provisions of the Ways and Means package are sufficiently new and complex to warrant more deliberate procedures. This proposal is not intended to detract in any way from the need to consider these other measures in due course.

FACT SHEET ON PROPOSED REPEAL OF PERCENTAGE DEPLETION FOR OIL AND GAS

This provision would abolish the percentage depletion allowance as of January 1, 1974, for all oil extraction and for natural gas not under Federal price control or already committed under fixed-price contracts. The annual revenue gain over five years would be as follows:

	Revenue Gain		
Calendar Year	This Proposal	Ways and Means Bill	Difference
	(billions of dollars)		
1974	2.0	0.0	2.0
1975	2.2	0.6	1.6
1976	2.6	1.3	1.3
1977	2.9	2.1	0.8
1978	3.3	2.4	0.9
Five-Year Average	2.6	1.3	1.3

Of the revenue gain from abolition, all but about $0.2 billion is traceable to the elimination of percentage depletion on domestic oil. The estimates for domestic oil are based on an average price of crude increasing gradually from $6.50 per barrel in 1974 to a world price of $9 in 1978, as assumed by the Joint Committee on Internal Revenue Taxation.

<u>How Depletion Works</u>

The percentage depletion option now permits 22 percent of the gross revenues from oil and gas extraction to go entirely free of Federal income tax, up to half of the producer's before-tax profits. For a successful well, percentage depletion can provide a total tax deduction much larger than the alternative of depreciating the investment in the well, as would be done by investors in other businesses. As a result of this and other tax preferences, major oil companies paid only about 6 percent of their income in U.S. income taxes in 1972. For instance, Gulf paid 1.2 percent; Mobil, 1.3 percent; Texaco, 1.7 percent; SoCal, 2 percent; Arco, 3.7 percent; Exxon, 6.5 percent; and Standard of Indiana, 10.2 percent.

Percentage depletion has been defended in the past as an incentive to exploration and drilling. For this purpose, it always has been a very costly form of subsidy, and it is less effective per dollar than a subsidy or tax credit applied directly to the desired activities.

The new high prices of oil render percentage depletion much more expensive than before and, at the same time, remove any justification for it, because today's oil prices provide ample incentive for oil development without any subsidy. Development activity now is constrained <u>not</u> by any lack of incentive but by the physical capacity of the industry and its equipment suppliers.

The recent increase in oil prices indeed presents an opportunity to abolish this aspect of undue favoritism in the tax system without reducing the incomes of oil investors from last year's levels. On the contrary, oil incomes will go up anyway. Depletion should be abolished now before it again becomes embedded in the new income levels, the asset values, and the cost structure of the oil business.

STRENGTHEN THE MINIMUM TAX

PURPOSE

1. Repeal the step in the calculation of the minimum tax which currently allows a deduction for other taxes paid.

2. Reduce the current $30,000 exclusion from the minimum tax to $10,000.

The proposed amendment makes no change in the list of tax preferences subject to the minimum tax, and no change in the current 10% rate of the minimum tax. It affects only the deduction for taxes paid and the $30,000 exclusion, the most obvious loopholes in the current minimum tax. The combined revenue gain from both provisions would be $860 million.

CURRENT LAW

The minimum tax was enacted by Congress as part of the Tax Reform Act of 1969, in an effort to insure that persons with substantial amounts of untaxed income would pay at least a modest tax on such income. Under the present minimum tax, a person is taxed at the flat rate of 10% on the sum of his income from certain tax preferences, which include most, but not all, of the major preferences in the tax code: accelerated depreciation on real property, accelerated depreciation on personal property subject to a net lease, amortization of certified pollution control facilities, amortization of railroad rolling stock, stock options, reserves for losses on bad debts of financial institutions, depletion, capital gains, and amortization of on-the-job training and child care facilities.

Before the minimum tax is applied, however, a taxpayer gets two important deductions from his preference income: First, an automatic $30,000 exclusion; Second, a deduction for the regular income tax he pays. These two deductions are largely responsible for the failure of the minimum tax to fulfill its promise.

DEDUCTION FOR TAXES PAID

This deduction allows substantial numbers of taxpayers to avoid the minimum tax completely, even though they have large amounts of income from tax preferences. In practice, the deduction is an "Executive Suite" loophole, since one of its principal effect is to allow highly paid executives to use the large amount of regular taxes they pay on their salaries as an offset against income they receive from tax preferences. The following example illustrates the point:

	A	B
Preference income	$100,000	$100,000
Regular tax on salary	100,000	0
Base for minimum tax	0	100,000
Minimum Tax	0	10,000

Individual A, who has $100,000 in income from tax preferences but pays $100,000 in regular taxes on his salary, owes no minimum tax. Individual B, who has $100,000 in income from the same tax preferences, but who pays no regular taxes, owes a minimum tax of $10,000. The minimum tax should operate equally on individuals A and B, yet the deduction for taxes paid lets A escape the minimum tax altogether.

Contrary to arguments raised in the past against the proposal to repeal the deduction for taxes paid, this reform would have only a marginal impact on capital gains. For individuals, the change would increase the effective tax rate on capital gains in the highest bracket from its present level of 36.5% to 40%. But the top 40% rate would apply only to that portion of capital gains over $460,000, and it is still a bargain rate compared to the 70% tax rate on ordinary income at such levels. In the Tax Reform Act of 1969, the maximum effective tax rate on capital gains was increased from 25% to 36.5%, with no measurable effect on the investment community or the flow of capital to business. For corporations, the change would increase the effective tax rate on capital gains from 30.75% to 33.75%. The Tax Reform Act of 1969 increased the rate from 25% to 30%. For all but the smallest corporations, the tax rate on ordinary income is 48%.

THE $30,000 EXCLUSION

The second part of the amendment would reduce the existing $30,000 exclusion to $10,000. The present level was set far too high by the 1969 Act. It enables wealthy taxpayers to enjoy their first $30,000 in tax loophole income, completely free of the minimum tax. This was the provision used by President Nixon to reduce

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his minimum tax to zero in 1971 and 1972, and to near-zero in 1970.

By reducing the level to \$10,000, substantial amounts of income that are currently tax-free will become subject to the minimum tax. At the same time, the \$10,000 level will be high enough to prevent any substantial deleterious impact on low and middle-income taxpayers with modest tax preference income such as a capital gain on the sale of a home. In addition, the \$10,000 level will avoid any unnecessary inconvenience in the administration of the minimum tax, since it will not require the forms to be filed or the tax to be paid on modest amounts of tax preference income.

EFFECT OF CURRENT LOOPHOLES

INDIVIDUALS -- In 1971, 100,000 individuals with tax preferences totaling \$6.3 billion paid \$169 million in minimum tax, for an effective tax rate of only 2.7% compared to the statutory rate of 10%. Of this group, 75,000 individuals, reporting preference income of \$2.3 billion, paid no minimum tax at all.

CORPORATIONS -- In 1970, 81,000 corporations paid \$280 million in minimum tax on loophole income of \$5.7 billion, for an effective rate of 4.8%. Of this group, 75,000 corporations, reporting preference income of \$1.6 billion, paid no minimum tax at all.

REVENUE GAIN (MILLIONS) FROM PROPOSED AMENDMENT (1972 INCOME LEVELS)

	Repeal Deduction for Taxes Paid	Reduce Exclusion to \$10,000	Combined Changes
Individuals	\$330	\$131	\$585 */
Corporations	250	20	275
TOTALS	580	151	860

*/ 80% from individuals with adjusted gross incomes over \$100,000.

Mr. CHAIRMAN. Next we will hear from Mr. Carl Gerstacker, chairman of the Dow Chemical Co., accompanied by Mr. Raphael Sherfy for the Manufacturing Chemists Association.

STATEMENT OF CARL GERSTACKER, CHAIRMAN, DOW CHEMICAL CO., ACCOMPANIED BY RAPHAEL SHERFY AND GLENN WHITE FOR MANUFACTURING CHEMISTS ASSOCIATION

Mr. GERSTACKER. Thank you, Mr. Chairman, members of the committee. My name is Carl Gerstacker, and I am appearing on behalf of the Manufacturing Chemists Association. I am chairman of the board of the Dow Chemical Co.

We appreciate this opportunity to present our views on the tax proposal set forth in your press release of May 31. Each of these proposals would effect a change of utmost importance to American business and particularly to the chemical inudstry. Each proposal would significantly add to the tax burden of U.S. industry and adversely affect our economy.

We believe it is unfortunate that your committee has found it necessary to hold these brief hearings because of the possibility that these proposals may be offered on the floor of the Senate as amendments to a minor tariff measure. This withholds the benefit of the usual, careful, in-dept consideration provided by your committee and its staff.

Experience has shown us that sound tax policy cannot be developed without such participation by your committee. We do appreciate your reasons for holding these hearings on such short notice, and giving us the opportunity to express our views before any precipitous action is taken.

PROPOSED TAX REFORM SEEN ADVERSELY AFFECTING THE CHEMICAL INDUSTRY

Let me turn now to some of the measures which are contained in your press release and which are of utmost importance to our industry.

Chemical manufacturing is a highly capital-intensive industry. Large expenditures are required to build modern and efficient U.S. chemical plants which can produce the goods and services necessary to our economy. The inflationary trends of recent years have added to our burden and have made it extremely difficult to generate from internal sources the funds necessary for our capital requirements.

Both the ADR system and the investment tax credit combat rising costs and high taxes. As a result, they contribute significantly to meeting these capital needs. The chemical industry has repeatedly pointed out to the Congress and to your committee that these tax policies contribute to the establishment of a more realistic capital recovery policy in our tax law. They help to generate programs for plant expansion resulting in the creation of more jobs, the reduction of inflationary trends through greater productivity, and increased ability to meet foreign competition. In order to fulfill these objectives, however, American business has to be assured of stable tax policies which are not on again, off again, as has been the case with the investment credit. We urge the ADR system and investment credit be retained as permanent features of our Federal tax policy.

Foreign trade and investments would be adversely affected by proposed changes in the tax base. Two of the proposals relate to the taxation of U.S. enterprises abroad. One would limit or eliminate the application of the foreign tax credit. The foreign tax credit has been the cornerstone on which the U.S. has eliminated international double taxation. This allowance relates only to foreign income taxes and applies only against the U.S. taxation of foreign profits. Under no circumstances does the foreign tax credit offset U.S. tax on U.S. income.

It is clear that the elimination of or a significant reduction in the foreign tax credit allowance would severely impair the U.S. competitive position abroad. The increased tax burden on U.S. foreign activity would be substantial, and in some cases would result in a combined U.S. and foreign income tax of over 70 percent.

Thus, the elimination of this credit would be unfair, discriminatory, and present an unacceptable burden on U.S. taxpayers. We urge strongly that the foreign tax credit provision remain unchanged.

The proposal to repeal the recently enacted provisions relating to the Domestic International Sales Corporation is undesirable because such repeal would remove from the law a concept which has helped American business increase its exports dramatically. This concept was adopted by the Congress in 1971 for the purpose of placing American exporters on a more equal basis with their foreign competitors. Only after careful study by many groups interested in our foreign trade area, were the DISC provisions adopted.

The National Export Expansion Council, the Treasury Department, the Manufacturing Chemists Association, and similar groups all reached the conclusion after years of study that deferment of the U.S. tax on export income was desirable.

Two reasons stand out. First, increased exports increase jobs at home, and second, they aid our balance of payments. The DISC provisions have been in effect only a few years, and a clear assessment of their impact is not yet possible. Many factors, including a major devaluation of the dollar have intervened during their short life, but the Treasury has indicated that they contribute positively to an increase in exports.

The Treasury study shows companies with DISC's increased their exports more than those not having DISC's. Our experience in the chemical industry is comparable to the Treasury's, and we feel it would be undesirable, if not foolhardy, to destroy this potentially valuable tool before its full impact is ascertained.

It would be far better to expand this provision to provide for 100 percent deferral of tax rather than the 50 percent presently provided under DISC rules.

Changes proposed in the tax on preference income only makes a bad tax worse. Reducing the $30,000 exclusion will have its most significant impact on middle income Americans. Eliminating the deduction for Federal income taxes changes the tax from a minimum tax to an additional tax. This is completely unrelated to the initial concern that all persons should pay some tax.

Secretary Simon has already pointed out in his testimony before your committee that neither of these provisions has any impact on the high income individuals who now pay no Federal income taxes. We urge that the recommended changes in the tax on tax preferences be dropped.

Crude oil and petroleum products are important feedstocks and energy sources to the chemical industry. Other natural resources are also very important. Oil and other minerals are becoming more scarce. The costs of finding and producing them are increasing. Eliminating percentage depletion will increase the cost of raw materials and energy for the chemical industry. As our costs increase, our prices must also increase. Unfortunately, the consumer bears the impact of this cost-driven inflation brought about by higher business taxes.

In summary, insofar as the so-called reform measures are concerned, it is clear that their adoption would tend to accentuate inflation to create an uncertain atmosphere for business decisionmaking, and to increase the likelihood of an economic downturn.

Inflation can best be fought by increasing productivity, by improving the U.S. balance of payments, and by settling the atmosphere of uncertainty in our corporate tax structure. Measures such as ADR and the investment tax credit directly encourage the use of new equipment that helps to increase productivity thus actually fight inflation.

The DISC provisions which encourage exports tend to improve our balance of payments. Retention of these provisions will help convince business that Congress really means to control inflation and strengthen the economy.

On these bases, forward-looking business decisions can be made. We urge your committee and the Senate to make these positive decisions.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

Senator Bennett, do you have any questions?

Senator BENNETT. I appreciate the statement. It has been a little hard to follow because you have been reading a separate statement, but I think you have raised the other side of the issue in contrast to the statement of Senator Kennedy, and this will be the basis of the discussion on the floor when we get there whether we should be concerned with trying to solve inflation by giving the consumer more money to spend, and at the same time reducing the capacity of American industry to produce. That seems to be one point of view.

I hold to the other one which was represented by your statement, and I am sure it will be useful to us when, as Senator Kennedy has indicated, we meet at the barricades on the floor of the Senate.

I have no other questions, Mr. Chairman.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. Mr. Chairman, I want to pay my respects to Mr. Gerstacker for his outstanding work in the field, for which he is to be congratulated.

DEPLETION ALLOWANCE

Are you asking for retention of the depletion allowance, both domestically and overseas?

Mr. GERSTACKER. I did not hit that point directly, Mr. Senator, and I am now speaking only personally because I am not prepared with my testimony. I would not be unhappy to see the overseas depletion allowance removed.

Senator HARTKE. I might be much more sympathetic to the depletion allowance if I thought that it would apply to the depletion of our resources here in the United States.

INVESTMENT TAX CREDIT

On the 7-percent investment tax credit: I might just point out again for the sake of the record that I am the only member of this committee who consistently opposed the repeal or suspension of the 7-percent investment tax credit. I would extend that 7-percent tax credit to some other fields, especially for utilization of unemployed people in certain high unemployment areas, or to those companies which are willing to use cooperative education in order to encourage business to employ people, or to help them go through college and other worthy social causes.

REPLACEMENT DEPRECIATION ALLOWANCE

Have you ever given consideration to a program, of which would provide a replacement depreciation allowance which would not go to corporations which are merely engaging in routine expenditures on a capital basis, but which are really modernizing their plants by replacing their equipment on the basis of their replacement costs rather than original costs?

Mr. GERSTACKER. First of all I would like to compliment the distinguished Senator from Indiana on his support for the fundamentals that getting more production and more efficient production helps everyone in our country. It makes for more jobs, it keeps us more competitive with our foreign competitors, and the better equipment we have, the more money we can pay our workmen, and the lower the cost to the consumer. So I agree very much with that.

As to your specific question about replacement depreciation, it is a very interesting point and a very intelligent question. You probably know, Senator, that other nations have adopted this. England, for example, Brazil, other places who have faced high inflation, perhaps somewhat longer than our country has, although we have always had some inflation, have adopted such measures.

It is true, Senator, that the depreciation allowed today for tax purposes is not enough to replace the equipment, the buildings, the plants, so that when you come to build a replacement, there is just not enough money in the depreciation fund.

I would welcome such a thing, I must add, because I know the Senator does understand these complicated matters. It is very difficult to write something on this subject because you have many different rates and problems.

Senator HARTKE. I don't believe that you can change investment credit at this point, but I would like to see the committee, take the position of supporting a request to the Treasury for a complete study which would give us the ultimate effects upon domestic production if you had the reinvestment depreciation allowance. I just think it would materially change the whole industrial complex of America, and I think it would be a major factor in reducing inflation.

Foreign Tax Credit

Now, back to those places where you and I find so much difference of opinion on those tax measures of the Burke-Hartke bill. Are your figures in your chart based upon complete elimination of the foreign tax credit, or are they based upon the change from the present credit to a deduction?

Mr. Gerstacker. Mr. Sherfy, would you help me on that?

Mr. Sherfy. The figures in our paper compute the tax burden with the allowance of the foreign taxes as a deduction, not a credit.

Senator Hartke. Not a credit?

Mr. Sherfy. It eliminates the foreign tax credit and shows what the burden would be in seven countries.

Senator Hartke. How much tax is avoided under the present foreign tax credit mechanism?

Mr. Sherfy. I do not know, but the Treasury has given you all that figure several times, I think.

Senator Hartke. Yes; I have them, but I can never get accurate statistics from individual corporations. I wonder if you would care to——

Mr. Sherfy. Oh, you were asking—I do not know the answer to that.

What was your question?

Senator Hartke. What is the total tax credit for all corporations with subsidiaries abroad using the last year and any previous year?

Mr. Sherfy. I do not know that answer. I think we can look into it, but I believe the Treasury——

Senator Hartke. When we get these figures back, it will show conclusively that this is a substantial amount. I believe that it amounts to an excess of $6 billion. This is roughly one-fifth of the $32 billion of the total corporate taxes collected.

What you have given us in your tables are the high-tax countries. At the present time, the foreign tax credit can also be utilized with low-tax countries, and frequently is so utilized as a tax haven operation in places like Switzerland.

Is that not true?

Mr. Gerstacker. Senator, let me reply to that by saying that at least the experience of the chemical industry is that you do business primarily in these other countries who have taxes like ours or even higher. There are undoubtedly some small or less developed countries with low taxation, but there is not much business there.

Senator Hartke. I disagree. I think there are many businesses in lesser developed countries, and they reap substantial tax benefits.

Mr. Sherfy. But the tax haven problems have been substantially taken care of in subpart (F).

Senator Hartke. No; for example, you go into Switzerland and use Switzerland as a tax haven country.

Mr. Sherfy. That is correct.

Senator Hartke. And you can reduce very substantially your tax liability in the United States by so doing. Isn't that true?

Mr. Gerstacker. I don't believe so, Senator.

Mr. Sherfy. I believe that your measure in 1962 went a substantial direction toward eliminating any tax havens.

Mr. GERSTACKER. At least Dow is not smart enough to find them if there are some, Senator.
Senator HARTKE. I just hope that you will give some thought to one of your Presbyterian schools in Hanover, Ind., which was hit very badly by the tornadoes. If you have any spare money from those foreign tax credits, I think you should use it there.
Mr. GERSTACKER. Thank you, Senator.
I am well aware of that and we will consider it.
Senator HARTKE. Thank you. I did mention your name in Indiana. I told them that I was sure with your background you would be interested in trying to keep that school on the map.
Mr. GERSTACKER. Senator, your communication is great. I heard from them immediately.
Senator HARTKE. Thank you.
The CHAIRMAN. Well, Mr. Gerstacker, I have only one comment. You are chairman of the board of a company that invested a lot of money in Louisiana, and I hope very much you make a profit down there.
Mr. GERSTACKER. We are, Mr. Senator.
The CHAIRMAN. Thank you very much.
Mr. GERSTACKER. Thank you, Senator.
The CHAIRMAN. We were pleased to have your testimony.
Mr. GERSTACKER. We are delighted to be a part of Louisiana.
The CHAIRMAN. Thank you so much, sir.
[The prepared statement of Mr. Gerstacker follows:]

SUMMARY OF PRINCIPAL POINTS
STATEMENT OF DR. CARL A. GERSTACKER
ON BEHALF OF
THE MANUFACTURING CHEMISTS ASSOCIATION
JUNE 10, 1974

1. Investment Tax Credit and Asset Depreciation Range (ADR) System

The retention of the Investment Tax Credit and the Asset Depreciation Range (ADR) System with the full 20% variance is urged by the chemical industry to stimulate continuous modernization of its plants and equipment to insure a high degree of domestic productivity, and to increase its competitive capabilities throughout the world. The increased capital investment in production facilities, which these tax incentives will help to generate, will provide a boost to the economy and will provide benefits which will be shared by workers, consumers and investors.

2. Taxation of Foreign Income

In order to remain competitive with foreign industry both at home and abroad, it is important that U. S. industry not be placed at a disadvantage as compared to the tax treatment extended to foreign industries by their parent governments. We recommend that no change be made (1) in the timing of the imposition of U. S. tax on foreign earnings of foreign subsidiaries and (2) in the foreign tax credit provisions.

3. DISC and WHTC

We recommend that DISC be retained in order to stimulate exports. We also recommend the retention of Western Hemisphere Trade Corporation provisions.

4. Minimum Tax for Tax Preferences

The "Minimum Tax for Tax Preferences", added by the Tax Reform Act of 1969, is actually an additional tax rather than a minimum tax. We recommend that it be made a true minimum tax by permitting a deduction of the income tax otherwise payable from the additional tax imposed by section 56 of the Code.

5. Natural Resources Taxation

The chemical industry is a consumer of substantial amounts of petroleum and mineral products. We believe that any change to the tax law which would adversely affect the flow of capital into the natural resource industry would be ill-advised and we recommend that the present tax treatment of natural resources be continued.

STATEMENT OF
DR. CARL A. GERSTACKER
ON BEHALF OF
THE MANUFACTURING CHEMISTS ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
TAX INCREASE PROPOSALS
JUNE 10, 1974

Mr. Chairman and Members of the Committee:

My name is Carl A. Gerstacker. I am Chairman of the Board of The Dow Chemical Company. I am appearing before you on behalf of the Manufacturing Chemists Association, a non-profit trade association of 178 United States company members representing more than 90% of the production capacity of the basic industrial chemicals within this country. Our companies also carry on extensive international operations throughout the world.

We particularly appreciate the opportunity to present to this Committee the Association's views on each of the tax proposals outlined in your Committee's release of May 31, 1974.

A careful examination of the various proposals which are being considered as amendments to H.R. 8712 would, if enacted in their entirety or singly, have a significant adverse impact upon the U.S. chemical industry and upon the economy of our country as a whole.

ELIMINATION OF THE ASSET DEPRECIATION RANGE (ADR) SYSTEM AND THE 7% INVESTMENT TAX CREDIT

The chemical industry is very capital intensive, with extensive investment needed in plant facilities in order to compete in domestic and world markets. Because of present inflationery trends resulting in high replacement costs it is difficult to obtain sufficient funds internally to meet capital needs. The asset depreciation range system and the investment tax credit are important factors in making capital investment decisions, particularly in light of the high taxes and the high cost of materials, supplies and services. By competing successfully the chemical industry contributes to increased employment and maintenance of a sound balance of payments position.

Furthermore, it is important in these inflationary times to provide a proper climate for additional capital investment. New plants and equipment will increase the productive capacity of American industry, which will combat these current inflationary trends.

You will recall that Congress in 1962 and again in 1971 in conjunction with the enactment of the investment credit shortened depreciation lives. Both provisions contribute towards maintaining an up-to-date industrial plant. This Association in 1971 expressed its firm view that restoration of the investment tax credit was necessary as a permanent part of the Federal income tax structure so as to increase American industry investment in production facilities. This Association expressed disapproval of the periodic repeal of the investment credit followed by periodic reenactment. It is pointed out that this off-again on-again policy is detrimental to sound financial planning. Plant modernization and expansion requires long range planning.

This Association continues to believe that the ADR system is essential to a healthy capital investment program. The ADR system, together with the 7% investment credit, work effectively in contributing to the ability of the chemical industry to meet the increased competition from new and highly efficient plants of foreign competitors. In many instances foreign governments provide significantly larger incentives to their industries in order to maintain a modern and efficient industrial plant. This is clearly so in the case of Japan, West Germany and the United Kingdom- countries where major chemical producers exist.

We urge, therefore, that the investment tax credit and the Asset Depreciation Range System be retained in their existing forms.

LIMITATIONS ON THE USE OF THE FOREIGN TAX CREDIT

Members of the chemical industry believe that, from an economic standpoint, foreign markets are best served by exports from the United States. This philosophy remains the practice so long as foreign government regulations and competitive factors permit. Foreign operations are established when competitive circumstances or government requirements make it impossible for the markets to be served by manufacturing in this country. The chemical industry does not build plants abroad purely for tax reasons.

In 1971, the level of chemical direct investment abroad amounted to $4.5 billion. This represents only 8.2 percent of the 1971 U.S. chemical assets.

The chemical industry is a positive contributor to the national trade account. The 1972 foreign trade surplus of the industry approximated $2.0 billion with exports in the neighborhood of $4.0 billion and imports of $2.0 billion. The industry has provided a trade surplus of $19 billion over the past ten years.

There is also ample evidence that direct investment abroad has served to increase export of U. S. manufactured products to the same markets in which foreign manufacturing is established. These exports are in the form of materials for further processing abroad or products to complement a line manufactured abroad where a position in the consumer market has been established by affiliates of U.S. enterprises.

Taxation of Unremitted Earnings of Foreign Subsidiaries

A basic principle of taxation both in the United States and abroad is the recognition that each separate entity is taxable solely on its own income. This principle is applicable to U. S. corporations operating domestically where there is ownership of one corporation by another, and as to individuals who are owners of stock of corporations. This same distinction between taxable entities is well-recognized in the taxing practices of all foreign countries.

Any attempt by the U. S. Government to disregard this fundamental concept of taxing income only when earned by entities within its jurisdiction will discriminate against U. S. interests which invest in foreign enterprises and will create an advantage to foreign competitors of U. S. industry. Current U. S. taxation of foreign earnings and profits of controlled foreign subsidiaries will result in a higher burden of taxation which will have to be paid currently. In most cases, funds will have to be withdrawn from investment abroad resulting in a serious reduction in U. S. enterprises' capacity to compete for the foreign markets.

Some of the consequences which must be weighed in considering such amendment to the U. S. tax system are:

1. Additional dividend withholding tax payments to foreign countries will presumably result since increased distribution of dividends would be the logical consequence. The combined income tax and withholding taxes in many foreign countries will serve to eliminate any U. S. taxes which might otherwise result from requiring full taxation currently of the foreign subsidiary's earnings.
2. Funds required by foreign subsidiaries for working capital, repayment of loans, and capital expansion will be drained away, thereby creating a strain on such companies' resources. Unilateral action by the U. S. which would lead to increased withholding taxes paid to foreign governments will do nothing to improve the U. S. economy but can limit the financial well-being of U. S. interests abroad.
3. Foreign countries with lower tax rates than the United States will have a tendency to increase their rates or increase their withholding taxes to offset any added tax imposition by the United States. Furthermore, some basic changes in the double taxation conventions which presently prescribe lower withholding rates may well take place.

The experience of U. S. chemical interests indicates a distribution level from foreign operations in the range of 50% to 60% of current earnings. With this result, there can be little additional U. S. tax revenue from earnings in countries where the major foreign investments are located since the tax rates of those countries approximate and often exceed those in the United States.

The following table illustrates this point:

	Foreign Income Tax	Foreign Withholding Tax on Dividends*	Effective Foreign Income Tax Rate
Canada	51%	$4.40	55.4%
France	50%	$1.50	51.5%
Germany	44%	$5.10	49.1%
Italy	46%	$1.60	47.6%
Japan	44%	$3.40	47.4%
Netherlands	47%	$1.60	48.6%
U. K.	40%	$5.40	45.4%
Average for Group	45.9%	$3.29	49.3%

*Per $100 earnings net after taxes assuming 60% payout as a dividends.

For the foregoing reasons, the Manufacturing Chemists Association recommends that no change be made in the timing of the imposition of U. S. tax on foreign earnings of foreign subsidiaries.

The U. S. Foreign Tax Credit System

The foreign tax credit has been the cornerstone by which the United States has eliminated international double taxation. It is unilateral recognition by the United States of the prior right for other countries to tax income derived from within their borders. There can be no question that the elimination of a credit for foreign income taxes would be unfair and discriminatory against the U. S. Taxpayer. The foreign tax credit is essential to our concept of imposing tax on the world-wide income of corporations.

Repeal of the foreign tax credit would increase the effective rate of taxation on most foreign subsidiary operations to over 70%. The comparative table presented below shows the effective tax rates applicable to income received by the parent corporation in one country from its wholly owned manufacturing subsidiary operating in each of the other major countries and how they would be affected by the proposal to make foreign taxes deductible rather than creditable.

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	COUNTRY IN WHICH SUBSIDIARY OPERATES AND PAYS TAX						
	Canada	France	Germany	Italy	Japan	Netherlands	U.K.
Corporate Income Tax Rate on Subsidiary's Earnings	51%	50%	44%	46%	44%	47%	40%
Statutory Rate of Withholding Tax on Dividends to Parent Located in the Following:							
United States	15%	5%	15%	5%	10%	5%	15%
Canada	-	-0-	15	30	15	15	15
France	-0-	-	25	15	15	-0-	5
Germany	15	-0-	-	30	10	10	15
Italy	15	15	25	-	10	-0-	5
Japan	15	15	25	10	-	5	10
Netherlands	15	-0-	10	-0-	10	-	5
U. K.	15	5	25	-0-	10	5	-
Tax imposed on Dividends Received:							
By each country where parent is located on dividends from subsidiaries located in countries shown in each column	-0-	-0-	-0-	-0-	-0-	-0-	-0-
By United States - if Burke/Hartke type proposal were adopted	22	23	24	25	25	24	26
Combined Effective Rate of Tax on Subsidiary and on Parent Located in the Following:							
United States	55	52	49	48	47	49	45
Canada	-	50	49	56	49	52	45
France	51	-	53	51	49	47	42
Germany	55	50	-	51	47	50	45
Italy	55	55	53	-	47	47	42
Japan	55	55	53	49	-	49	44
Netherlands	55	50	47	46	47	-	42
U. K.	55	53	53	48	47	49	-
United States - if Burke/Hartke type proposal were adopted	77	75	73	73	72		71

Above computations :e based on assumed dividend d..tributions of 60% of net profits after foreign corporation tax

The foregoing table illustrates the uniform pattern and consistency in tax rates and concepts which prevail in the capital exporting countries with respect to taxation of earnings, both domestic and foreign. The dividend withholding taxes which range from -0- to 30%, with 10% and 15% predominating, are governmed in many cases by a network of conventions for avoidance of double taxation.

It should be particularly noted that in no cases would a tax be paid to the country in which the parent is located on receipt of dividends from earnings of subsidiaries in the other capital exporting countries. This situation would be severely changed by the United States if the foreign tax credit were eliminated. This would create an additional tax of 22% to 26% as shown in the table. When this is added to the normal income taxes due in most countries, the combined effect is a tax rate of 71% to 77% for a U. S. parent with earnings abroad, a discrimination against foreign operations which would seriously affect the ability of U. S. corporations to compete.

U. S. companies with foreign interests have reevaluated their position in view of these proposals. It is clear that the elimination of the foreign tax credit would place severe burdens on operations abroad and, consequently, would reduce the earnings flow to this country.

In connection with our foreign tax credit system, proposals have been made for gross-up of dividends from less developed country corporations. When the gross-up amendment was incorporated in the Internal Revenue Code in 1962 for purposes of computing the foreign tax credit, it was recognized that it would be inappropriate to extend this amendment to dividends received from corporations engaged in active conduct of business in less developed countries. To do so would have canceled out the advantage of generally lower income tax rates imposed by those countries in order to encourage development of their economy. As long as it is the continuing policy of the United States to support economic expansion of less developed countries, the participation of private enterprise in this effort should be encouraged.

In consideration of the foregoing remarks, the Manufacturing Chemists Association recommends that the foreign tax credit tax provisions be continued without change.

DOMESTIC INTERNATIONAL SALES CORPORATIONS

Introduction of the domestic international sales corporation provisions in 1971 met a challenging need to bolster exports from the United States to keep pace with rising imports. The Secretary of the Treasury in his recent testimony points out that DISC has been a factor in increasing exports. We believe this is the case as to chemical exports during 1972. However, it should be noted that the original concept was to permit deferral of tax on the entire earnings of the DISC rather than on only 50% of such earnings.

At a time when the United States is faced with an unfavorable trade balance, additional government measures appear necessary to assist industry in increasing exports in competitive world markets. Other governments are making incentives available to their nationals who manufacture for consumption abroad as well as at home. This, together with high manufacturing costs in the United States, makes it increasingly difficult for U. S. manufacturers to remain competitive.

Accordingly, this Association recommends, rather than repealing a tax provision without reasonable trial, that full opportunity be given to demonstrate the accomplishments of the DISC concept by granting deferment of tax on the full earnings of such companies. It should be noted that the controls already built into the Code will terminate tax deferment whenever the DISC fails to invest adequately in export property needed to support additional exports of manufactured products from the United States.

WESTERN HEMISPHERE TRADE CORPORATIONS

The Western Hemisphere Trade Corporation concept was introduced in 1942 to encourage participation by U. S. companies in trading with other countries in the Western Hemisphere and a substantial number of countries in the Western Hemisphere have established income tax rates at levels below that prevailing in the United States. Therefore, this treatment gives recognition to these lower tax rates and does not penalize either the U. S. seller in the American markets or the consumers by providing that the full U. S. rate of tax be applicable. Obviously, to increase the effective tax rate will either increase the cost of U. S products in these markets or reduce the return to the Western Hemisphere trade corporation. In either event, any change at this time would impair the competitive position of U. S. industry vis-a-vis that of other countries, many of which benefit from lower rates of tax prevailing in a number of Western Hemisphere countries.

In summary, the Manufacturing Chemists Association believes that removal of the Western Hemisphere Trade Corporation provisions under current conditions would have an adverse effect on U. S. business interests in the Western Hemisphere and particularly in Latin America.

CHANGE IN THE MINIMUM TAX FOR TAX PREFERENCES

The minimum tax on tax preference items was added to the federal tax structure by the Tax Reform Act of 1969. Even though it is entitled a "Minimum Tax for Tax Preferences", it is not a minimum tax but a tax imposed in addition to the other taxes levied by the Internal Revenue Code. The tax on tax preference items is imposed at a 10 percent rate on the excess of the taxpayer's tax preference items over the sum of $30,000 plus the taxpayer's regular income tax. The list of preference items prescribed in the statute consists of nine categories including: amortization of certified pollution control facilities; percentage depletion in excess of the cost of the property; the excess of accelerated depreciation over straight line depreciation on real property; the "untaxed" portion of long-term capital gains; the bargain element of stock options; and bad debt reserves of financial institutions.

It is inappropriate to subject business to the tax on tax preference items. Although this tax is unsound in its application to any taxpayer, it is particularly unsound when it results in penalizing the taxpayer for the vigorous conduct of its ordinary trade or business.

The feature which makes it particularly unsound is that it imposes an additional tax rather than a true minimum tax. The rationale for the tax was that every taxpayer of significant income should pay some tax to the Federal Government. This rationale supports a minimum tax, but not an additional tax.

We recommend that the Minimum Tax For Tax Preferences be made a true minimum tax by permitting a deduction of the income tax otherwise payable from the additional tax imposed by Section 56. This would, of course, be in lieu of the present deduction of the income tax otherwise payable from the sum of the items of tax preference.

PERCENTAGE DEPLETION ALLOWANCE FOR NATURAL RESOURCES

The chemical industry, as a consumer of substantial amounts of petroleum and mineral products, is interested in the retention of the present tax incentives available to the natural resource industry. Higher prices, reduced additions to U. S. reserves of oil and gas and hard minerals, or a combination of both, would result from the reduction of tax benefits presently available. The Manufacturing Chemists Association believes that any amendment to the tax law which would adversely affect the flow of capital into the natural resource industry would be ill advised and we recommend that the present tax treatment of natural resources be continued.

CONCLUSION

Mr. Chairman, in closing I wish to thank you for having given me the opportunity to present to your Committee the views of the Manufacturing Chemists Association on these important tax issues.

The CHAIRMAN. Mr. J. R. Greenlee, vice chairman, National Association of Manufacturers Committee on Tax, Director of Taxes, Hanna Mining Co.

We are very pleased to have you here today, Mr. Greenlee and we will be pleased to have your views on this matter.

STATEMENT OF J. R. GREENLEE, VICE CHAIRMAN, TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY EDWARD A. SPRAGUE, VICE PRESIDENT, FISCAL AND ECONOMIC POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. GREENLEE. Thank you, Mr. Chairman.

My name is J. R. Greenlee. I am vice president of the Hanna Mining Co. of Cleveland, Ohio. I appear here today on behalf of the National Association of Manufacturers as vice chairman of its taxation committee. I am accompanied by Mr. Edward A. Sprague, who is vice president of the Fiscal and Economic Policy Department at the NAM.

I appreciate this opportunity to present our views to you regarding the proposed tax amendments. My statements will be quite brief, as I know this committee is familiar with our views on most of the proposed amendments as listed in the committee release on May 31.

BUSINESS CONCERNED ABOUT TAX CHANGES

Let me say at the outset that we would like to associate ourselves in virtually every respect with the fine statement presented by Secretary Simon to the committee last Wednesday. His points were all well taken, and we commend them to the attention of all parties interested in sound tax policies.

As Secretary Simon pointed out, the business community is very concerned about the possibility of abrupt changes in the ground rules of taxation. Such changes can definitely have direct and adverse effects on business planning, on business employment, and general economic performance. It is for good reason that any significant tax reform should be given careful and deliberate consideration and not casually thrown in on the Senate floor.

The Chairman's call for these hearings specifically requested witnesses to estimate the incidence of the proposed tax increases under these amendments whether on business or on consumers. I am reminded of the maxim that "only people pay taxes." And it is true that all taxes are ultimately borne by people—as consumers, as employees, and as shareholders or investors. To assume that business is a sort of unfeeling and therefore unsuffering element that can absorb an additional tax burden is a fantasy. In the end, it is always individuals who will bear such a burden.

However, this does not diminish the importance of how taxes are levied, because it certainly does have a great deal to do with our investment capability, our productivity, and our ability to employ new entrants to the labor force.

Consumers Bear Cost of Increased Corporate Taxation

It is, naturally, much easier to sympathize with the problems of real people than with these problems of a business organization because a business is not a flesh and blood creature. But it is vital to our economic well-being that people multibillion-dollar corporation to the sole proprietor in the retail store on the corner, which provides employment and income for most people in this country. If punitive tax measures are applied to a business, the ultimate victims will be the employees of that business and its customers. On a larger scale, when taxes on business in general are increased or when capital formation becomes more difficult, employees and consumers will feel the ultimate pinch.

The CHAIRMAN. If I might just interrupt you for one moment here, some people make the point that an excise tax on gasoline or something of that sort is borne by the consumer. But in the last analysis, is it not pretty much true that almost all of these corporate taxes have to be borne by the consumer? Because the only way that corporation can stay in business is by making a profit; and so if it is not able to pass these tax increases on to the public, then it is unable to make a profit and it cannot stay in business.

Mr. GREENLEE. Mr. Chairman, I agree with you completely on that observation. That is exactly the point that we were making here. They have to be passed on to people.

The substance of the proposed amendments before you would, in almost every case, increase the tax burden on the investment and capital formation sector—very directly, of course, in the case of the proposed phaseout of the investment credit and repeal of the ADR system, and indirectly in the case of the proposed "tightening" of the minimum tax, repeal of percentaeg depletion for oil and gas, repeal of DICS, and limitations on the foreign tax credit. They all would tend to limit funds available for productive investment at a time when such investment is critically needed for modernization of our industrial base to stay competitive and expansion of our industrial base in many areas where supplies of essential raw materials are very tight.

Thus, in our view, the incidence of these proposed tax increases would be first primarily on the investment sector. They would penalize capital formation and investment. In some cases where the demand situation is very strong and supplies are relatively fixed over the short term, such as in the case of oil and gas, the proposed repeal of percentage depletion would result almost immediately in higher prices to the consumer—in addition to making exploration for new oil and gas resources more difficult. If investment in new capacity is discouraged, eventually higher consumer prices for a wide range of products also could be expected to result from application of these amendments.

While provisions such as the investment credit, ADR, and DISC are often attacked as loopholes, and therefore the targets of specific tax reform proposals, it is usually forgotten that such provisions were put in the code to offset the continuing bias against the investment sector of the existing overall income tax structure. In spite of some ameliorations made in the 1971 Revenue Act, we have never seen a study that effectively refutes this persistent tax bias which exists because of high income tax rates, double taxation of dividends, and other factors.

Just one aspect of this, for instance, the double taxation of dividends, results in a "reverse loophole," if you will, of approximately $15 billion at current income levels.

As your agenda has called for comment on specific amendments, this is not the time for us to detail our case for what we consider to be more balanced tax reforms. We will present these, of course, to this committee in due order, as your consideration of an overall general reform bill envolves.

I should emphasize that while we oppose all of the amendments to H.R. 8217 listed on your May 31 release, we have made what we consider to be some constructive comments on the specifics.

Our written statement deals with each of the six items which you listed in the May 31 release. A number of other business associations have had oral statements which dealt very well with the proposals affecting the foreign tax credit, DISC, the percentage depletion for oil, and minimum tax, so I will comment now only on the investment credit and the ADR amendments.

Investment Tax Credit and ADR

The 7-percent investment credit was restored and the ADR concept came into the code as part of the 1971 Revenue Act. These are probably the two most generally helpful existing provisions of the code from the manufacturers' point of view. Whether large or small, every company making productive investments can benefit from these two provisions.

As you are aware, the investment credit has had a very checkered history. The on again/off again manner in which it has been applied has not helped us maintain a stable tax policy regarding capital formation. Nevertheless, the reinstitution of the credit in 1971, coupled with the ADR concept, has encouraged productive investment, employment, and higher productivity.

Following the 1971 act, business capital spending has shown a relatively steady increase, while the unemployment rate gradually has declined during 1972 and 1973. Of course, we cannot accurately isolate the effect the investment credit has had on overall economic recovery, but there is reasonable certainty that it has worked and still is working quite well toward its objectives. Because of these favorable results, we do not understand why anyone believes that the credit should now be limited.

We had hoped that a lesson had been learned from the previous gyrations in this area. What useful purpose can the credit possibly serve if business cannot be certain this year that the credit will still be around next year? Any tinkering at all or even threats of tinkering whether by varying the allowable credit percentage or by restricting the value of the assets which can utilize the credit, creates uncertainty which stands to upset the encouraging aspects of the credit.

Like the investment credit, the Class Life System for depreciation, better known as ADR, has had a positive impact on capital formation.

Just after Treasury had announced ADR as a regulatory system in early 1971, Senator Jacob Javits addressed an NAM-sponsored conference on depreciation. He said that the ADR critics do not seem to realize that our current depreciation provisions are the most repressive in the industrialized world and that they are 20 to 30 years out of date.

The inclusion of the ADR credit within the Revenue Act of 1971 brought us somewhat closer to a modern system of capital recovery but we still do not have something to be very proud of. In fact, Roger Milliken, a former member of the President's Task Force on Business Taxation, told the House Ways and Means Committee last year that we are still lagging far behind all our major industrial competitors, including countries such as Japan, France, Canada, Belgium, and England in the capital recovery area.

Studies by MAPI and others indicate that if the present rate of inflation continues, a 7-percent credit from ADR will not even enable us to preserve the capital that we already have, much less to expand it.

Considering our history of sluggish reforms in this area and our present position, we are amazed to hear suggestions that the United States, in effect, would repeal one of the truly positive changes made with regard to business income. What we should be considering is an entirely new concept, one which allows rapid write-offs for all industrial assets. This would help avoid the ravages of inflation and the lack of reality which accompanies the shopworn useful life concept on which the ADR is stilled based.

Until such time as this new system can be adopted, we strongly urge the retention of ADR. It has made a positive, even if not sufficiently large, contribution to the much needed modernization and expansion of U.S. industry.

Mr. Chairman, this concludes the oral presentation of NAM's views on the specific proposals which are before you now. We urge rejection of each one. We would look forward to a time in the future when we may discuss with the Committee a number of very constructive reforms which the NAM feels should be adopted.

Again, I thank you for the opportunity to present our views to you on these current proposals.

The CHAIRMAN. Thank you very much.

Do you have any questions, Senator Bennett?

Senator BENNETT. I have no questions.

The CHAIRMAN. Senator Hartke?

FOREIGN TAX CREDIT

Senator HARTKE. Let me ask you, as I asked Mr. Gerstacker; what is the amount that has been avoided in the last 5 years by use of the foreign tax credit?

Mr. GREENLEE. Senator Hartke, I do not know.

Senator HARTKE. You mean the National Association of Manufacturers do not know what the amount is? You must know.

Mr. SPRAGUE. We do not have those figures with us.

Senator HARTKE. You do not have the figures?

Mr. SPRAGUE. I think your estimate of about $6 billion sounds about right in terms of the amount taken from the Statistics of Income, corporate income, for the year 1969 or so.

Senator HARTKE. You could give a $6 billion subsidy to domestic production if you closed that tax loophole and provide for the jobs here instead of providing them overseas. Is that not correct?

Mr. GREENLEE. I would suggest, Senator, that we would be losing a lot of jobs here. I think a great deal of this is business that is carried on in foreign countries because we just would not have the business if we were not there and engaged in it in a great many situations.

Senator HARTKE. For example.

Mr. GREENLEE. Well, I think that——

Senator HARTKE. For example, the shoe industry. The Washington Post, indicates that the shoe industry has seen Mr. Simon and they have talked about countervailing duties. The president of U.S. Shoe, which is probably one of the biggest manufacturers, tells me that the reason he has built his plants overseas is because he just doesn't receive the same tax benefits here as abroad.

FOREIGN TRADE RESTRICTIONS

Mr. GREENLEE. Senator, I think there probably are some exceptions to the rule that I stated, but I think on balance the vast majority of American business done overseas is done simply because they would not be able to engage in it—partly because of taxes, but very, very seriously, because of economic conditions. The drug industry, for example——

Senator HARTKE. The what kind of industry?

Mr. GREENLEE. The drug industry.

Foreign countries would just not permit the export of that type of commodity from the United States in many cases.

Senator HARTKE. Why not?

Mr. GREENLEE. I am not——

Senator HARTKE. Many have trade restrictions against importation of American drugs.

Mr. GREENLEE. Because of contents, and other reasons—quality——

Senator HARTKE. Yes, I am glad to have that testimony. I think the committee ought to be aware of this when it deals with the trade bill. Other foreign countries have already retaliated against U.S. products. In other words, they have taken the action against the United States and we have permitted them to do so.

Mr. GREENLEE. I suspect that many countries have various reasons for this kind of regulation—while they are not necessarily designed to be restrictive against American business.

Senator HARTKE. Do you think that if we took the restrictive action against these countries which they have taken against our drugs that we would not straighten out some of that difficulty?

They come into our market freely and openly. Why should we have a one-sided trade operation? Others have closed the door. We are the only free market in the world.

Mr. GREENLEE. Senator, I——

Senator HARTKE. You have to make up your mind. If you want the foreign tax credit, then insist that we be treated fairly in the international marketplace.

Why should not those drugs be made here in the United States of America. Then ship them over to these other countries and help our balance of payments. With Pfizer, Lilly—and they are Indiana corporation—Mead-Johnson, Bristol-Myers, Miles Laboratories—we should be able to produce here in the United States.

Mr. GREENLEE. Senator, I do not think that the trade restrictions are the main problem, nor could we fill it in if we imposed such quotas. I think what would happen, if I may, we would find nationals of other capital exporting companies competing in these foreign countries and we would just be out of business. The markets would be filled, but they would not be filled from U.S. exports. This is a point that I am making, and not only because of the trade laws.

Senator HARTKE. What is the strongest currency in the world?

Mr. GREENLEE. I guess the Swiss franc or the German mark is pretty strong.

Senator HARTKE. The German mark.

Mr. GREENLEE. Right.

Senator HARTKE. Do they have any difficulty manufacturing all those Volkswagens and shipping them here? Do they have any difficulty in manufacturing Bayer aspirin and shipping it here?

Mr. GREENLEE. No, sir, but——

Senator HARTKE. If they have a free and open market here to sell their products, they have a favorable balance of trade, in spite of the fact that they have revalued the German mark three times.

Mr. GREENLEE. I think the devaluation of the dollar has made it much more difficult for Volkswagen.

Mr. GREENLEE. Well, the dollar also.

Senator HARTKE. They devalued the dollar twice.

Mr. GREENLEE. Yes, sir.

Senator HARTKE. And we continue to have a trade deficit. They revalued the mark and they continued to have a trade surplus. Every economist in the world will tell you exactly the opposite is supposed to occur, will they not?

Mr. GREENLEE. Yes, sir, but we now have presently a trade surplus, partly, that has resulted from the devaluation of the dollar and put it more in line with other foreign currencies. I think at the present time we are in a surplus position.

FOREIGN TAX CREDITS—WHY NOT DOMESTIC TAX CREDITS?

Senator HARTKE. If we subsidized domestic industry to the tune of $6 billion then we would create jobs here in the United States. We have to treat those people who want to build a plant in Indiana and Louisiana and Utah in the same fiscal way as those who want to invest abroad. Do you not think that is fair?

Mr. GREENLEE. No, sir; I do not think it works that way. I just do not think we can restrict trade in that manner.

Senator HARTKE. Why then do we not give a domestic tax credit for all of the taxes you pay to Louisiana, Utah, and Indiana?

Mr. GREENLEE. In the first place, sir, the amounts are much, much smaller, and our whole tax system has been built against the difference between State taxes and Federal taxes as a deduction. Perhaps it could be done; I cannot envision such a situation where we could make such a change in the laws, because of the way they have grown up and work. They are very satisfactory.

Senator HARTKE. Would you support a measure of giving a tax credit for all local taxes?

Mr. GREENLEE. No, sir; I do not think I would, because I think that this would not be a responsible thing to do from the standpoint of the States, the local communities, if we adopted such a measure—I would oppose such a measure.

Senator HARTKE. Would you go back to your association members and tell your purely domestic corporate people that you are in favor of a tax credit for any taxes paid to a foreign country but you are opposed to a tax credit for any taxes they pay locally? Would you be willing to go ahead and say that?

Mr. GREENLEE. I have so stated, yes, sir.

Senator HARTKE. All right, that is fine. I would be glad to meet with you to see which one wins the battle.

Mr. GREENLEE. All right, sir.

Senator HARTKE. And we will take a vote afterward. You are going to lose some members. Somebody is going to stop paying their dues real fast.

Mr. SPRAGUE. Senator, could I respond to one thing on this $6 billion in terms of——

Senator HARTKE. Pardon me?

Mr. SPRAGUE. Could I respond to one thing on the $6 billion as far as the worth to the foreign tax credit?

Senator HARTKE. Sure.

Mr. SPRAGUE. I realize you are talking in terms of whether this might be available for domestic purposes. This, of course, represents taxes paid to foreign countries, and if we did not have the foreign tax credits and our businesses were not able to operate over there, I do not think it would be reasonable to expect that we would have this money available for domestic purposes.

Senator HARTKE. Whose capital is it? Where did it get created?

Mr. SPRAGUE. The $6 billion is dollars.

Senator HARTKE. No; where was the original capital created?

Mr. SPRAGUE. By the processes of production here and abroad.

Senator HARTKE. Right here in the United States?

Mr. SPRAGUE. No.

Senator HARTKE. These are American multinational corporations. We are talking about the National Association of Manufacturers of the United States of America are we not?

Mr. SPRAGUE. Yes.

Senator HARTKE. These are American corporations. They created capital here; you took the capital overseas and their expansion overseas was subsidized. If you want us to continue this policy of investing overseas and investing in developed countries, you have got to give domestic industry a tax subsidy. In truth, you must say that foreign investment is subsidized by about $6 billion which is roughly about 16 percent of the total corporate taxes paid. We are subsidizing jobs overseas with American capital, created by the American workingman in the United States. I was elected to be a Senator from the United States of America. If you are going to subsidize them I will say subsidize that factory here. I supported the 7-percent investment tax credit. You praised Senator Javits here, and I grant you he deserves praise, but he voted against the 7-percent investment tax credit which would have put more people out of business in this country than any one single thing. And you know that is true, do you not?

Mr. SPRAGUE. We would not like to se it happen, though.

Senator HARTKE. If the American manufacturers had to go ahead and make the choice tomorrow between the 7-percent investment tax credit and the foreign tax credit, which would they choose?

Mr. SPRAGUE. Well, that depends on which business you talk to, of course.

Senator HARTKE. Yes, if they are multinational, they would take a foreign tax credit, and if they are domestic, they would take a 7-percent investment tax credit.

Mr. SPRAGUE. That is very possible.

Senator HARTKE. Right.

Mr. SPRAGUE. But we view the credit, of course, not as a subsidy, but as a way of achieving neutrality between the foreign and U.S. governments.

Senator HARTKE. I am not so naive, as not to know that a 7-percent tax credit is a subsidy. It is a subsidy which I am in favor of. You are subsidizing the local industry to the extent that they go ahead and invest in new capital expenditure, which, according to your statement—with which I quite agree—increases productivity. If you are going to increase the productivity in the United States, you have got to keep your plant modern, and two-thirds of our plants are still of World War II vintage. I deplore that. I will help you modernize domestic plants. I do not want to close our overseas business, I just want it to be on a fair basis. I just want you to treat the little old manufacturer in Decatur, Ind., as well as you do a Central Soya.

Senator BENNETT. I have no questions.

The CHAIRMAN. Thank you very much gentlemen. I appreciate your testimony this morning.

Mr. GREENLEE. Thank you, sir.

[The prepared statement of Mr. Greenlee follows:]

SUMMARY

1. The 7% investment credit has spurred capital investment over the last decade despite its on-again, off-again history. The credit should remain a stable and predictable provision of the Code to provide a sound inducement to productive investment.

2. The Class Life System (ADR) has helped to overcome the repressive nature of our basic depreciation policy. By allowing accelerated capital cost recovery, this system partially offsets the anti-capital bias of the Code. Until a more basic reform is adopted, the Class Life System should be continued.

3. The foreign tax credit is a neutral, non-discriminatory mechanism for preventing double taxation of foreign source income. The proposed fragmentation of income types for purposes of applying the credit would be unsound tax policy. The credit does not cause the allegedly inequitable situations which fragmentation seeks to change, therefore integrity of the credit should not be compromised in dealing with those situations.

4. The DISC provisions were enacted just over two years ago. They have had a favorable impact on our export trade since that time. They have not yet operated for a sufficiently long period of time to justify any conclusions as to their net long-term effect. Therefore, they should be retained.

5. Percentage depletion is a vital capital recovery mechanism for all minerals, including oil and gas. At this time of energy and raw material scarcities, percentage depletion should not be weakened or repealed.

6. The existing minimum tax provisions include several corporate "preference" items which are inappropriate to a minimum tax concept. If they remain therein, the deduction for regular tax liability must be maintained. Without this deduction, there would be simply an additional tax on preference items, not a minimum tax.

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STATEMENT OF J. R. GREENLEE
ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
ON PROPOSED AMENDMENTS TO H.R. 8217
BEFORE THE COMMITTEE ON FINANCE
U. S. SENATE
JUNE 10, 1974

My name is J. R. Greenlee. I am Vice President of The Hanna Mining Company of Cleveland, Ohio, and I appear here today on behalf of the National Association of Manufacturers as Vice Chairman of its Taxation Committee. I am accompanied by Edward A. Sprague, Vice President, Fiscal and Economic Policy Department at the NAM.

My statement will be quite brief as I know this Committee is familiar with our views on most of the proposed amendments, as listed in the Committee release dated May 31, 1974.

Let me say at the outset that we would like to associate ourselves in virtually every respect with the fine statement presented by Secretary Simon to the Committee last Wednesday. His points were all well taken, and we commend them to the attention of all parties interested in sound tax policies.

As Secretary Simon pointed out, the business community is very concerned about the possibility of abrupt changes in the ground rules of taxation. Such changes can definitely have direct and adverse effects on business planning, employment, and general economic performance. It is for good reason that any significant tax reform should be given careful and deliberate consideration and not casually thrown in on the Senate floor.

The Chairman's call for these hearings specifically requested witnesses to estimate the incidence of the proposed tax increases under these amendments whether on business or on consumers. I am reminded of the maxim that "only people pay taxes." And it is true that all taxes are ultimately borne by people--as consumers, as employees, and as shareholders or investors. To assume that business is a sort of unfeeling and therefore unsuffering element that can absorb an additional tax burden, is a fantasy. In the end, it is always individuals who will bear such a burden.

However, this does not diminish the importance of how taxes are levied, because it certainly does have a great deal to do with our investment capability, our productivity, and our ability to employ new entrants to the labor force.

It is, naturally, much easier to sympathize with the problems of real people than with these problems of a business organization because a business is not a flesh-and-blood creature. But it is vital to our economic well-being that people realize that it is the <u>business entity</u>, ranging from the multi-billion dollar corporation to the sole proprietor in the retail store on the corner, which provides employment and income for most people in this country. If punitive tax measures are applied to a business, the ultimate victims will be the employees of that business and its customers. On a larger scale, when taxes on business in general are increased or when capital formation becomes more difficult, employees and consumers will feel the ultimate pinch.

The substance of the proposed amendments before you would, in almost every case, increase the tax burden on the investment and capital formation sector--very directly, of course, in the case of the proposed phase-out of the investment credit and repeal of the ADR system, and indirectly in the case of the proposed "tightening" of the minimum tax, repeal of percentage depletion for oil and gas, repeal of DISC, and limitations on the foreign tax credit. They all would tend to limit funds available for productive investment at a time when such investment is critically needed for modernization of our industrial base to stay competitive and expansion of our industrial base in many areas where supplies of essential raw materials are very tight.

Thus, in our view, the incidence of these proposed tax increases would be first primarily on the investment sector. They would penalize capital formation and investment. In some cases where the demand situation is very strong and supplies are relatively fixed over the short term, such as in the case of oil and gas, the proposed repeal of percentage depletion would result almost immediately in higher prices to the consumer--in addition to making exploration for new oil and gas resources more difficult. If investment in new capacity is discouraged, eventually higher consumer prices for a wide range of products also could be expected to result from application of these amendments.

While provisions such as the investment credit, ADR, and DISC are often attacked as loopholes, and therefore the targets of specific tax reform proposals, it is usually forgotten that such provisions were put in the Code to offset the continuing bias against the investment sector of the existing overall income tax structure. In spite of some ameliorations made in the 1971 Revenue Act, we have never seen a study that effectively refutes this persistent tax bias which exists because of high income tax rates, double taxation of dividents and other factors. Just one aspect of this, for instance, the double taxation of dividends results in a "reverse loophole" of approximaterly $15 billion at current income levels.

As your agenda has called for comment on specific amendments, this is not the time for us to detail our case for what we consider to be more balanced tax reforms. We will present these, of course, to this Committee in due order, as your consideration of an overall general reform bill evolves.

I should emphasize that while we oppose all of the amendments to H.R. 8217 listed on your May 31 release, we have made what we consider to be some constructive comments on the specifics.

I. Investment Credit

While its usefulness has been somewhat flawed by its on-again, off-again history over the last decade, the 7 per cent investment credit nevertheless has been notably successful in encouraging productive investment, employment, and increased productivity. Following its reinstitution in 1971, in conjunction with the liberalized depreciation allowances of the Class Life System, business capital spending has shown a relatively steady increase while the unemployment rate gradually declined during 1972 and 1973.

Obviously, it is very difficult to isolate the effect of the investment credit itself in the context of the general economic recovery, but, as during the mid-1960's, there is a reasonable certainty that the credit has worked, and is continuing to work, quite well towards its stated objectives. Thus, it is hard to comprehend demands for restricting the investment credit to assets costing less than $100,000, as proposed in one amendment to H.R. 8217. This suggests that we have not learned any lessons from past gyrations in this area.

It doesn't even make sense as a small business incentive. A small business may very well depend on one or two very costly pieces of machinery while a large business may depend on thousands of relatively low unit cost types of equipment that would still qualify for the credit under such an amendment. If tax relief for small business is to be actively considered, and we certainly agree that it should, then a positive new provision is the proper method, e.g., raising the corporate surtax exemption substantially.

The 7% investment credit is a necessary stimulus to capital investment, given our other tax laws. Its usefulness in spurring new purchases of production assets cannot be denied. Unless some drastic reform of the Code corrects its bias against capital formation, the credit must remain inviolate. Its positive effects are neutralized if business cannot be certain this year whether or not the credit will be available next year. We do not need further instability in our economy at this time, or at any time, for that matter.

II. Class Life System (ADR)

In April 1971, Senator Jacob Javits (R.-N.Y.) spoke to an NAM sponsored conference on depreciation and capital recovery policy. Referring to critics of the Asset Depreciation Range system which had earlier been announced by the Treasury, Senator Javits said that they "do not seem to realize that our current depreciation provisions are the most repressive in the industrialized world and that they are 20 to 30 years out of date."

Later in 1971, the Congress adopted the Class Life System as a part of the Revenue Act of 1971. This was essentially the Treasury initiative. Coupled with the reinstatement of the 7% investment credit, this reform has been helpful in overcoming the anti-capital bias of the Code and in bringing our capital recovery structure more into line with other industrial nations.

However, the U.S. is still by no means a shining example in this area.

In testimony before the House Ways and Means Committee on March 5, 1973, Roger Milliken, a former member of the President's Task Force on Business Taxation, referred to an updated version of the Board's original comparison of cost recovery allowances of various industrial nations and noted that:

> This new study shows that despite our 1971 changes, the United States, during early years of cost recovery (which are by far the most important) still falls far behind all our major industrial competitors including countries such as Japan, France, Canada, Belgium, and the United Kingdom. Over the longer seven year period, the study indicated that the United States, even with the benefit of the investment credit and ADR, is not ahead of any of the leading nations and that it continues to lag far behind seven of them.

Studies of the Machinery and Allied Products Institute and others indicate the startling degree of under-depreciation of productive plant and equipment due to accelerating inflation. These studies indicate that if present price trends continue, the value of the 7% investment credit and existing accelerated depreciation including the ADR system, will be inadequate even to preserve our capital base.

Given our history of sluggish reforms in this area and given the position in which we still find ourselves, it is quite surprising to hear suggestions that the U.S. effectively repeal one of the truly positive changes made in the Code. Instead of reverting to what Senator Javits called "the most repressive" depreciation provisions in the industrialized world, we should be moving even further away from our former shopworn depreciation system.

In fact, as a very much needed reform, the NAM supports a complete break with the conventional depreciation concepts and the adoption of a capital cost allowance system which would allow the quick recovery of capital without regard to any estimate of useful life. Such a system would bring us more into line with our chief competitors and provide a better degree of protection of our industrial base against the ravages of inflation.

Until such a system is adopted, we strongly urge retention of the ADR. It has contributed positively, even if not sufficiently, to the needed modernization and expansion of U.S. industry.

III. Foreign Tax Credit

The foreign tax credit provisions of the Code are of considerable importance to the U.S. economy in general. Because it prevents the double taxation of foreign source income, the credit is an essential factor in determining the effectiveness with which U.S. firms can compete with foreign businesses in foreign markets. Without the credit, double taxation would place U.S. companies at a prohibitive competitive disadvantage in foreign markets. As detailed in many studies submitted to this Committee, the loss of such markets would affect adversely domestic employment and exports of U.S. companies.

The proposal before the Committee would fragment foreign source income into mineral income and other income for purposes of applying the credit. A similar proposal was included by the Ways and Means Committee in H.R. 14462, the Oil and Gas Energy Tax Act of 1974, but only with respect to foreign oil related income. The purpose of the amendment proposal appears to be to disallow the classification of mineral royalty payments as income taxes for foreign tax credit purposes, thereby possibly generating some excess credits.

We believe that this type of approach is bad tax policy because of the nature of the credit itself. The foreign tax credit is a totally neutral provision of the Code. It is available to all U.S. citizens, U.S. resident aliens and domestic corporations. It is available for income taxes paid to any foreign country, and it is available with regard to any foreign source income. All determinations as to what is a tax and what is income are uniformly based on U.S. rules. The non-discriminatory manner in which the credit is applied to all types of U.S. taxpayers and their foreign source income is its principal strength.

However, this neutrality is currently under attack. The proposal before you, as well as H.R. 14462, and other House proposals all would fragment foreign source income into different types for purposes of applying the foreign tax credit. Such distinctions among types of income are inconsistent with the unbiased nature of the credit which is designed simply to prevent double taxation. It performs this needed function very well because it is non-discriminatory. Fragmentation of income types would begin to undermine the integrity of the credit itself.

In addition, fragmentation is inherently arbitrary and unfair. How would you define the boundaries of mineral income to which different treatment will be accorded? The lines between what is one type of income and what is another type will be very difficult to draw in many instances, and the results may seem quite unrealistic. For example, H.R. 14462's "foreign oil-related income" seems to include dividends from a foreign oil producing or refining subsidiary, but it seems to exclude both dividends from a domestic corporation which receives its income solely or primarily from foreign sources and interest paid by a foreign refining subsidiary on a loan from a domestic affiliate. Drawing fine lines such as these in order to make distinctions is always difficult, and it is generally unfair to someone. The neutrality of the foreign tax credit should not be downgraded by such arbitrary distinctions.

A credit, which is based on fragmented income, would become an administrative problem, particularly if more and more distinctions are made. Very extensive Treasury regulations would be required to draw the lines between types of income. Compliance with existing rules and regulations on foreign source income taxation is no easy matter now, and such provisions would add greatly to their complexity and administrative difficulties for both taxpayer and tax collector.

The principal purpose of the proposals seems to be to avoid excess credits being generated by royalties. If this is truly a problem, then the solution is to tackle this problem directly. Since the credit itself is not the cause of the situation, there is no justification for tinkering with it.

IV. Domestic International Sales Corporation (DISC)

The DISC provisions were enacted in 1971 to encourage U.S. export trade. It was hoped that this concept would promote the modernization of U.S. plants which produce export goods and would encourage smaller domestic corporations to increase their export trade by allowing them essentially the same tax treatment as larger corporations which operate foreign subsidiaries in foreign markets. One of the proposals before you would repeal these DISC provisions.

We believe that DISC should be continued without restriction. DISC has been in effect for only two full taxable years. This is too little time in which to make a definitive decision as to the effect DISC has had, and will have, on our long term export picture. The Treasury's first report on the effects of DISC, dated April 15, 1974, concludes that U.S. exports have increased due to the DISC incentive.

Such initially positive results do not suggest that the DISC provisions are a failure. Quite the opposite, they appear to be working. Instead of repealing DISC, we urge its continuation, and we suggest that DISC's be further encouraged by allowing a 100% exemption. This would be in line with the original DISC concept.

V. Percentage Depletion for Oil and Gas

For several months now, the U.S. has been forced to make do with significantly less oil and natural gas than we would like to have used. Whether one calls this an energy crisis or an energy emergency or an energy shortage is irrelevant to our consideration of the basic problem. As is true of all large undertakings, solving this problem will require money. If the U.S. is to avoid a chronic recurrence of whatever it was that we experienced last winter, the oil and gas industry will need to invest over $250 billion for exploration, development and transportation by 1985, according to a 1972 study by the Chase Manhattan Bank. To a very great extent, these funds must be internally generated if there is to be any hope of achieving this goal and a prime mechanism through which the oil and gas industry generates its own capital is the percentage depletion allowance.

Percentage depletion is a popular target of those who see loopholes on every page of the Code. But, at a time when new exploration for and extraction of our domestic petroleum resources are needed, it is particularly unwise to repeal this capital recovery provision. Government should be providing encouragement for new capital investment and new exploration in energy fields, rather than making the process more expensive.

Proponents of the repeal of the percentage oil depletion allowance argue that the current price level for "new" oil is high enough to encourage the necessary exploration and production and, therefore, the depletion allowance is no longer necessary. It may be true that the current extraordinary situation will encourage additional exploration activities in the near future, but policymakers should look farther down the road. If increased supplies cause a decline in prices later on, or if increasing costs begin to shrink profit margins, incentives to new exploration will wane. If there is no depletion allowance to provide a continuing incentive--or more accurately in our view, a reduction of tax obstacles to investment in natural resources--then exploration will once again fall off and shortages could reappear.

This was at least implicitly recognized in an earlier tentative decision of the Ways and Means Committee to relate a depletion phaseout to price increases. If the assumed increase in price level didn't occur, at least part of the allowance would remain.

While the amendment to repeal depletion relates only to the petroleum industry, the precedent would create more pressure to eliminate percentage depletion for all extractive industries.

VI. Minimum Tax

The Treasury Department's 1969 proposal regarding a minimum tax indicates clearly that the tax was not intended originally to apply to corporations. It was directed, instead, against individual taxpayers with substantial gross incomes but no taxable income.

The nature of the principal preference items which are relevant to corporate income is such that these items are particularly inappropriate for minimum tax considerations. Accelerated depreciation and amortization are merely variations in the timing of allowable deductions, not the amount. Percentage depletion has a built-in maximum deduction of 50% of taxable income. In both situations, the deductions are limited by the Code without regard to the minimum tax provisions. Therefore, their inclusion as preference items for minimum tax purposes is inappropriate.

If the minimum tax concept remains in the Code, however, then we feel strongly that a full deduction for regular income tax liability must be maintained. Without this deduction, the provisions would be simply an additional tax on the listed "preference" items, not a guarantee of a minimum tax on a taxpayer's gross income. It was a true minimum tax which the Treasury originally proposed and which the public believes is being imposed.

Adoption of the proposed reduction in the present $30,000 exemption or repeal of the regular tax liability deduction would further weaken needed capital recovery provisions, some of which were introduced along with the minimum tax in the 1969 Act. For example, the five year write-offs for pollution control equipment and for railroad rolling stock have been less than totally effective because the minimum tax reduced their impact as soon as they were enacted. These and other provisions which are designed to assist businesses in the capital formation process have already been weakened by being listed as preference items, and the proposed amendments would only aggravate the problem.

Our Taxation Committee has taken no specific position as to the desirability of the Treasury's minimum taxable income (MTI) and limitation on artificial accounting losses (LAL) proposals. There appear to be some problems with the application of these concepts which we understand must be adopted as a package if they are to achieve the desired purpose.

However, we can flatly state that MTI and LAL are far preferable to the proposals before you. The Treasury proposals tend to move in the direction of a pure minimum tax whereas the proposed amendments would definitely result in an additional tax on taxpayers already paying regular income taxes.

The CHAIRMAN. Next, we will call Mr. C. Wrede Petersmeyer, chairman of the Corinthian Broadcasting Corp., for the American Council on Capital Gains and Estate Taxation.

STATEMENT OF C. WREDE PETERSMEYER, CHAIRMAN, CORINTHIAN BROADCASTING CORP., FOR AMERICAN COUNCIL ON CAPITAL GAINS AND ESTATE TAXATION, ACCOMPANIED BY JAMES JACKSON, COUNSEL TO AMERICAN COUNCIL ON CAPITAL GAINS AND ESTATE TAXATION

Mr. PETERSMEYER. Mr. Chairman and members of the Finance Committee, my name is C. Wrede Petersmeyer.

The CHAIRMAN. Would you please introduce your associate?

Mr. PETERSMEYER. Excuse me.

I have with me today Mr. James Jackson, who is counsel to the American Council on Capital Gains and Estate Taxation.

Thank you.

My name is C. Wrede Petersmeyer, chairman of the Corinthian Broadcasting Corp. in New York. Formerly, I was a partner for many years of J. H. Whitney & Co., a private venture capital firm. I am also a member of the board of directors of the American Council on Capital Gains and Estate Taxation. It is in this capacity that I appear before you today.

CAPITAL FORMATION

The American Council was organized to provide a forum for citizens interested in the critical problem of capital formation. We believe that sound Federal tax policies are the appropriate, and indispensable, tool for encouraging capital accumulation and the reinvestment of that capital by millions of individual citizens.

Seven former Secretaries and Under Secretaries of the Treasury of both political parties form an advisory committee supporting the goals of the council. They are: Dr. Charls Walker, chairman, the Honorable Robert B. Anderson, the Honorable David Kennedy, the Honorable Randolph Burgess, the Honorable Frederick H. Deming, the Honorable Robert V. Roosa, and the Honorable Fred C. Scribner, Jr.

I cannot take the time of this committee for lengthy comments today. I think it would be appropriate, however, to summarize briefly the council's views and its program.

The council views capital formation as a vital key to continued U.S. prosperity and growth. Clearly, intensive capital investment per worker has long been the key to the high U.S. standard of living. We are now seeing an increasing demand for capital: capital for energy exploration, for meeting environmental needs, and, of particular importance, to provide jobs for our increasing labor force. Greater capital investment is also essential if we are to meet foreign competition abroad and particularly to provide more goods and services to cope with the awesome problems of inflation at home—an inflation fueled by rampant consumption resulting from the lack of incentive to save.

In a number of U.S. industries we find that plant expansion and technological innovation is not keeping pace with consumer demand. A principal cause of this insufficient growth is a dearth of capital, particularly equity capital. Unless financial resources are available to support our industrial growth, the inflationary pressures will continue to mount. Inadequate capital deters business expansion. And this inadequate pace of growth acts to further the inflationary spiral.

Adverse Effects of Increasing the Capital Gains Tax Rate

The council advocates tax measures to encourage savings and investment. Particularly important in this regard are favorable changes in the capital gains tax rate. The tax system has become weighted in favor of consumption and against investment, particularly investment by the private sector. One need only look at the depressed state of the equity market and the indifference of millions of individuals to equity investment. The maximum rate of long-term capital gains prior to 1969 was fixed at 25 percent and has in recent years risen absolutely, and even more strikingly, in relation to the rate on earned income. Within the past 5 years, the maximum rate on long-term capital gains has risen to 36.5 percent, while the maximum rate on earned income has been reduced from a theoretical high of 91 percent in 1963 to a current 50 percent.

We are distressed to note that, in the face of a critical need for more capital, there are proposals to discourage, rather than to encourage, capital formation. I refer, of course, to the several proposals to increase the tax on capital by a further increase in the capital gains tax rate, and an expansion of the minimum tax provisions which impact the tax burden on capital gains. This is the road taken in the 1969 Tax Act, which, in the council's view, ill-served the national interest.

Certainly, any congressional action to increase the tax on capital would have two extremely adverse effects. One, it would diminish, to the extent of the tax increase, a capital available for needed industrial expansion. Second, and perhaps of more importance, it would have a profound adverse psychological impact on business expansion. It is in effect a congressional pronouncement that business expansion is not needed. In a time of raging inflation and a need for increased jobs, it is a national policy that makes no economic sense at all.

To encourage a greater pace of capital formation and to assure a more equitable tax treatment, the American Council strongly urges measures that would reduce the capital gains rate. As a first step, the council urges a return to the capital gains tax rates in effect prior to the 1969 Tax Act, when no more than 25 percent of any capital gain was taken by the Government. Such a rollback, as former Secretary Robert B. Anderson has said:

> Could be a symbol that our Nation wishes to encourage investment and this should be a significant boost to business confidence, serving to expand our productive capability to meet the many serious challenges.

This is not to say that it will not be necessary in the future to make additional reductions in capital gains tax rates as further stimulation to capital formation.

Moreover, the enactment of a graduated capital gains tax, depending upon the length of time the assets have been held, might be the tool for encouraging capital formation. To help offset the effects of inflation on long-held capital assets, a graduated or sliding scale must result in a clear reduction in the tax on capital. At least part, and sometimes all, of the gain on the disposition of long-held property is not income at all, but reflects the changing value of the dollar.

Let us assume a man purchased a farm for $50,000 in 1935 and sold it in 1974 for $150,000. On its face, it would appear that he had a $100,000, increase in his capital. However, his $150,000 in 1974 dollars has less purchasing power than his $50,000 in 1935 dollars.

The CHAIRMAN. Would you mind giving me those 2 years again, sir? I am trying to follow it closely.

Mr. PETERSMEYER. Yes. It is $50,000 in 1935, and assuming he sold it in 1974 for $150,000, the Government presumably would tax him $100,000 in so-called gain. However, his $150,000 in 1974 dollars were not worth as much as the $50,000 in 1935.

The CHAIRMAN. I am impressed by that comparison, because 1935 was the year I entered college. I am just amazed to find that his dollar is only worth a third what is was at that time.

Mr. PETERSMEYER. That is exactly right. Hence, he enjoyed no economic gain at all. To tax him on the illusory $100,000 profit is grossly unfair. Even without a capital gains tax he would be left with less capital than he originally had in 1935.

The CHAIRMAN. If I might just interrupt at that point, I agree with you completely. What you are doing, then, is imposing a penalty on that taxpayer for the failure of his Government. It is assessing a penalty on him because his Government failed to maintain the purchasing power of his money—an event with which he had no power of control whatever, and no power of decision.

Mr. PETERSMEYER. Yes, sir. And the Treasury, it seems to me, gains with more and more inflation, and the taxpayer loses by it, and I think that is extremely unfair, if not immoral.

The council believes that a sliding scale might free up locked-in investments, thus encouraging a greater economic rationalization of the capital markets and increasing Federal tax revenues. It is a concept that I hope this committee and its expert staff will examine with care.

The impetus of the council's program obviously lies in the areas of capital gains and estate taxation. We are not, therefore, in a position to comment on a number of the proposed amendments alluded to in the press release announcing these hearings. I do, however, want to comment on proposals to increase the minimum tax.

OPPOSITION TO THE MINIMUM TAX PROPOSALS

We are strongly opposed to such measures as those advanced by Senators Kennedy, Muskie, and others. The minimum tax is a complex issue. It needs the careful scrutiny of tax experts and does not lend itself to floor action without the benefits of guidance from the tax-writing committees.

The proposal for increasing the minimum tax may fall most heavily on those already paying high tax rates and not on those nontaxpayers to whom it is intended to apply. To impose an additional burden on this group of taxpayers is contrary to the purpose of any minimum tax.

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Capital gains are already being taxed at rates established by Congress. They do not escape taxation. The so-called minimum tax is an additional tax on capital gains and, as I have testified, the council thinks the capital gains tax rate is already too high.

The proposed minimum tax amendments would tend to defeat the purpose of the capital gains tax differential rate, a rate intended to reflect the sacrifices of capital savings and the undoubted risks of long-term capital investment. To disregard these is to discourage the process of capital formation which is extremely vital to the Nation's economic vitality. We fear, also, that an increase in the capital gains tax rate under the guise of a minimum tax would be but a forerunner of a direct attack on capital formation in later tax reform measures.

We urge, therefore, that the proposed minimum tax measures be defeated. Or, in the alternative, that capital gains be removed from the list of preferences on which a minimum tax is calculated.

Mr. Chairman, I greatly appreciated the opportunity of appearing before this distinguished committee. While this concludes my remarks, I have with me Mr. Jackson, whom I have already introduced, counsel to the American Council on Capital Gains and Estate Taxation, and together we will be glad to respond to any questions that you may have.

The CHAIRMAN. Thank you very much, sir.

I have asked my questions. I think your statement is very clear.

Do you have any questions, Senator Curtis?

ESTATE TAXES

Senator CURTIS. What immediate steps would you suggest to meet this situation in reference to estate tax?

Mr. PETERSMEYER. On estate taxes?

Senator CURTIS. Yes; a raising of the exemption, or are you proposing more of a total revision of approach?

Mr. PETERSMEYER. It is my understanding the council proposes an increase in the exemption from $60,000 to $200,000, which would about offset the inflationary spiral, as I understand it, from the time it was enacted.

Senator CURTIS. Yes, I think we must do something along that line. The estate taxes do not produce a great deal of revenue from the standpoint of the total size of our budget. But the high estate taxes that we have now are giving impetus to mergers and conglomerates. There will be families who have a business. It would perhaps be kept in the family and operated as a small or medium-sized business. But in order to pay the entire tax, it must be offered for sale, and not many of those sales are made to individuals or to small companies. It has a tendency to centralize the economic power rather than diffuse it.

Mr. PETERSMEYER. Yes, sir. The American Council, I believe, Senator, also proposes a maximum tax on the estate of 50 percent. I think it now goes up to 77 percent or something.

Mr. JACKSON. I might add the council has several proposals that would defer the tax on an individual farm or business. These proposals would defer the estate tax while the particular business stayed within the family. As long as the business stayed in the family, you would defer the estate tax, and the estate tax would be assessed only if the family decides to discontinue the family business. Of course, you could have a size limit, but I think it is a sound proposal.

Senator CURTIS. That is a proposal that I have introduced.

Mr. JACKSON. Yes, sir.

Senator CURTIS. We find it particularly important in agriculture of various types. The appraised value of the real estate involved is so high that there is no possible way that a family can raise the money for the estate taxes and justify the additional investments on the income from the property. And the principle ought to be adopted that its value be arrived at based upon its production rather than the so-called market value, because market value anticipates a sale, and oftentimes these sales are made not to individuals who are in the same activity, but they are made to nonresident owners, corporate owners, to larger concerns.

I appreciate that you gentlemen are here this morning.

The CHAIRMAN. Thank you very much, gentlemen.

Next we will call Mr. Sture Olsson, chairman of the Chesapeake Corp. of Virginia, and Mr. A. Felton Andrews, Forest Farmers Association for the Forest Industries Committee on Timber Valuation and Taxation.

STATEMENTS OF STURE OLSSON, CHAIRMAN, CHESAPEAKE CORP. OF VIRGINIA, AND A. FELTON ANDREWS, FOREST FARMERS ASSOCIATION, FOR THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION, ACCOMPANIED BY WILLIAM CANDRELL, GENERAL COUNSEL, COMMITTEE ON TIMBER VALUATION AND TAXATION

STATEMENT OF STURE OLSSON

Mr. OLSSON. Mr. Chairman and members of the committee, I am Sture G. Olsson, chairman of the board of the Chesapeake Corp. of Virginia, West Point, Va. My statement today is made on behalf of the Forest Industries Committee on timber valuation and taxation.

Accompanying me are Mr. Felton Andrews, a private landowner of Memphis, Tenn., and Mr. William Condrell, general counsel of the committee.

The committee is a voluntary organization of timber-growing individuals and corporations from throughout the country whose principal objective is to bring about the widest possible understanding of the relationships between tax policies and the state of the Nation's private forest resources. The committee's supporters constitute approximately 80 percent of the ownership of the Nation's industrial commercial forest land, and ownership in much of the nonindustrial sector as well.

We appreciate the opportunity to be heard in the course of these hearings, because we are troubled by some of the trends that we see developing in the tax policy sector.

It is not unexpected that there are pressures for income tax reductions for low- and middle-income individuals. The combination of soaring inflation and reduced business activity in some sectors of the economy has had severe impact on persons with fixed or reduced incomes, and we will leave it to you to evaluate the merits of these proposed reductions.

Our concern, however, is the threat by advocates of reduced personal income taxes to balance revenue costs through higher taxes on the business and capital investment sectors.

FOREST INDUSTRY AND PROPOSED MINIMUM TAX REFORM

Our major and immediate concern is with proposed changes in the minimum tax on tax preferences because of the potential impact on capital gains. Because investments in forest plantings require such a long time for economic return and are subject to high natural and economic risks, Congress in 1944 made income from qualified timber transactions eligible for capital gains tax treatment.

Detailed evidence of the beneficial effects of that action on the Nation's forest resources was given last year in hearings of the House Ways and Means Committee. We would be happy to provide this and any other additional material which members of the committee may desire on the general subject of timber capital gains treatment.

When the minimum tax on tax preferences was enacted in 1969, it was purported to be a means of insuring that virtually all income, from whatever source, would be subject to at least a minimum level of taxation. At that time, we heard a great deal about the 155 individuals earning over $200,000 who paid no taxes at all in the year 1967.

While capital gains are taxed below ordinary income rates—for reasons that are perfectly evident, it seems to me—it is at the same time clear that capital gains treatment cannot be a factor in escaping tax liability. Capital gains already pay a tax of 30 percent in the case of corporations, and effective rates ranging up to 36.5 percent for individuals. But in spite of the special nature of capital gains income and its role in the processes of capital development so vital to a free market economy, it was included as a tax preference for the purposes of the minimum tax.

It is not a minimum tax by any means, particularly in its effect on capital gains. It is an additional tax on capital for which the full statutory rate has already been assessed. The Treasury Department has calculated that 84 percent of minimum tax revenues from individuals are attributable to capital gains. The impact on corporations is also severe. This is especially true in the forest products sector where capital gain is not merely incidental to corporate activities but is an essential factor in the financing of long-term forest improvements.

Consequently, the impact of the minimum tax as now constituted is serious to timber growers, both individual and corporate. The changes proposed by Senators Nelson, Kennedy, Mondale and others would compound that impact. By denying the deduction for other taxes paid, the amendments would make the minimum tax even more regressive than at present.

It would strike hardest at those individuals and corporations with the highest effective tax rates. It would have the least effect on those paying low taxes on large incomes. And, the amendment would have no effect whatsoever on those who, for one reason or another, have no tax liability on large incomes. Therefore, the proposals would completely subvert the original intent of the minimum tax.

Forest Industry and Capital Gains Tax Proposals

The forest industry is now feeling the effects of the substantial capital gains rate increases enacted in 1969. The corporate rate was increased by 20 percent. Similar increases were imposed on the capital gains of individuals, and for some the increases were as high as 40 percent.

An example of the combined effects of the capital gains rate increase and the imposition of the minimum tax on a timber-growing corporation focusing on its capital gains income alone is attached as appendix A. It also shows the effects of the proposed minimum tax amendments. In appendix B we have shown the effect of the 1969 capital gains rate increase and the minimum tax as under present law and as proposed for both individuals and corporations.

All of the demonstrable rules of economic behavior dictate that these increases are bound to have an adverse effect on capital formation, and consequently on the actual and potential level of investment in timber growing.

While tax questions of critical economic import to timber growers are being debated, those of us in the forest products business are being urged to: first, grow more trees and to grow them faster to avoid predicted shortages of forest raw materials; second, to invest in more and better manufacturing facilities to counter the inflationary effects of short-term wood and paper shortages; and, finally, to do these things in ways that have the least environmental impact.

We believe all of these objectives are possible. Furthermore, we think they are essential if we are to make the wisest and best use of our Nation's resource base. But they are achievable only if our tax laws fully recognize the realities of capital requirements in forest production and management. I know of no other economic enterprise with such an extraordinarily long investment cycle, where one generation of land managers is expected to make investments which will not mature for the next or possibly even two generations removed.

I might add here, Mr. Chairman, that this is, in our State at least, one of the real difficulties—getting the landowner to make a substantial capital investment for the benefit of his grandchildren.

There are two elements to the capital requirements of the forest products industry.

First, there is the necessity for greatly increased investments in the land and in trees. To bring all private, commercial forest land in the United States to the same level of productivity now being achieved on some of the better-managed industrial timberland would require an estimated $55 billion between now and the year 2000. Much of this acreage is in small and medium size ownerships, and I do not know where these owners can possibly get that kind of money if capital markets remain as they are today. Even under the best of circumstances, it will require extraordinary measures.

For example, in my home State of Virginia, we recognized that, even with the full capital gains tax incentive, special planting allowances were necessary for small growers to enable them to get started on the long timber investment cycle. The Federal Government has also taken a step in this direction through a program of planting incentives for small landowners.

The other element to the forest industry investment problem is the need for more and better manufacturing plants.

We should be encouraging greater capital savings, not less. We should be stimulating higher levels of investment in raw materials production and manufacturing capacity, not less.

Yet, we have experienced in recent years a profound change in our tax structure that has shifted from the encouragement of savings and capital investment to the encouragement of consumption. The narrowing of the differential between the tax rates on capital gain and earned income is indicative of this trend. The maximum rates used to be 90 percent on earned income and 25 percent on capital gain. Now the maximum rates are 50 percent on earned income and, including the present minimum tax, 36½ percent on capital gains; notice, only a 13½ point spread.

When you consider that all capital gain is not real income, then the significance of this shift becomes even more apparent.

For these reasons, we urge this committee and your colleagues in the Senate not to impose any additional taxes on capital. More specifically, we urge: first, that the Nelson-Kennedy-Mondale minimum tax amendments not be enacted; second, that capital gains be removed from the minimum tax; and, third, that the incentives that worked so effectively up to 1969 be restored to stimulate needed capital investments in timber growing and other risk enterprises.

Mr. Chairman, we in the forest industry have no reservations about making these suggestions. Capital gains treatment of timber income has been no windfall. Our return on investment is well below other industries and other forms of capital investment, and our average effective tax rates are above other capital intensive industries and compare favorably with all U.S. industry.

We cannot overemphasize, however, the crisis of capital facing timber growers. The productivity required to meet the country's need for wood and fiber cannot be achieved unless there is an adequate recognition in the tax laws of the difficulties and risks involved in long-term forest investments.

Thank you, sir.

The CHAIRMAN. Thank you very much for your statements, gentlemen.

STATEMENT OF FELTON ANDREWS

Mr. ANDREWS. Mr. Chairman, my name is Felton Andrews, from Memphis, Tenn. I am part of a family company that owns about 23,000 acres in Tennessee and northern Mississippi. I am also director of the Forest Farmers Association and appear representing the Forest Industries Committee on Timber Valuation and Taxation.

I think probably our family's timber operation is fairly typical throughout the South over the past 30 years. Prior to this time, the South was an area of diminishing timber and timber resources, but during that period the South has come up in a tremendous way, and today it is a big producer of timber and wood fiber. I think it is probably true in your State as it is in mine that over 50 percent of the farm income comes from timber.

Everybody that I talk to says we are going to have to carry a bigger and bigger share of the timber needs of this country, and the wood fiber.

Now, we entered this business in the early 1950's as an investment, and we bought up nonproductive, low-income, hardwood lands. And the worse of it we converted into pine lands at the rate of about a million pine seedlings a year. And over that more than 20-year period we have yet to be able to harvest our first pine tree. We very recently had to lease a portion of our land in order to pay ever-increasing property taxes. It was either this or sell it.

And the property taxes during this period have about tripled, as well as all of the other costs of operations, the maintenance, supervision, and so forth. Back then it was about $15 an acre to prepare and plant an acre of pine. Now it is about $55 an acre. And 20 years is an awful long time to wait for income from an investment.

Very definitely, when we made this decision in the early 1950's the long-term capital gain incentive was a very decisive factor in our decision to go into this business. We thought, regardless of other risks we were taking, that at least we could count on this incentive. But 5 years ago you made a big cut in it and established the minimum tax at the same time.

Now, I firmly believe if this margin between long-term capital gain and ordinary income decreases, the people that I know are going to be much beter off putting their money in savings and loans and having the Government insure their capital.

This is what I am driving at. During the past 25 years prior to 1969, the tax incentive on long-term capital gain did a tremendous job in increasing our timber production in the South. It has proven itself. But an individual, when he looks at the dangers of being wiped out in a day by fire and over a year or possibly more by insects, he is going to think twice about investing, especially if the Government is going to pull the rug out from under him, if they are not going to keep their part of the bargain. It is like repealing the deposit insurance law retroactively after the bank fails.

I think the Government has a commitment to the small forest owners, as well as larger timber investor, that they maintain the differential between long-term capital gain and personal income taxes that was in effect at the time the investment was made—maintain that until he is able to harvest it and get his investment back out of it. And this is the beauty of long-term capital gains, because it does tax a person at the same rate; if ordinary income has increased, capital gains have increased in the same rate, unless you single us out like you did in 1969 and increase ours out of proportion.

So I hope that, as a first step in a needed commitment to the future of private forest development, you will reject the proposed minimum tax amendments or completely remove capital gains from the special minimum tax assessment.

Thank you.

The CHAIRMAN. Thank you very much for a clear and understandable statement. We appreciate it.

Mr. OLSSON. Thank you very much, Senator.

[The prepared statements of Messrs. Olsson and Andrews follow:]

STATEMENT OF

STURE G. OLSSON
THE CHESAPEAKE CORPORATION OF VIRGINIA
WEST POINT, VIRGINIA

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

June 10, 1974

Mr. Chairman and Members of the Committee, I am Sture G. Olsson, Chairman of the Board of The Chesapeake Corporation of Virginia, West Point, Virginia. My statement is made on behalf of the Forest Industries Committee on Timber Valuation and Taxation. The Committee is a voluntary organization of timber-growing companies and individuals from throughout the country whose principal objective is to bring about the widest possible understanding of the relationships between tax policies and the state of the nation's private forest resources. The Committee's supporters constitute approximately 80 percent of the ownership of industrial commercial forest land, and ownership in much of the non-industrial sector as well.

We appreciate the opportunity to be heard in the course of these hearings because we are troubled by some of the trends that are seen developing in the tax policy sector.

It is not unexpected that there are pressures for income tax reductions for low and middle-income individuals. The combination of soaring inflation and reduced business activity in some sectors of the economy has had severe impact on persons with fixed or reduced incomes, and we will leave it to you to evaluate the merits of these proposed reductions.

Our concern, however, is the threat by advocates of reduced personal income taxes to balance revenue costs through higher taxes on the business and capital investment sectors. These pressures come at a time when businesses are also fighting the effects of inflation. The debt ratio of many businesses--and certainly this is true in the wood and paper industries--has increased dramatically in recent years. This results primarily from

-- the need for greatly expanded forest production,

-- the need for improved processing plants,

-- the increasing ratio of capital investment in pollution abatement equipment,

-- and the low rate of capital generation in the industry because of unpredictable and below average profits.

Consequently, high interest rates and capital shortages have a special impact on forest products industries--not only because they are capital intensive, but in the case of timber growing because capital is tied up for so many years.

We are also plagued with rising costs for equipment, labor and services required to maintain investments in high level, sustained-yield forest management. We suffer the same agonies of materials shortages, fuel prices and other economic uncertainties as many other sectors of the economy.

But there are more specific reasons for the concern of timber growers over some of the tax adjustments now proposed for action in the Senate.

MINIMUM TAX AMENDMENTS

Our major and immediate concern is with proposed changes in the Minimum Tax on Tax Preferences because of the potential impact on capital gains. Because investments in forest plantings require such a long time for economic return and are subject to high natural and economic risks, Congress in 1944 made income from qualified timber transactions eligible for capital gains tax treatment.

Detailed evidence of the beneficial effects of that action on the nation's forest resources was given last year in hearings of the House Ways and Means Committee. We would be happy to provide this and any other additional material which members of the Committee may desire on the general subject of timber capital gains treatment.

When the Minimum Tax on Tax Preferences was enacted in 1969, it was purported to be a means of ensuring that virtually all income--from whatever source--would be subject to at least a "minimum" level of taxation. At that time we heard a great deal about the 155 individuals earning over $200,000 who paid no taxes at all in the year 1967.

While capital gains are taxed below ordinary income rates--for reasons that are perfectly evident--it is at the same time clear that capital gains treatment cannot be a factor in escaping tax liability. Capital gains already pay a tax of 30 percent in the case of corporations, and effective rates ranging up to 36.5 percent for individuals. But in spite of the special nature of capital gains income and its role in the processes of capital development so vital to a free market economy, it was included as a tax preference for purposes of the minimum tax.

It is not a "minimum" tax by any means, particularly in its effect on capital gains. It is an additional tax on capital for which the full statutory rate has already been assessed. The Treasury Department has calculated that 84 percent of minimum tax revenues from individuals are attributable to capital gains. The impact on corporations is also severe. This is especially true in the forest products sector where capital gain is not merely incidental to corporate activities but is an essential factor in the financing of long-term forest improvements.

Consequently, the impact of the minimum tax as now constituted is serious to timber growers, both individual and corporate. The changes proposed by Senators Nelson, Kennedy, Mondale and others would compound that impact. By denying the deduction for other taxes paid, the amendments would make the minimum tax even more regressive than at present. It would strike hardest at those individuals and corporations with the highest effective tax rates. It would have the least effect on those paying low taxes on large incomes. And, the amendment would have no effect whatsoever on those who, for one reason or another, have no tax liability on large incomes.

Therefore, the proposals would completely subvert the original intent of the minimum tax.

1969 CAPITAL GAINS TAX INCREASES:

The forest industry is now feeling the effects of the substantial capital gains rate increases enacted in 1969. The corporate rate was increased by 20 percent. Similar increases were imposed on the capital gains of individuals--and for some the increases were as high as 40 percent. An example of the combined effects of the capital gains rate increase and the imposition of the minimum tax on a timber-owning corporation focusing on its capital gains income alone is attached as Appendix A. It also shows the effects of the proposed minimum tax amendments. In Appendix B we have shown the effect of the 1969 capital gains rate increase and the minimum tax as under present law and as proposed for both individuals and corporations.

All of the demonstrable rules of economic behavior dictate that these increases are bound to have an adverse affect on capital formation, and consequently on the actual and potential level of investment in timber growing.

NEED FOR TIMBER

While tax questions of critical economic import to timber growers are being debated, those of us in the forest products business are being urged to

-- grow more trees and to grow them faster to avoid predicted shortages of forest raw materials,

-- to invest in more and better manufacturing facilities to counter the inflationary effects of short-term wood and paper shortages,

-- and to do these things in ways that have the least environmental impact.

We believe all of these objectives are possible. Furthermore, we think they are essential if we are to make the wisest and best use of our nation's resource base. But they are achievable only if our tax laws fully recognize the realities of capital requirements in forest production and management.

I know of no other economic enterprise with such an extraordinarily long investment cycle--where one generation of land managers is expected to make investments which will not mature until the next or possibly even two generations removed.

NEED FOR CAPITAL

There are two elements to the capital requirements of the forest products industry.

First, there is the necessity for greatly increased investments in the land and in trees. To bring all private, commercial forest land in the U. S. to the same level of productivity now being achieved on some of the better managed industrial timberland would require over $55 billion between now and the year 2000. Much of this acreage is in small and medium size ownerships, and I don't know where these owners can possibly get that kind of money if capital markets remain as they are today. Even under the best of circumstances it will require extraordinary measures.

For example, in my home State of Virginia, we recognized that, even with the full capital gains tax incentive, special planting allowances were necessary for small growers to enable them to get started on the long timber investment cycle. The Federal Government has also taken a step in this direction through a program of planting incentives for small landowners.

The other element to the forest industry investment problem is the need for more and better manufacturing plants.

The paper industry is an excellent example. To stave off threatened paper shortages, the industry is operating at maximum capacity. But much of that capacity is obsolete, and new plants are not coming on line fast enough. Historically, earnings in the paper industry have been ~~so far~~ SUFFICIENTLY below other industries that it was difficult to attract capital for needed improvements and expansion. And today, when shortages are staring us in the face, sufficient capital is simply not obtainable, or interest costs are prohibitive.

We are all concerned about inflation and its corrosive effects on the substance of our economy. We have been through several cycles of cost-push inflation since World War II, and the response was always to tighten up on capital to dampen things down. But what we have now is a genuine, ring-tailed demand-pull inflation where consumer demand has outstripped our capacity to produce in many areas. To use the remedies of the past would be disastrous.

We should be encouraging greater capital savings, not less. We should be stimulating higher levels of investment in raw materials production and manufacturing capacity, not less.

Yet, we have experienced in recent years a profound change in our tax structure that has shifted from the encouragement of savings and capital investment to the encouragement of consumption. The narrowing of the differential between the tax rates on capital gain and earned income is indicative of this trend. The maximum rates used to be 90 percent on earned income and 25 percent on capital gain. Now the maximum rates are 50 percent on earned income and (with the minimum tax) 36.5 percent on capital gain.

When you consider that all capital gain is not real income, then the significance of this shift is apparent.

For these reasons we urge this Committee and your colleagues in the Senate not to impose any additional taxes on capital. More specifically, we urge:

1. That the Nelson-Kennedy-Mondale minimum tax amendments not be enacted;
2. That capital gains be removed from the minimum tax; and
3. That the incentives that worked so effectively up to 1969 be restored to stimulate needed capital investments in timber growing and other risk enterprises.

Mr. Chairman, we in the forest industry have no reservations about making these suggestions. Capital gains treatment of timber income has been no windfall. Our return on investment ~~has averaged~~ IS well below other industries and other forms of capital investment, and our average effective tax rates ~~compare favorably with~~ ARE ABOVE other capital intensive industries, AND COMPARE FAVORABLY WITH ALL U.S. INDUSTRY.

We cannot overemphasize, however, the crisis of capital facing timber growers. The productivity required to meet the country's need for wood and fiber cannot be achieved unless there is adequate recognition in the tax laws of the difficulties and risks involved in long-term forest investments.

Thank you.

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APPENDIX A

EXAMPLE: TAX ON CORPORATE TIMBER-GROWING OPERATION

(Assuming No Ordinary Income)

	Pre-1969	Present Law	Proposed Kennedy Amendment
Capital Gain On Timber Sale	$1,000,000	$1,000,000	$1,000,000
Capital Gain Tax	250,000	300,000*	300,000*
Preferences (18/48ths of capital gain)	None	375,000	375,000
EXCLUSION		30,000	10,000
Deduction For Other Taxes Paid		300,000	(No Deduction Allowed)
Balance		45,000	365,000
10% Minimum Tax		4,500	36,500
TOTAL TAXES	$ 250,000	$ 304,500	$ 336,500
		(22% increase over 1969)	(35% increase over 1969)

~~*Excludes effect of the first $50,000 exemption from the 1969 rate increase.~~

APPENDIX B

MAXIMUM RATES ON CAPITAL GAINS

FOR EACH $100 MARGINAL GAIN*

	Pre-1969	Present Law	Proposed Kennedy Amendment
INDIVIDUALS			
Capital Gains Tax	$25.00	$35.00	$35.00
Minimum Tax Calculation:			
Preference Income	None	50.00	50.00
Less Other Taxes Paid		35.00	Not Allowed
10% Minimum Tax		1.50	5.00
TOTAL TAX	$25.00	$36.50	$40.00
		(46% increase over 1969)	(60% increase over 1969)
CORPORATIONS			
Capital Gains Tax	$25.00	$30.00	$30.00
Minimum Tax Calculation:			
Preference Income	None	37.50	37.50
Less Other Taxes Paid		30.00	Not Allowed
10% Minimum Tax		.75	3.75
TOTAL TAX	$25.00	$30.75	$33.75
		(23% increase over 1969)	(35% increase over 1969)

*Assuming gains over the $50,000 amount exempted from the 1969 rate increase and over the amounts excluded from the minimum tax (i.e. $30,000 under present law and $10,000 under the Kennedy amendment.)

STATEMENT OF

A. FELTON ANDREWS
MEMPHIS, TENNESSEE

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

June 10, 1974

Mr. Chairman, my name is A. Felton Andrews. I live in Memphis, Tennessee. I am part owner of a family company which owns about 23,000 acres of timberland in Tennessee and Northern Mississippi. I am a Director of the Forest Farmers Association, and appear today on behalf of the Forest Industries Committee on Timber Valuation and Taxation.

There probably is no "typical" way for people to get into the timber growing business, but ours is probably representative of many of the operations which--over the past 30 years--have transformed the Southern States from an area of declining timber resources to one of tremendous importance to the nation's future timber supply. Most forest economists agree that the South will have to furnish a larger and larger share of the wood and fiber needed to meet consumer requirements in the years ahead. This certainly could not be the case if not for the capital gains tax treatment of income from sustained-yield, long-term forest management operations which was enacted in 1944.

We entered the timber business in the early 1950's, acquiring non-productive, cut-over timberland and converting it to pines at the rate of approximately one million seedlings a year. The only harvest that has yet been realized from this 20 year investment in planted forest stock is a recent one required to help pay the increasing property taxes on the land and the timber. Twenty years is a long time to wait for a return on any investment; and during this period our property tax load has about tripled, and other expenses of maintaining the investment have gone up dramatically.

I hope that you will consider our point of view in any action you take affecting the taxation of timber income. The capital gains rate in effect in the 1950's when we made our initial investment was a decisive factor in our investment planning. We felt that no matter what happened otherwise, we would at least be assured of the full capital gain benefit on whatever future gain might be realized.

But five years ago part of that was taken away from us. The capital gains rate was increased, and we still had a long time to go before our investment fully matured. On top of that, capital gains were included in the minimum tax, which further narrowed the rate differential that had been a factor in our decision. And since 1969, hardly a month goes by but what somebody isn't threatening to either wipe out capital gains altogether, further reduce its benefits, or to modify the minimum tax in such a way that the benefit would be rendered practically meaningless. If this happened, I don't know of a single timber grower in our area who wouldn't be better off if he had put his money in a savings and loan instead of into pine seedlings--and the government would have insured him against any loss.

What I'm driving at is this: for twenty-five years after 1944 the tax laws affecting timber did exactly what they were intended to do. They encouraged people to plant timber and manage it on a permanent, sustained-yield basis. Now everyone tells us we need timber more than ever, but how many of my neighbors and other people around the country are going to put their savings into something that can be wiped out in a single day by fire, or in a single year by insects when the government doesn't keep its part of the deal?

It's like repealing the deposit insurance law retroactively after the bank fails.

There needs to be an honest commitment to forest farmers, to individual timber investors and to industrial forest owners that the future income from investments they make today will be treated for tax purposes in the same ratio to other forms of income as at the time the investment was made. That's the beauty of capital gains. As regular tax rates change, the capital gains liability changes proportionately--except when capital gains is singled out, as it was in 1969, for special increases.

I hope that, as a first step in a needed commitment to the future of private forest development, you will reject the proposed minimum tax amendments or completely remove capital gains from the special minimum tax assessment.

Thank you.

The CHAIRMAN. Next we will call Mr. Gerard Brannon, professor of economics at Georgetown University.

STATEMENT OF GERARD BRANNON, PROFESSOR OF ECONOMICS, GEORGETOWN UNIVERSITY

Mr. BRANNON. Thank you, Mr. Chairman.

In this oral testimony I would like to address the taxation of energy resource companies and the DISC provision. My paper also deals with the foreign tax credit and capital gains.

PERCENTAGE DEPLETION REPEAL CALLED FOR

I think percentage depletion should be repealed immediately. Things have changed since 1972 when we were still protecting the high-cost U.S. oil and coal industries by import quotas. In that situation when Americans were being required to pay $3 a barrel for domestic oil, at a time when we could have imported oil for $2, percentage depletion kept the domestic price from going even higher. It did not hold the price down very efficiently because close to half of the percentage depletion benefit went into higher royalties, but it did have some relation to that overall policy of keeping down the prices on U.S. oil.

Now, the world price has tripled. The policies that were appropriate to protecting the high-cost domestic industry must be changed to face the fact that the real cost to the United States of consuming more oil is now the import price, which is about $10 or $11 a barrel.

Nevertheless, we are continuing price controls and tax incentives. The substance of a tax incentive is that we use the Treasury in part to pay oil producers instead of requing producers to get all of their incentives in the marketplace. My use of the expression low prices for oil may surprise you, but let me clarify it.

The present average price on U.S. crude is about $7 a barrel, which is at least $3 below import prices. The percentage depletion allowance alone is worth as much as $1.50 to the producer, so that companies are doing as well as if they were earning $8.50 and paying regular taxes.

If we make an allowance for their special advantage in intangible drilling expenses, the benefits are even greater.

CONSEQUENCES OF THE PROGRAM USING TAX INCENTIVES TO MAINTAIN LOWER PRICES

Now, there are three consequences of this program of using tax incentives to maintain lower prices. In the first place, low oil prices discourage the production of alternative fuel sources. When you take into account the base of percentage depletion, it is outrageously discriminatory between fuels. It is about 3 times better for oil and gas than for nuclear fuel or for coal energy, and it is almost 13 times better for natural oil and gas than for the fuel produced by liquefying or gasifying coal. Such a discriminatory subsidy can hardly be a sensible energy policy. It is simply favoritism for oil and gas.

Now, a second consequence of this program of tax incentives and lower prices is to encourage consumption and to undercut conservation. The fact of low gas consumption of European cars is not an accident of geography. It is a response to the fact that gasoline prices in Europe have been historically about twice the level of U.S. prices; this due to the heavy taxation of gasoline in Europe.

Now, the third consequence of low oil prices is that they seem to help consumers. High prices in turn seem to transfer income from consumers to oil companies, but this income transfer problem is one that Congress can correct very well by tax measures.

One of many ways would be to provide an "energy price" refundable tax credit of say $50 a person which would come to $200 for a family of four. At the same time that higher prices are received by oil companies they should in the first place pay the taxes imposed on other businesses without percentage depletion. It makes no sense to impose low taxes on income earned by using up our scarce valuable resources, and full tax on processes that can produce good end products like oil and coal by doing extensive manufacturing on cheaper resources.

Now, notice from the standpoint of the oil producer, there is no difference, when the market price of oil is $10, between a price control law that says old oil must be sold at $5.25 and the combination of a $10 market price plus a $4.75 windfall excise tax. I simply use those numbers for illustration to make the point that price control is similar from the producers' point of view to higher taxation. As I have indicated before, I would not like to see that large an excise tax imposed. I would like to see more of the tax raised by applying regular income taxes. Notice how different is the combination of tax and some sort of consumer relief from the consumer's standpoint.

When you hold the price of old oil down to $5.25, we give consumers a benefit which increases the more they use oil or oil products. This $5.25 price for old oil combined with uncontrolled prices for new oil accounts for the average price of $7 cited above. The benefit from the low price is far more for the Cadillac owner than for the person who drives a Volkswagen. It is far greater for the person who keeps his home temperature at 80 degrees than someone who tries hard to listen to this conservation talk from the Government and keeps his house temperature down to 65.

But you can provide consumers with as much benefit as you want through general tax relief or tax credits, or welfare increases or social security tax reductions. These reliefs do not have the characteristic that they increase the benefit the more the person uses oil. And this is what the whole function of price system and a market economy is supposed to carry out, to bring across to consumers that the marginal cost for consuming more oil is in the neighborhood of $10 or $11 in this country, which is the cost of real goods that we have to export to buy more oil abroad.

Finally, with regard to oil, I see no justification for a ploughback grant. This amounts to an investment subsidy limited to companies that have already enjoyed windfall oil profits. It is no more than a recipe for increasing concentrated control of the energy business in the hands of oil companies.

Neither is there justification for retaining percentage depletion for small producers, producers of up to $8 million worth of oil. These producers have been enjoying very good profits under the current price structure which has increased their oil price on the average of more than 100 percent over a period of a year.

If you want to go around and look for small companies to help, these must be the least deserving of small companies in our country. If would be far better to help small steel companies or small automobile companies or small machine shops.

Termination of DISC Called For

Now, turning briefly to DISC in my remaining time, there are many reasons why DISC should be terminated. In the first place, all of our evidence on the responsiveness of exports to price changes suggests that this increase in exports in response to lower prices is very small, and consequently a tax subsidy to exporters is an inefficient way to improve our balance of payments.

Second, exports as such, are inflationary, as we have learned from the food situation where an increase in exports has been something of a domestic problem.

Finally, I would like to call your attention to the connection between DISC and the 15-percent devaluation of the dollar that occurred in 1971 through 1973. Look at what devaluation means. Let us say that an American manufacturer before devaluation was selling widgets in Europe at a competitive widget price of say 200 francs. In early 1971, the proceeds of these sales could have been converted to $10 in U.S. money. After the 15-percent devaluation, the proceeds of the widget sales converted to $11.50, another producer windfall.

Now, this is borne out by the recent Treasury report on DISC. The one thing that surprised the Treasury compared to its original DISC revenue estimates was that export sales were about twice as profitable as regular U.S. domestic business, as you would have expected, because devaluation made these foreign receipts more valuable.

Basically the DISC is rather in the pattern of percentage depletion of providing tax benefits for very well off firms, and for that reason it is unnecessary.

Thank you, Mr. Chairman.

Oil and Gas Prices

The Chairman. Let me see if I have got something straight from your statement.

Do I understand your statement to be that we would repeal the depletion allowance, and that this would necessarily mean a higher price for the product in this country?

Mr. Brannon. Well, strictly speaking, it is the price control agency that determines the price. I would expect that if you repealed the percentage depletion allowance, they would raise the price. But I do not see that there is a necessary connection.

The Chairman. Well, I just think that these things ought to be laid out so everybody could understand them, because if we do not, people will think there must be some reason why we do not want to make the whole thing clear. It would seem to me that if you assume that the price is being controlled at the right level, then my offhand impression would be that a repeal of the depletion allowance would require an increase in the price of oil of about $1.35 a barrel.

Does that seem about right to you?

Mr. Brannon. About $1.50, but okay. But you see, my point is, the price is too low. It is a mistake for the Government to struggle with things like depletion allowance to keep the price down. This discourages competitive energy sources. It encourages more use of energy.

The Chairman. Well, I heard an eminent economist make a statement a while back that he had never agreed with the depletion allowance. He thought there just ought to be a higher price for oil.

Mr. Brannon. Yes.

The Chairman. And you agree with that.

Mr. Brannon. Yes.

The Chairman. Now, there is no doubt in my mind that an elimination of the depletion allowance would necessarily require the Federal Power Commission to permit those producers, who are already regulated on a cost of production basis, to increase their price to get back what they lose by taking away the depletion allowance. Because in arriving at whatever you think their fair return would be, a tax increase is necessarily a cost increase, and that would have to be passed on to the consumer of the product. There are some who make the point that perhaps we ought to say that when the price of oil goes to something around $9 a barrel, that there would be no depletion allowance, and I have been led to believe that major companies feel that they could live with having no depletion allowance and the price at $9 a barrel.

But if that is to be the case, it seems to me that we ought to honestly and forthrightly tell the American consumer that that means an increase in the price of fuel oil and it means an increase in the price of gas at the pump of about 3 cents a gallon. That is about where I would put it.

Does that seem about right to you?

Mr. Brannon. Yes, but also when you're talking about what to tell the consumer, tell him that you can give him this money, that is the sequence you are talking about is increased money coming into the Treasury. Now, you can use that to increase the purchasing power of consumers. I suggested this energy price credit as one way of making the connection very explicit, or simply reduced incomes or social security taxes, but give him the money in such a way that he knows that using gasoline is more expensive, so that he knows the real marginal cost of using gasoline.

The present system in effect gives him that money every time he uses gasoline, and the more gasoline he uses, the more money you are giving him.

The Chairman. Well, there are some who have communicated to my assistants and others that they really feel that the tax on oil should go up by eliminating the depletion allowance or anything else, and that the price should go up for the simple reason that they feel that there are a lot of people just wasting a great deal of energy that they would not be wasting if it were priced at a higher point.

Mr. Brannon. That is right.

The Chairman. And I can understand that argument, but I honestly think that if that is what we want to do, we ought to make it clear to the consumer that this is what we want to do and that we are doing it for that reason. I just do not think it is good to confuse or mislead people.

Now, it can well be argued that if we had raised the price at the pump by an excess tax at the pump, that there would be no windfall to anyone, and that would have tended to retard the consumption of the product which at a time of shortage might not be too bad an idea, I am not sure that I am ready to vote that way, but I think that if we do take that approach, we ought to explain it as you have, that this is what we have in mind, and that we believe that on balance it is justified.

I would like to study more carefully your suggestion about giving some of this back to the consumer who is doing what you think he ought to do. I personally very much approve of tax laws that seek to encourage whoever it is, be it the consumer, the producer or whoever, to do what you think is in the Nation's interest at that particular point.

Mr. BRANNON. Well, could I suggest a little differently on that part of it? I am less enthusiastic than you just expressed yourself as being, in the matter of encouraging people to do things. My emphasis here was simply to give money back to consumers. How much they use gasoline should essentially be their business. If people want to use a lot of gasoline and want to push the gasoline price up high, then we will have a faster development of other fuel sources. We will have a faster development of liquefied and gasified coal and I am willing to rely on the market process in a lot of these things. We do not have to be telling the consumer how to behave all the time, but we can rely on market prices.

The CHAIRMAN. Well, we have a tax system, Professor Brannon, which is not built on the theory of complete tax uniformity. It is built on the theory that the amount you are going to pay in taxes depends upon both how you make your money and what you did with it, and as much as I have seen some administrations such as the Eisenhower administration come into power advocating that the taxation should depart entirely from that concept, I have never seen any of them have the courage to stick with it when they were confronted with the realities of a business recession or something of that sort that set the stage for urging a change in the tax laws to try to stimulate the economy. I just have not seen any administration that is willing to live with it after they came in and proposed it.

You know, George Humphrey was strong for that theory, and it took about 6 months for him to turn around and head in the other direction.

Mr. BRANNON. You see, there are two kinds of theories that I think you have got involved there. One is this effort which is persistent in our tax law to encourage people to do one thing rather than another because the Government thinks that the world would be better off if, say, businessmen had different attitudes toward growing timber or mining coal. You could reduce that emphasis in the tax law a great deal and still say that in a period of recession there should be more purchasing power in the economy. We are not going to tell people how to spend it, but we are going to make more money available so that they will have more total to spend, and will rely on free market indications to indicate where that money will go.

The CHAIRMAN. Well, thank you very much, Professor Brannon. I will study your statement further. It provides a lot of food for thought.

We will now stand in recess until 2:30 this afternoon.

[The prepared statement of Mr. Brannon follows:]

Statement on Tax Reform
by
Gerard M. Brannon
Professor of Economics, Georgetown University
Senate Finance Committee June 8, 1974

I will address this testimony to some of the tax reform amendments which might be considered in connection with HR 8217. Specifically I will argue:

(1) the percentage depletion allowances should be repealed immediately with no allowances for small producers;

(2) the provisions dealing with foreign income should be made more severe without repealing the foreign tax credit;

(3) the export subsidy provision, DISC should be repealed; and

(4) this Committee should provide for study of the taxation of unrealized appreciation on transfer by death or gift.

Percentage Depletion

The most pressing problem before the Congress is the taxation of income related to energy. The present posture of U.S. law in the area of energy is basically absurd. On the one hand we tax oil companies less than other corporations, through percentage depletion and the deduction of intangible drilling expenses. On the other hand we hold down the price of oil and natural gas. Tax benefits are an incentive for production and the controlled price is a disincentive for production. Simultaneously the controlled price is an incentive for consumption. For all of our efforts to talk about conservation, we are following the contrary policy of providing producer incentives from the U.S. Treasury to finance lower energy prices which have the effect of holding up consumption.

There has been inadequate attention to two basic elements of energy policy:

- the character of the changed world situation in oil, and
- the simple economics of markets.

Prior to 1973 our national situation was by consensus that high oil imports would weaken national security. This led to a program of protection for the high cost U.S. oil industry. We propped up U.S. oil prices by import quotas, by a program of output limitations on productive wells and by tax incentives to oil producers.

As oil companies frequently repeat, prior to 1973 the profit after tax in the U.S. oil industry was not out of line with U.S. manufacturing profit rates. This tells us that the tax incentives were going into lower prices, that is, the part that was not going into higher royalties.

What has changed is that in the last year the world oil price has tripled. The U.S. industry is no longer a high cost cripple that needs protection from cheap imports. On the contrary the concern has been with windfall profits.

At the present time the cost to the U.S. of an additional barrel of oil is the import price which is in the neighborhood of $ 10 to 11. At those prices there will be ample supplies. Instead of permitting prices to rise we have price controls and the Treasury Department tells you that these controlled prices should be subsidized by letting oil companies get a substantial part of their incentives from the U.S. Treasury, in the form of lower taxes, instead of from the market place.

Let us look at the consequences of low oil prices:

(a) In the first place low oil prices discourage production of alternative fuel sources. One of the worst features of percentage depletion and expensing of intangibles is that they provide a highly discriminatory incentive between energy sources. The tax benefits for oil and gas are equivalent to about 13 percent of the price of oil and gas delivered to an electric company. The tax benefits for uranium are about 5 percent of the delivered fuel price. For coal they are about 4 percent. For oil or gas manufactured from coal they will be about 1 percent. For solar energy they are zero.

A policy to discriminate between fuels in this way is not a sensible energy policy, it is only a relief program for oil producers and oil land owners.

(b) In the second place low oil prices encourage consumption. There is no solid evidence that papers out of Washington are going to change consumption habits. There is a great deal of evidence that prices do change consumption habits. That is what free markets are all about. The difference in gasoline consumption of U.S. and European cars is not just a matter of differences in tastes between the U.S and Europe; it is a matter of gasoline prices, which due to taxes have been twice as high in Europe as in the U.S. With high prices people consume less.

(c) Finally, I come to the low price effect which is politically important. Low prices for oil seem to provide a benefit to consumers, and high prices seem to provide a transfer of real income to energy producers. This problem, however, can be easily solved by the Congress. The solution is to tax the producers and provide tax reliefs to consumers.

One way to provide the relief would be to provide in the tax law an energy-price refundable credit of, say, $ 50 per person, or $ 200 for a family of four. The credit should be paid in cash to non-taxable families. The feature of this credit is that the money would be paid irrespective of outlays on energy. Each family would be faced with real market prices when it bought energy and it would have the usual market incentives to cut consumption. There are other ways to restore the lost purchasing power of consumers, such as a combination of income tax cuts plus welfare increases. The relief could be limited to low and lower middle income families.

The other part of the income transfer matter is taxes on the companies. The first priority should go to immediate repeal of percentage depletion, and the elimination of the expensing of intangible drilling expenses on successful wells. This simply puts the tax system on natural resource income on all fours with the tax system on other businesses.

The basic illogic of a low tax on natural resource income can be seen by considering the whole matter of substitutes. If an ingenious manufacturer can find a way to use a valueless raw material like dirt and manufacture it into a valuable resource, he gets little or no tax benefit because his value added comes from manufacture. The producer who gets the same end product by extracting a valuable natural resource and depleting our long run supply is rewarded by lower taxes. This is absurd!

Beyond repealing the special tax benefits for natural resources, there should be some sort of windfall profits tax. Notice that so far as the producer is concerned a price ceiling of $ 5.25 on old oil when the market price of oil is $ 10.00 is no different from repealing the price ceiling and imposing a $ 4.75 windfall excise tax on "old" oil. The windfall tax has the advantage of exposing consumers to the real price for more oil, and it provides revenue for an income transfer to low income consumers.

It is important to see precisely how this tax-transfer, free-price arrangement is different from price control on the consumer side. When we try to help consumers by lowering the price, then the consumer benefits only by consuming more energy and he benefits in proportion to the energy use. The Cadillac driver benefits far more than the driver of an economy car. We can help consumers' purchasing power by things like tax reduction without confusing them about the real price of energy and without encouraging the purchase of heavy cars.

From the national standpoint oil should only be used when its use is worth to the consumer more than $ 10 to 11 a barrel. More energy use means more imports and to import oil we have to give up exports of resources worth $ 10 to 11.

If you impose a windfall tax on oil, I would argue strongly against a plow-back credit for reinvestment. With freer prices the energy industry will attract new investment. The plow-back approach is like a selective subsidy to new investment, one that only goes to firms that are already making windfall profits from selling old oil. This is no more than an invitation to these firms to dominate the expanding energy industry.

Finally on oil, I would argue strongly against retaining the depletion allowance for the first 3,000 barrels of oil per day per producer. Even with the present average market price of slightly over $ 7, this size firm has oil production receipts of $ 7.7 million! Furthermore, even the $ 7 price is exactly twice as high as the price a year ago! If you want to help "small" business, it would be far more sensible to lower taxes for small steel plants, or small equipment manufacturers. This so-called small business relief would be a welfare hand-out for some very big and very, very prosperous firms.

Foreign Tax Credit

I do not favor repeal of the foreign tax credit. Very simply, I do not believe that U.S. companies that operate across international borders should pay higher income taxes because of U.S. action than companies that operate at home. I would like international borders to become less important in the world rather than more important.

At the same time I think the appropriate U.S. position should be that U.S. based companies should not pay lower income taxes than companies that stay at home. It is a reasonable position for the U.S. to permit, as most other countries do, capital to flow abroad when the before tax rate of return is higher abroad. In terms of market economics, a higher before tax rate of return is the measure of need for capital.

What is bad from both the standpoint of world economics and from the standpoint of U.S. interest is to encourage capital to flow abroad when foreign investment is economically less efficient, i.e., expects lower before-tax profit, than domestic capital. This result can come about when the taxes on foreign business are lower than those on domestic business.

This relative treatment of foreign and domestic investments by U.S. firms is the important comparison. In general, it is not important to the U.S. if U.S. firms pay higher taxes in a foreign situation than some foreign companies. If foreign countries don't want our capital, then we have ample use for it.

Since this notion is very persistent that the tax on U.S. firms abroad should be no higher than the tax on foreign firms in the same market areas, let me suggest a way of looking at it. Assume that Germany decides to extend a 50 percent tax abatement, we can call it percentage depletion, to firms making computers. This should produce over-investment in the computer business, which is why we have not adopted a silly rule like this in the U.S. The question is should we adapt U.S. law to encourage U.S. firms to engage in this over-investment in the computer business? The answer is clearly, "No!" If Germany wants to waste part of its capital this way, the U.S. should not be imitators.

The implications of a rigid insistence that a U.S. firm should pay as high taxes on foreign business as on U.S. business are fairly straightforward. They are:

(a) we should terminate deferral for all foreign business;

(b) we should treat the first 5 points of foreign taxes as deductible, not creditable, on the grounds that this is a typical state income tax paid in the U.S.;

(c) foreign losses should be carried forward against foreign income in computing the limitation on the foreign tax;

(d) assuming the foreign loss rule is adopted, the optional overall limitation in the foreign tax credit should be repealed; and

(e) the Western Hemisphere Trade Corporation provisions should be repealed.

DISC

There is no justification for continuing the preferential treatment of export operations involved in DISC. We have internationally a more or less effective system of variable exchange rates and these can provide balance of payments adjustments.

With the cost of DISC approaching a billion dollars, the evidence is that exports are not sufficiently price elastic to make export subsidies an efficient measure.

More fundamentally, exports are in themselves inflationary as we have seen from the jump in food exports. They use up national resources which otherwise could be used to bring down domestic prices. It is a sensible policy to rely on the market system, that is, to let imports and exports flow when they can provide goods and services at less than domestic prices, but there is no need to make exports artificially cheaper by subsidies.

It should be a matter of concern to this Committee that export business tends to be highly concentrated in very large firms.

It throws a great deal of light on DISC to explore the connection between that tax relief and devaluation of the dollar. The 15 percent devaluation in 1971-72, as you know, followed from the suspension of gold payments that was announced in the same message in which President Nixon urged DISC on the Congress.

Consider what devaluation means in terms of exports. Devaluation of the dollar does not immediately change foreign markets. Let's say American exporters were selling widgets in France before devaluation and were more or less in competition with European widget makers at a price of 200 francs. Before devaluation a widget sold in France for 200 francs would convert to about $ 10. After devaluation the sale proceeds of 200 francs would convert to $ 11.50.

Exporters were in Fat City. They got 15 percent more dollars for doing what they were going to do anyway. All this and tax reduction, too. This is just like giving percentage depletion to companies with windfall oil profits.

It was to be expected that as a result of devaluation U.S. exports would rise and the larger supply would bring about a lower price eventually, but look at what happened in 1972.

It turned out that DISC cost twice as much as Treasury estimated. (I can comment on this because I helped make the estimate.) We estimated the revenue cost by first predicting the level of exports and the portion that would go through DISC's. Then we applied the standard U.S. profit to sales ratio of 8 percent to calculate the profit that would qualify for deferral. The export sales and the portion of DISC's was about right.

The major forecast error, as revealed by Treasury's first annual report on DISC, was that the profit rate on DISC sales was not 8 percent, but 15 percent, virtually twice the average U.S. profit rate. DISC is tax relief for a super profitable sector of business. In competition some of this extra profitability goes into price reduction, for world wide customers of U.S. exports. It escapes me why we are anxious to subsidize this group.

Capital Gains

I would like to bring it to the attention of this Committee that in all the current talk of tax reform amendments, there is little attention being given to the most important problem of all, unrealized appreciation transferred by death or gift.

An estate tax is no substitute for a tax on capital gains at death. For the taxpayer who has accumulated wealth from dividends, profits, salary or rents, there is an income tax as the money comes in and an estate tax on what is accumulated after tax. The estate tax is, so to speak, a delayed addition to lifetime income taxes. When wealth is accumulated as unrealized appreciation of capital, however, there is no lifetime income tax.

This is the root of the capital gain problem. A taxpayer with appreciated assets has a simple alternative to paying a capital gains tax on realized gains, she can simply not sell. On the face of things, not selling is a very rational procedure for an investor. When she sells, she will obtain a price that the market thinks the stock is worth. When she reinvests she can buy things at prices that the market thinks they are worth. There is sure to be a loss in the turnover to cover the capital gains tax. For the investor to win, he has to outguess the market both times. If he has other sources of income, a very rational investment strategy is to not sell at all, and this strategy becomes even more attractive as the tax on realized capital gains rises. All of this changes dramatically if we provide that the tax on capital appreciation will be paid ultimately whether or not there is a realization.

Taxing gains on transfer at death or gift is both fair and efficient. It is, however, an involved matter that must be worked out carefully, and attention must be given to how the revenues will be used (to reduce estate rates, to reduce high bracket individual rates, or otherwise), and attention must be given to the important transition measures.

The most valuable single thing that this Committee could do to improve the tax system is to undertake a serious study of the problem of gains at death. One very simple dimension of this problem is that the usual statistics on income distribution greatly understate the degree of income concentration. There must be enormous increases in wealth among the very wealthy that are not reported because they are not realized. This is, I think, one important explanation of why we have little change in wealth concentration over time despite what purports to be a progressive tax system.

I believe that basic work on this problem is more urgent than short run fooling around with tax on realized gains.

[Whereupon, at 12:20 p.m., the committee recessed, to reconvene at 2:30 p.m. the same day.]

AFTERNOON SESSION

Senator HARTKE [presiding]. Good afternoon. We will continue these hearings.

Mr. Gilbert G. Roessner, president of the National Savings & Loan League.

STATEMENT OF GILBERT G. ROESSNER, PRESIDENT, NATIONAL SAVINGS & LOAN LEAGUE, ACCOMPANIED BY WILLIAM F. McKENNA, GENERAL COUNSEL AND VICE PRESIDENT, NATIONAL SAVINGS & LOAN LEAGUE

Mr. ROESSNER. Thank you, Mr. Chairman. My name is Gilbert G Roessner. I am president of the National Savings & Loan League and president of City Federal Savings & Loan Association, Elizabeth, N.J.

With me is William F. McKenna, general counsel of the National Savings & Loan League.

Mr. Chairman, I appreciate the opportunity to appear before the committee on behalf of the national league on the general question of tax preference legislation, proposals which must be taken in the context of the impact that increased taxation of savings and loan associations will have on the availability of housing funds to our citizens.

SAVINGS AND LOAN INDUSTRY AND MINIMUM TAX PROPOSALS

Based on Internal Revenue Service data, the minimum tax today raises some $500 million per year in revenues. Of this total, corporations account for about 60 percent.

Several changes in the minimum tax have been suggested in the Congress and by the administration as a result of large numbers of taxpayers with high incomes being able to shelter this income from the Federal income tax.

The changes most commonly suggested by reform proponents fall into three areas: one, reduction or elimination of the $30,000 exemption; two, elimination of the deduction for regular taxes paid; and three, increasing the minimum tax rate in some fashion.

One proposal made in the Congress last year would have made changes in all three of these areas, by reducing the $30,000 exemption to $10,000, by eliminating the deduction and carryover provisions, and by raising the minimum tax rate from the current 10 percent to one-half the rate of the regular income tax.

Another proposal would have eliminated the $30,000 exemption completely.

The administration, in its proposals for tax change, made last April, recommended the present minimum tax be retained for corporations and mutual organizations, but that major changes be made for individual taxpayers.

Mr. Chairman, the National Savings & Loan League would like to address itself to the question of the tax preference items insofar as they affect the savings and loan industry, also our competition with the commercial banking industry, and the impact of savings and loan taxation on the housing and home finance markets.

To evaluate the effects of the existing minimum tax, as well as proposed changes in it on competing financial intermediaries, we have prepared two tables, 1 and 2, which are attached to my statement. I would like to have these tables entered as a part of the record of these hearings.

Senator HARTKE. They will be entered.

Mr. ROESSNER. In table 1, a comparison is presented of the impact of the current minimum tax on commercial banks, savings and loan associations, and mutual savings banks.

What this table shows is that savings and loan associations have nearly twice as much preference income, so-called preference income as do commercial banks, and more than six time that of mutual savings banks.

The reason for this is clear, Mr. Chairman. It is because the savings and loan associations' additions to loss reserves in excess of experience is included as a preference item in the minimum tax base, while the interest on State and local tax exempt bonds is not included.

And, of course, the commercial banks have become heavy investors in tax-exempt bonds largely because of the tax breaks these investments afford them.

Basically, because of the allowance for deduction of regular taxes, commercial banks are able to reduce the minimum tax base to 8.8 per cent of their preference income, compared with a startling 49.4 percent and 51.6 percent for savings and loan associations and mutual savings banks, respectively.

As a consequence of this, savings and loan associations are paying 12.5 times as much tax under the provisions of the minimum tax as do commercial banks, although our preference income is slightly less than twice that of commercial banks.

What this results in, Mr. Chairman, is that savings and loan associations are paying effective rates on preference income of between 4.8 and 5 percent, compared with an effective rate of between 0.7 and 0.8 percent for commercial banks.

The minimum tax consequences to thrift institutions have thus been a major factor in changing the longstanding pattern of effective tax rates between savings and loan associations and commercial banks.

That pattern, until 1969, provided thrift institutions with a tax rate advantage over banks because our industry was heavily committed to the housing market.

The 1969 Tax Reform Act changed all that, and the minimum tax was and is partially responsible for that change.

In the period since the 1969 act, commercial bank tax rates have been declining steadily, while the tax rate for savings and loan associations has been climbing.

Today, in fact, savings and loan associations, even though we must still place the vast bulk of our funds into low-yielding home loans, are paying a much higher effective tax rate than are commercial banks.

Mr. Chairman, the minimum tax aided in eliminating this differential, this aid, if you will, to homebuyers.

We in the savings and loan industry, who are charged with providing money to the Nation's homebuyers, obviously feel this is discriminatory against the homebuyer. And, taken a step further, any additional increases in the taxation of savings and loan associations merely will aggravate the problem of consumers trying to find mortgage money at reasonable rates of interest.

Table two provides an example of how this picture might be affected under certain revisions in the minimum tax which have been suggested in various congressional proposals.

The table examines the relative tax burdens of savings and loan associations, commercial banks, and mutual savings banks, based on proposed changes in the minimum tax along the lines suggested by Congressmen Reuss and Vanik.

The overall effect on the three intermediaries of eliminating the deduction for regular taxes, reduction of the exclusion allowance, and increasing the rate to one-half of the corporate rate would be to establish equal effective rates of maximum tax for all three at 23.5 percent.

But it should be stressed that this would be true with regard to the minimum tax only.

It would not apply to the total Federal tax, and it is the total picture which must be looked at because of the special restrictions upon investments by thrift institutions.

In this proposal, moreover, the rates are equal across a narrowly defined preference income base, as defined in the provisions of the existing minimum tax.

For savings and loan associations, the minimum tax under such a change would increase to $103 million, as compared with the $21 million today.

Mr. Chairman, that is $82 million dollars that will not be used for home financing.

The increase is equal to 56 percent of current income taxes, and represents a net tax increase of about 45 percent. Mutual savings banks would be similarly affected, having their tax increased by nearly 38 percent.

Now, by comparison, Mr. Chairman, commercial banks, which admittedly would find the minimum tax payments they make substantially increased, would hardly feel the impact insofar as their total tax bill is concerned.

In fact, the increase in their total tax bill would be somewhat less than 4 percent.

That's 4 percent to them, 45 percent to savings and loan associations.

The inequity of this, again in terms of the restrictive capacity of thrift institutions, seems quite obvious.

In other words, Mr. Chairman, the impact of the minimum tax on savings and loan associations has been twofold: first, to help to increase our effective rate of Federal tax to a point far above that of commercial banks, our chief competitors; second, to decrease the attractiveness for savings and loan associations to hold qualified assets. and by that I mean home mortgage loans, and to increase the attractiveness for our associations to move into other income producing nonqualifying assets.

Now, most of the major changes in the minimum tax which have been proposed would accentuate this, and in our view the real loser here is the homebuyer who will find it increasingly difficult to secure home mortgage funds at reasonable rates of interest.

As regards the more general issues of tax equity and tax neutrality within the context of competing intermediaries, we believe several important factors stand out.

With respect to tax equity, the minimum tax as enacted in the 1969 Reform Act has succeeded in increasing the effective tax rates of savings and loan associations by two to three percentage points.

Between competing financial institutions, the effect has been to increase the gap which currently exists between commercial banks and savings and loan associations.

Proposed changes in the minimum tax would only increase this divergence in favor of commercial banks, since they are to a great extent excluded from the impact of the minimum tax because a major tax preference item, income on tax exempt securities, is not included as a preference item in the minimum tax base.

On the other hand, the primary tax preference of savings and loan associations is included in this base, namely, additions to bad debt reserves in excess of experience.

Since initially all recommended changes in the existing minimum tax involve either alterations in the rates or variations in existing exemptions on deductions, and not changes in what constitutes preference income for purposes of the tax, the data shows clearly that any pretense of either establishing or even maintaining tax equity between commercial banks and savings and loan associations by these changes is false, and would in fact have just the opposite effect.

We are dealing here, Mr. Chairman, with a situation of apples and oranges. And while you can set so-called equal rates on minimum tax, so long as our chief competitior has a major preference item not included in the base for computing the tax, and our associations' major preference item is indeed in the base, then equity simply cannot be found.

As to neutrality considerations, the one overriding consequence of changes in the Federal income tax structure which has resulted from both the minimum tax and reductions in the bad debt allowance is that incentives for intermediaries to hold so-called qualified assets such as residential mortgages have been significantly reduced.

There is in fact evidence to indicate that these changes have brought about a decrease in such assets held by savings and loan associations.

The National Savings and Loan League has been conducting an in-depth study into financial institution taxation, and the data gathered so far by the Georgetown University economists retained to undertake the study suggest this shift in thrift institution portfolio investments.

The degree and recent experience of these portfolio changes cannot be assessed at this time, but we would hope to be able to provide the committee with such data as soon as possible.

Finally, Mr. Chairman, one must regard the minimum tax and its proposed changes with a certain amount of skepticism.

Under the guise of tax equity, the minimum tax was intended to subject to tax that income which escaped regular taxation. In fact, the original proposals of the Treasury Department in 1969 would have been fairly successful in accomplishing this among individual taxpayers.

However, the version of the minimum tax which was ultimately legislated fails on the equity count in various ways.

First, many preference income items which should be included in the tax base have been excluded.

Second, many income items were included which are tax deferrals; not tax exemptions, with no recapture provisions.

Third, the minimum tax we feel discriminates against thrift institutions vis a vis commercial banks, an inequity which does not seem to be justified on the basis of the impact on the regular income tax.

Fourth, the impact of the minimum tax, and suggested revisions, on the mortgage market appears to conflict with stated congressional policy toward housing.

Minimum tax legislation which would raise the rates and reduce or eliminate existing deductions, without changing preference items included in the base, would increase the incentive for thrift institutions to reduce further their investments in residential mortagages.

This, I submit, is not in the public interest.

Mr. Chairman, the minimum tax is one cog in the Federal revenue wheel. To date, however, it has not done the job it set out to do. If changes are inevitable in the minimum tax, I earnestly hope that the Congress will not discriminate further against the Nation's homebuyer.

When it come right down to it, that's precisely what the Congress did when it included the bad debt additions to reserves in the base while excluding a major preference income item for our biggest competitor.

Mr. Chairman, we appreciate the opportunity to appear today. Thank you very much.

Senator HARTKE. All right, thank you, sir.

If we got away from the minimum tax and just eliminated some of the tax exemptions such as those for municipals would that be a better way to attack this whole problem?

Mr. ROESSNER. Well, at least in terms of tax neutrality or tax equity as between significant competitors, commercial banks and savings and loans, that would go a long way. In terms of the public policy, there are other considerations.

Senator HARTKE. Are you advocating the restoration of comparable treatment for commercial banks and savings and loans? Are you suggesting we add tax-exempt interest to the list of tax preferences or a minimum tax?

Mr. ROESSNER. Well, certainly I would, except that I do not see the rationale in the bad debt allowance being included in the preference tax base to begin with. After all, it is a tax deferral, Senator. It is not income that is free of the taxation consequences. It is designed to build up a bad debt reserve that can only be used to absorb losses and to free up that reserve would become a tax consequence.

Senator, really from my own experience around the country in talking about this subject with savings and loan people, it is incredible that they are aware of the increase in tax burden on their net income, but this so-called preference income is a term that much of our industry does not really understand. We wonder why it is called preference income, whereas roughly 50 percent of the income of commercial banks is derived from tax-exempt securities, and that is not considered preference income for purposes of taxes.

Senator HARTKE. All right. I want to thank you for your testimony.

Mr. ROESSNER. Thank you, sir.

[The prepared statement of Mr. Roessner follows:]

Statement of

Gilbert G. Roessner, President,

National Savings and Loan League

Before the

Senate Finance Committee

June 10, 1974

Mr. Chairman, members of the Committee, my name is Gilbert G. Roessner. I am President of the National Savings and Loan League and President of City Federal Savings and Loan Association, Elizabeth, New Jersey.

I appreciate the opportunity to appear before the Committee on behalf of the National League on the general question of tax preference legislation--proposals which must be taken in the context of the impact that increased taxation of savings and loan associations will have on the availability of housing funds to our citizens.

Based on Internal Revenue Service data, the minimum tax today raises some $500 million per year in revenues. Of this total, corporations account for about 60 per cent.

Several changes in the minimum tax have been suggested in the Congress and by the Administration as a result of large numbers of taxpayers with high incomes being able to shelter this income from the Federal income tax.

The changes most commonly suggested by reform proponents fall into three areas:

1) Reduction or elimination of the $30,000 exemption.
2) Elimination of the deduction for regular taxes paid.
3) Increasing the minimum tax rate in some fashion.

One proposal made in the Congress last year would have made changes in all three of these areas, by reducing the $30,000 exemption to $10,000...by eliminating the deduction and carryover provisions...and by raising the minimum tax rate from the current 10 per cent to one half the rate of the regular income tax.

Another proposal would have eliminated the $30,000 exemption altogether.

The Administration, in its proposals for tax change, made last April, recommended the present minimum tax be retained for corporations and mutual organizations, but that major changes be made for individual taxpayers.

Mr. Chairman, the National Savings and Loan League would like to address itself to the question of the tax preference items insofar as they affect the savings and loan industry, our competition in the commercial banking industry, and the impact of savings and loan taxation on the housing and home finance markets.

To evaluate the effects of the existing minimum tax, as well as proposed changes in it on competing financial intermediaries, we have prepared two tables, one and two, which are attached to my statement. I would like to have these tables entered as a part of the record of these hearings.

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And, of course, the commercial banks have become heavy investors in tax exempt bonds largely because of the tax breaks these investments afford them.

Basically, because of the allowance for deduction of regular taxes, commercial banks are able to reduce the minimum tax base to 8.8 per cent of their preference income, compared with a startling 49.4 per cent and 51.6 per cent for savings and loan associations and mutual savings banks, respectively.

As a consequence of this, savings and loan associations are paying 12.5 times as much tax under the provisions of the minimum tax as do commercial banks, although our preference income is slightly less than twice that of commercial banks.

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The minimum tax consequences to thrift institutions have thus been a major factor in changing the long-standing pattern of effective tax rates between savings and loan associations and commercial banks.

That pattern until 1969 provided thrift institutions with a tax rate advantage over banks because our industry was heavily committed to the housing market.

The 1969 tax reform act changed all that--and the minimum tax was and is partially responsible for that change.

In the period since the 1969 Act, commercial bank tax rates have been declining steadily, while the tax rate for savings and loan associations has been climbing.

Today, in fact, savings and loan associations--even though we must still place the vast bulk of our funds into low yielding home loans--are paying a much higher effective tax rate than are commercial banks.

Mr. Chairman, members of the Committee, the minimum tax aided in eliminating this differential...this aid, if you will, to homebuyers.

We in the savings and loan industry, who are charged with providing money to the nation's homebuyers, obviously feel this is discriminatory against the homebuyer. And, taken a step further, any additional increases in the taxation of savings and loan associations merely will aggravate the problem of consumers trying to find mortgage money at reasonable rates of interest.

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Now, by comparison Mr. Chairman, commercial banks, which admittedly would find the minimum tax payments they make substantially increased, would hardly feel the impact insofar as their total tax bill is concerned.

In fact, the increase in their total tax bill would be somewhat less than four per cent.

That's four per cent to them...45 per cent to savings and loan associations.

The inequity of this, again in terms of the restrictive lending capacity of thrift institutions, seems quite obvious.

In other words, Mr. Chairman, the impact of the minimum tax on savings and loan associations has been twofold:

1) To help to increase our effective rate of Federal tax to a point far above that of commercial banks--our chief competitors.

2) To decrease the attractiveness for savings and loan associations to hold qualified assets--and by that I mean home mortgage loans--and to increase the attractiveness for our associations to move into other income producing nonqualifying assets.

Now, most of the major changes in the minimum tax which have been proposed would accentuate this--and in our view the real loser here is the homebuyer who will find it increasingly difficult to secure home mortgage funds at reasonable rates of interest.

As regards the more general issues of tax equity and tax neutrality within the context of competing intermediaries, we believe several important factors stand out:

With respect to tax equity, the minimum tax as enacted in the 1969 Reform Act has succeeded in increasing the effective tax rates of savings and loan associations by two to three percentage points.

Between competing financial institutions, the effect has been to increase the gap which currently exists between commercial banks and savings and loan associations.

Proposed changes in the minimum tax would only increase this divergence in favor of commercial banks, since they are to a great extent excluded from the impact of the minimum tax because a major tax preference item, income on tax exempt securities, is not included as a preference item in the minimum tax base.

On the other hand, the primary tax preference of savings and loan associations is included in this base--namely, additions to bad debt reserves in excess of experience.

Since initially all recommended changes in the existing minimum tax involve either alterations in the rates or variations in existing exemptions on deductions, and not changes in what constitutes preference income for purposes of the tax, the data shows clearly that any pretense of either establishing or even maintaining tax equity between commercial banks and savings and loan associations by these changes is false, and would in fact have just the opposite effect.

We are dealing here, Mr. Chairman, with a situation of apples and oranges. And while you can set so-called equal rates on minimum tax, so long as our chief competitor has a major preference item not included in the base for computing the tax, and our associations' major preference item is indeed in the base, than equity simply cannot be found.

As to neutrality considerations, the one over-riding consequence of changes in the Federal income tax structure which has resulted from both the minimum tax and reductions in the bad debt allowance is that incentives for intermediaries to hold so-called qualified assets such as residential mortgages have been significantly reduced.

There is in fact evidence to indicate that these changes have brought about a decrease in such assets held by savings and loan associations.

The National Savings and Loan League has been conducting an in-depth study into financial institution taxation, and the data gathered so far by the Georgetown University economists retained to undertake the study suggests this shift in thrift institution portfolio investments.

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Finally, Mr. Chairman, one must regard the minimum tax and its proposed changes with a certain amount of skepticism.

Under the guise of tax equity, the minimum tax was intended to subject to tax that income which escaped regular taxation. In fact, the original proposals of the

Treasury Department in 1969 would have been fairly successful in accomplishing this among individual taxpayers.

However, the version of the minimum tax which was ultimately legislated fails on the equity count in various ways.

First, many preference income items which should be included in the tax base have been excluded.

Second, many income items were included which are tax deferrals; not tax exemptions, with no recapture provisions.

Third, the minimum tax we feel discriminates against thrift institutions vis a vis commercial banks--an inequity which does not seem to be justified on the basis of the impact on the regular income tax.

Fourth, the impact of the minimum tax--and suggested revisions--on the mortgage market appears to conflict with stated Congressional policy towards housing.

Minimum tax legislation which would raise the rates and reduce or eliminate existing deductions--without changing preference items included in the base--would increase the incentive for thrift institutions to reduce further their investments in residential mortgages.

This, I submit, is not in the public interest.

Mr. Chairman, members of the Committee, the minimum tax is one cog in the Federal revenue wheel. To date, however, it hasn't done the job it set out to do. If changes are inevitable in the minimum tax, I earnestly hope that the Congress will not discriminate further against the nation's homebuyer.

You know, when it comes right down to it, that's precisely what the Congress did when it included the bad debt additions to reserves in the base while excluding a major preference income item for the savings and loans' biggest competitor.

I appreciate the opportunity to appear today. Thank you very much.

TABLE 1

A Comparison of Minimum Tax Items: Commercial Banks, Savings and Loan Associations and Mutual Savings Banks[a]

Item	Savings & Loan Associations	Commercial Banks	Mutual Savings Banks
Gross Preference Income[b]	$438.3	$228.3	$70.2
Net Preference Income[c]	216.7	20.1	36.2
Net Preference Income as Percent of Gross Preference Income	49.4%	8.8%	51.6%
Minimum Tax[d]	$21.4	$1.7	$3.5
Minimum Tax as Percent of Gross Preference Income	4.88%	.74%	4.98%
Minimum Tax as Percent of Total Taxes Paid	11.60%	.12%	9.95%

[a] Source: <u>Corporation Source Book</u>, 1970-71, Internal Revenue Service Department of the Treasury, Washington.

[b] In millions of dollars; gross preference income defined as preference income according to Sec. 57 of the IRS Code regarding the minimum tax.

[c] In millions of dollars; gross preference income less exclusion allowance and deductions for regular taxes paid.

[d] In millions of dollars; differences in these figures and 10 percent of the corresponding entry in line 2 are due to deferred taxes resulting from carryover provisions.

TABLE 2

Impact of the Reuss-Vanik Amendment Upon Federal Income Taxes of Commercial Banks, Mutual Savings Banks and Savings and Loan Associations[a]

Item	Savings & Loan Associations	Commercial Banks	Mutual Savings Banks
Minimum Tax under Present Law[b]	$21.4	$ 1.7	$ 3.5
Minimum Tax under Reuss-Vanik Amendment (R-V)[b]	103.0	53.7	16.5
R-V Minimum Tax as % of Gross Preference Income	23.5%	23.5%	23.5%
R-V Minimum Tax as Percent of Total Taxes Paid	56.0%	4.0%	47.0%
Percent Increase (Net)[c] in Total Taxes Under R-V Amendment	45.1%	3.9%	37.9%

[a] Sources: "Analysis of Reuss-Vanik Minimum Tax Amendment", prepared by the Staff of the Joint Committee on Internal Revenue Taxation, November, 1973;

Corporation Source Book

[b] In millions of dollars

[c] Minimum tax increase in excess of present minimum tax.

Senator HARTKE. Mr. Wallace Woodbury and Myron C. Roberts for the National Association of Realtors.

STATEMENT OF WALLACE WOODBURY, CHAIRMAN OF FEDERAL TAXATION SUBCOMMITTEE, REALTORS' LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS, ACCOMPANIED BY MYRON C. ROBERTS, CHAIRMAN, REALTORS' LEGISLATIVE COMMITTEE; RICHARD TROTTER, LEGISLATIVE COUNSEL, NATIONAL ASSOCIATION OF REALTORS; AND STEPHEN BODZIN, SPECIAL TAX COUNSEL

Mr. WOODBURY. Thank you, Mr. Chairman.

On behalf of the National Association of Realtors, we appreciate this opportunity to testify an certain tax increase proposals now pending for Senate consideration.

I am Wallace R. Woodbury from Salt Lake City, Utah, chairman of the Federal Taxation Subcommittee of the Realtors' Legislative Committee. Accompanying me today on my left immediately is Mike Roberts from Newton, Mass., chairman of the Realtors' Legislative Committee, and on his left, Mr. Richard Trotter who is National Association of Realtors' legislative counsel, and on my right, Mr. Stephen Bodzin, our special tax counsel.

The National Association of Realtors represents more than 500,000 individuals and business entities engaged in every aspect of the real estate industry.

ADVERSE EFFECTS OF MINIMUM TAX PROPOSALS ON THE REAL ESTATE INDUSTRY

The present state of the real estate economy and the haphazard procedure involving potential changes to the tax system prompts us to present our views concerning a proposed Senate floor amendment to increase the existing minimum tax and to make other changes in the tax law. Some proposals involving the minimum tax would lower the $30,000 exemption to $10,000; eliminate the deduction for regular income taxes and related tax carryovers; and increase the rate from the current flat 10-percent rate to as much as one-half of the regular income tax rates.

Before going into these proposals and other similar proposals which would adversely affect the real estate industry and the economy, we believe it incumbent to inform the committee of the current state of the real estate economy and the many other special problems facing that industry at this time.

The current economic situation of the real estate industry is chaotic as a result of the current inflationary spiral in costs of construction, record high interest rates, and the serious shortage of mortgage credit, and the cost of mortgage money when it is available, and then such relatively new factors as the community concern with the improvement of the environment and its related costs. These and other such factors tend to cause problems never before experienced by our industry. Since the real estate industry must be able to solve these complex and very costly nontax problems in order to continue to function, it is less able than many other industries to suffer the additional disadvantage of haphazard, ill-considered and ill-conceived changes in the tax laws. As we have noted frequently in the past, the mere discussion of such changes has an adverse effect on the ability of the industry to make the long-range plans, decisions, and commitments which are necessary for day-to-day activities.

Real estate development involves extremely high risks and long advance planning time with minimum ultimate liquidity. It is a fiction to assume that real estate gets a fair return in relation to the risk, plus tax shelter. Supposed tax shelter or capital recovery are measurable elements of internal rate of return contemplated in competing for investment capital.

We urge the Senate to consider legislation affecting the real estate industry within the context of today's serious declines in housing starts, construction permits, and slumping real estate sales. Also, the Senate should make clear that any proposed changes will operate only prospectively so that the changes will not interfere with the bona fide advance arrangements which must be made in order for the real estate industry to properly function and to avoid stagnation. Finally, we request that the Senate not impose any changes in the tax laws which would discriminate against the real estate industry and in favor of other industries.

The 1969 and 1971 tax changes were heavily weighted against real estate and substantially shifted the progressivity of the tax burdens. It would be most unfortunate if changes aimed at a very few taxpayers should upset a very delicate balance and further discriminate against an already depressed and most vital industry.

Our association has found undesirable and therefore opposes the Treasury Department proposal made last year for a limitation on artificial accounting losses, termed LAL, and for a minimum taxable income, termed MTI, because these proposals would again particularly discriminate against the real estate industry.

The proposed Senate floor amendments to increase the minimum tax on tax preferences would adversely affect real estate and we very strongly oppose them.

On the other hand, the existing minimum tax, despite its many imperfections, has now become a familiar part of the law. If changes are in fact considered essential, the minimum tax as presently constituted may perhaps present an approach that does the least harm. However, if the Senate considers changes to the minimum tax, we feel it is essential that the inherent nature of the tax not be changed, and that its present burdensome imperfections be recognized. For example, the Senate should recognize that the present list of tax preference items is not complete, and that by omitting other preference items, this tax becomes heavily weighted against the real estate industry.

There are many other imperfections in the present minimum tax, such as the failure to provide a proper adjustment to tax bases for depreciation subject to the tax. The need for correcting these imperfections would become even more essential if the present rate of the tax were to be increased, thereby magnifying the burden resulting from the imperfections inherent in the present law. We urge that there be no change in the rate structure of the minimum tax.

Furthermore, any change in the minimum tax should not remove the present deduction of the regular income tax paid for the current year, which is allowed in computing items subject to tax. This deduction is essential in order for this to remain in fact a "minimum tax." If this deduction is now allowed, the minimum tax would then clearly become a "surcharge" or "surtax." Such result would be dramatically inconsistent with the stated purpose of the original enactment of the minimum tax, which was to assure that everyone paid some tax.

In connection with the minimum tax we also note that there has been some discussion of including certain construction period deductions as items of tax preference. As you know, the Treasury also included construction period items in its LAL recommendation to the House Ways and Means Committee last year. The experience of our industry is that the current deduction of these construction period expenses must be continued if risk capital is to be available for development, new construction, rehabilitation, maintenance and repair. To change this traditional treatment would increase cost and initial equity capital requirements during the predevelopment and development period when the risks are the greatest, thus discouraging capital investment and increasing rents. The alternative to risk capital would be direct Government subsidies, and our experience has shown that the Nation is better served when risk capital is furnished by the private sector, rather than through direct Government subsidies.

In reviewing the minimum tax and related tax changes made in recent years, the Senate should consider the fact that the adverse provisions enacted for so-called excess investment interest do not achieve the purpose for which these provisions were intended. These provisions have the unusual effect in the real estate industry of discriminating against the small or the new entrepreneur and in favor of corporations and established investors. Furthermore, these provisions create administrative complexities of unusual difficulty. If the Senate plans to make changes in existing laws, we believe the original policy of the Congress would be better served by an outright repeal of these provisions.

The National Association of Realtors has considered the proposals for a general revenue reduction at this time. We strongly oppose this action because it would contribute to the present inflationary spiral. The inflation we are presently experiencing has had the effect of reducing the supply of funds necessary for a healthy real estate industry. Therefore we must oppose a general revenue reduction at this time.

We would ask that our written statement be incorporated into the record, Mr. Chairman, and we would be pleased to discuss further any of the foregoing matters with the committee or members of the staff, or submit additional information if we can be helpful in that regard.

We appreciate the opportunity of appearing here today.

Senator HARTKE. All right, your entire statement will appear in the record.

Senator HARTKE. Do you feel that the minimum tax provisions have been a material contributing factor to the present decline in the real estate business?

Mr. WOODBURY. I think that the determination to invest capital in a real estate venture is the sum total of all components of yield which are generally reflected in what we would call the internal rate of return. The minimum tax is a factor which has decreased that yield, particularly in regard to real estate those cases where anyone has taken any accelerated depreciation or where they sell and there is capital gains income. As result, I think it has been a depressant.

Now, we favored the minimum tax concept, Mr. Chairman, in 1969 on this condition, that it have a very broad base. We agree with the savings and loan people that unfortunately when many areas were excluded from the base, it became a very discriminatory thing, intended to shift investment out of real estate and toward other capital markets because of its impact on real estate.

Senator HARTKE. It is a major factor or just one of many factors?

Mr. WOODBURY. I think it is a substantial factor.

GENERAL REVENUE REDUCTION DISCUSSED

Senator HARTKE. Let me go into a more generalized operation.

On page 6 you say "the National Association of Realtors has considered the proposals for a general revenue reduction at this time. We strongly oppose this action because it would contribute to the present inflationary spiral."

On what evidence do you base that?

Mr. WOODBURY. We are in a position where we are unable to get money because of the demands for capital. We are of the opinion that making more money available in terms of reducing Federal revenue, should that happen, would result in a very substantial additional demand by the Federal Government for funds, and we are already in a most difficult position trying to compete with Government bonds and other types of Federal expenditures for money.

Senator HARTKE. Do you hold the view that the present restrictive monetary policy of the Federal Reserve Board is a depressant upon business?

Mr. WOODBURY. We think that it is essential that——

Senator HARTKE. I didn't ask you if it was essential. I asked you if it is a depressant. The reason I am asking you these questions is because you appear to be on both sides of the question in your statement. You meet yourself coming around facing yourself, and you have to make up your mind to go one direction or the other. You cannot go both directions at the same time.

Mr. WOODBURY. I do not claim——

Senator HARTKE. It is very simple. In the first part of your statement you criticize the minimum tax. At the same time, you argue against a general revenue reduction. Are you saying you do not want a revenue increase, either? You just cannot be on both sides of the fence. I have never understood this position of the board of realtors. You people have always been hurt by restrictive monetary policy. You have always been helped by reduction in taxes.

You know, I never saw a group that has a more suicidal operation than you people. You absolutely astonish me. I do not understand it, and some of my best friends are realtors.

Mr. WOODBURY. Mr. Chairman, I think that our attack on the changes in the minimum tax relate to the discrimination against our industry as compared to other industries.

Senator HARTKE. You are opposed to a general tax cut because you say that would be a reduction in revenue, and you say the Government therefore would have an increased inflation problem on their hands.

That would be true if you had a continuation of the expansion in your economy. That is not going to be true if you have a cutback in your economy. Your economy is severely restricted and unemployment has increased. You have two operations going. You have reduction in profits, and you have an increase in unemployment, which means you will have a reduction in general personal tax revenue. You will also have increased costs for unemployment compensation and welfare.

This country has always followed a tight-money, high-interest-rate policy in order to cure inflation. If we follow the pattern of the Federal Reserve Board's tight-money policies much longer there will be a sharp increase in inflation.

Mr. WOODBURY. I am not sure I claimed to be an economist. I will say this. I was interested in the comments of Mr. Brimmer of the Federal Reserve Board when he spoke to the National Economic Association just before the end of the year where he observed that whether it be a tight-money or a loose-money policy, the change always resulted in impacting of mortgage money, and it was his suggestion that it was high time something be implemented to use fiscal policy in the area of monetary controls and restraints which was an innovation.

Senator HARTKE. I even listened to him on the fiscal policy side. I would like to talk to some of your economists sometime and ask them if they can get away from their textbooks they have written and deal in the practical world where you people have to work. Most real estate people do not make their money out of textbooks. You have 72 percent of your people today who earn less than $18,000, and the absolute minimum requirement today for any type of loan is $18,000.

That means that three-fourths of the people of the United States are not any longer able to secure loans and buy houses. You are trying to make your living out of 25 percent of the people. You are putting a lot of construction people out of business.

Mr. WOODBURY. We agree with that, and frankly, any further tax impact that results in reducing the internal rate of return has to result in increased rents, and all that does is eliminate another segment of the economy.

Senator HARTKE. I just cannot understand this policy. I am just using you as a sounding board. But I really wish that you could get the board of realtors to sit down sometime and remember that what you need is a group of people out there who can afford to buy a house. They cannot buy a house unless they have a job, and that job has to pay them sufficient money after they pay the grocery bill and taxes and the children's education, to go ahead and buy that house.

That number of people is dwindling away. The net result is that you are becoming much more competitive and therefore less profitable.

Mr. WOODBURY. Thank you.

Senator HARTKE. I want you to keep on living like Republicans. That is fine with me. I want you to understand that when we reduced the taxes in 1964 by $10 billion, we increased the revenue, although we reduced the rates, and that is what I am saying here today. That is what I tried to communicate to Senator Kennedy this morning. The very simple fact is that if you really want to make this country move, you put money in the hands of those who have been hit the hardest.

Tax Exempt Municipal Bonds

With whatever inequity there is here in this minimum tax, I am of an entirely different viewpoint. I am an old mayor, so I have already had a tendency to being in favor of tax-exempt municipals. In retrospect, I think it is wrong. If your Government wants to provide for some kind of special incentives, why doesn't it go ahead and provide it to the cities directly through some type of subsidy to the interest rate. Let those securities compete in the marketplace on an equal basis. Everyone would be a whole lot better off, including Uncle Sam. And it would not hurt the municipalities either. If you want to give them a subsidy, I am not against a subsidy. But give it to a municipality rather than giving it to some type of jackleg operation which absolutely does not guarantee you getting a benefit for the municipality.

Mr. WOODBURY. We think that is important, Mr. Chairman. Our concern is that the changes that keep being proposed further discriminate against an already downtrodden real estate industry and the net effect on the American consumer on employment, on householders and everything else is going to be dramatic.

Senator HARTKE. Like what for example?

Mr. WOODBURY. Pardon me?

Senator HARTKE. Would you tax the municipals?

Mr. WOODBURY. No, no, no, we are all in favor of that. We favor——

Senator HARTKE. The trouble is, we cannot pass that. You know that. Even though I am in favor of taxing municipals and providing a subsidy so the municipalities would still receive their money at the same rate.

Mr. WOODBURY. And you say you cannot pass that?

Senator HARTKE. No; you cannot do that.

Mr. ROBERTS. Politically you feel it is impossible.

Senator HARTKE. In the political arena you cannot do that. I am not in favor of putting the burden on the municipalities. They have got enough problems as it is. But you ought to deal with them in a fashion which you are sure of benefiting the municipality and not causing all of these other difficulties like you have in the minimum tax. In effect, the minimum tax is a form of sales tax or excise tax, and you try to put an excise tax up on top of a graduate income tax——

Mr. WOODBURY. Right.

Senator HARTKE. And in order to do that you cause all of these disparities that you are talking about.

Mr. WOODBURY. That would really be emphasized if you eliminated the present tax as part of the exemption.

Senator HARTKE. That is right.

Mr. ROBERTS. Basically, Mr. Chairman, we do not disagree with your philosophy. As individuals, as citizens, we are against inflation and we are willing to suffer if it will help inflation from running away, but we still have to protect our industry.

Senator HARTKE. I just do not understand it. I have never believed in suffering for suffering's sake. I never saw anybody made any better simply because he chopped off his hand, and that is what the tight money policy does to you. All it does is increases your interest rates, which is inflationary.

Mr. WOODBURY. Let me tell you what it does.

Senator HARTKE. Increase in taxes is inflationary. Neither one of them are productive.

Mr. WOODBURY. When there is dramatic inflation, too, it creates so much demand for capital funds in other areas, other than those that require such long-term planning and that tie up your capital without flexibility and liquidity that it makes it very, very difficult for the real estate to compete for those funds.

EFFECTS OF A NEGATIVE RESERVE POSITION

So we are anxious to create more stability.

Senator HARTKE. Let me just make one final comment.

I brought this to the attention of the Finance Committee in 1965 when the Federal Reserve Board went into a negative reserve position for the first time since 1961. I pointed out that one of the effects of that policy would be to increase inflation. Of course, the war in Vietnam did not help any, I understand that. We have never had a policy which really addressed itself to the fact that if you are going to have a progressive nation, you had better let it progress, and if you are going to increase the standard of living for people, when you increase the number of people, you cannot do it with yesterday's money supply, and you cannot do it with yesterday's houses.

Mr. WOODBURY. We have some of our economists with us.

Senator HARTKE. Is he with you here today?

Mr. WOODBURY. He is.

Would you care to have him respond?

[General laughter.]

Senator HARTKE. I am in a good humor today, so I will let you go home early so you can go to your golf courses that much sooner.

Mr. WOODBURY. Thank you, sir.

Mr. ROBERTS. Thank you, sir.

[The prepared statement of Mr. Woodbury follows:]

NATIONAL ASSOCIATION OF REALTORS

REALTOR®

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S U M M A R Y

Statement of the

NATIONAL ASSOCIATION OF REALTORS®

Before the

Senate Committee on Finance

June 10, 1974

The NATIONAL ASSOCIATION OF REALTORS® strongly opposes the proposed Senate floor amendments to H.R. 8217 which would increase the Minimum Tax on Tax Preferences. These proposed amendments will have an adverse effect on the real estate industry.

The adversities of a mortgage crisis, lagging production, spiraling costs, and the many other special problems facing the real estate industry at this time should be carefully considered before any changes are made to the existing tax laws. Further, we request that the Senate not impose any changes in the tax laws which would discriminate against the real estate industry.

The NATIONAL ASSOCIATION OF REALTORS has found undesirable, and therefore opposes, the Treasury Department's LAL and MTI proposals.

If the present Minimum Tax is to be changed, the inherent nature of that tax as a "minimum tax" should not be changed and its present burdensome imperfections should be recognized. The existing 10% Minimum Tax rate should remain unchanged. The Senate should recognize that the tax preference list is incomplete. Also, the deduction of regular income tax should be retained.

We strongly oppose the proposal for a general revenue reduction at this time because it would contribute to the present inflationary spiral.

NATIONAL ASSOCIATION OF REALTORS

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STATEMENT OF WALLACE R. WOODBURY

on behalf of

The NATIONAL ASSOCIATION OF REALTORS®

Before the Senate Committee on Finance

on

Certain proposals to amend H. R. 8217

June 10, 1974

The NATIONAL ASSOCIATION OF REALTORS is comprised of more than 1,630 local boards of REALTORS located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is approximately 500,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the U. S. concerned with all facets of the real estate industry. Principal officers are: Joseph B. Doherty, President, Andover, Massachusetts; Art S. Leitch, Vice President, San Diego, California; and H. Jackson Pontius, Executive Vice President. Headquarters of the Association are at 155 East Superior Street, Chicago, Illinois. The Washington office is located at 925-15th Street, N.W., Washington, D. C. 20005. Telephone 202-628-5300.

Statement of Wallace R. Woodbury
on behalf of
The NATIONAL ASSOCIATION OF REALTORS®

Before the Senate Committee on Finance
on
Certain proposals to amend H. R. 8217
June 10, 1974

Mr. Chairman and Members of the Committee:

The NATIONAL ASSOCIATION OF REALTORS® welcomes this opportunity to testify on certain tax increase proposals now pending for Senate consideration.

I am Wallace R. Woodbury of Salt Lake City, Utah, Chairman of the Federal Taxation Subcommittee of the REALTORS' Legislative Committee. Accompanying me today is Mike Roberts of Newton, Massachusetts, Chairman of the REALTORS' Legislative Committee.

The NATIONAL ASSOCIATION OF REALTORS, comprised of more than 1,630 local boards of REALTORS located in every state, the District of Columbia and Puerto Rico, represents more than 500,000 individuals and business entities engaged in every aspect of the ·al estate industry.

Because of the present depressed state of the real estate economy, the haphazard procedure involving potential changes to the tax system prompts us to present our views concerning a proposed Senate floor amendment to increase the existing Minimum Tax and to make other changes in the tax law. Some minimum tax proposals would:

1) Lower the $30,000 exemption to $10,000;
2) Eliminate the deduction for regular income taxes and related carryovers; and
3) Increase the rate from the current flat 10% rate to as much as one-half of the regular income tax rates.

Before going into these proposals and other similar proposals which would 'versely affect the real estate industry, we believe it incumbent to inform the Committee of the current state of the real estate economy and the many other special problems facing our industry at this time.

Below we will briefly discuss the current economic situation of the real estate industry as the result of the current inflationary spiral in costs of construction, record high interest rates, and the serious shortage of mortgage credit, and such relatively new factors as community concern with the improvement of the environment. These and other such factors tend to cause problems never before experienced by our industry. The real estate industry must be able to solve these complex non-tax problems in order to continue to function and it is less able than many other industries to suffer the additional disadvantage of haphazard and ill-considered changes in the tax laws. As we have noted frequently in the past, the mere discussion of such changes has an adverse effect on the ability of the industry to make the long-range plans, decisions and commitments which are necessary for day-to-day activities.

Economic Problems of Real Estate Industry

The present proposals may have been directed at situations which existed years ago. Currently, a faltering level of construction and a laggard rate of turnover in the existing inventory of housing and other real estate development indicate activity far below the level needed to maintain adequate supplies to serve the dynamic economy in which mobility is a vital feature.

Responding to tightening credit markets last summer, housing starts declined rapidly. They dipped below an annual rate of 2 million last August and have been below that level each month since. The April rate of 1,626,000 is 25% below the level of a year ago.

Similarly, since August the REALTORS® Existing Home Sales Series recorded eight consecutive months in which sales volume failed to match the pace for the same month a year ago. During this period the declines fluctuated within a range of 2.0 to 12.2%, but in some market areas the fall-off in sales greatly exceeded the national average. For example, in March one-fifth of our areas reported sales declines in excess of 20%. Our April sales figures did show some improvement as volume rose 7.6% above the same month in 1973, but these data do not yet reflect the impact of the most recent reversals in the mortgage market.

Real estate represents two-thirds of the nation's wealth and construction is a vital share of the Gross National Product. Historically, private construction has accounted for more than half of all Gross Private Domestic Investment and about 10% of all production.

The magnitude of the role of real estate and construction in the economy, however, is in sharp contrast to the generally small size of the business firms engaged in this industry. For example, about 70% of all construction firms and almost 90% of real estate offices have fewer than eight employees.

Lacking extensive lines of credit or sizable personal assets, these small businesses are always more drastically affected than the corporate giants during protracted periods of declining sales and accelerating expense. During such periods our industry suffers real financial hardships and its efficiency is impaired by the permanent loss of an unknown portion of its experienced work force.

The current mortgage market illustrates the financial climate in which the industry is trying to function. Since early April, financial markets have experienced several major changes. The prime lending rate reversed its downward course and moved sharply higher, first equaling and then surpassing previous record levels. Other short-term rates advanced more rapidly than expected, and bond prices have moved downward.

With the whole structure of interest rates moving upward, the nation's thrift institutions have been hit by a new wave of disintermediation. Federal Home Loan Bank Board data show that insured savings and loan associations had a net loss in savings deposits of $335 million in April. This contrasted sharply with the $1,751 million of net new savings received in the previous month. Similarly, a survey by the National Association of Mutual Savings Banks showed a net deposit outflow in April of $650 million. According to NAMSB, this matched the outflows recorded during the peak ot last year's disintermediation of the July-September period.

This Association's April survey confirmed the abrupt, precipitous and widespread turnabout in mortgage conditions. Among our mortgage panel members, 46.5% reported decreased availability and 77.8% reported higher interest rates. The change was particularly drastic in the income property market where 49.1% said availability decreased and 84.5% reported an upturn in rates.

The real estate industry as of any point of time reflects previous long-range planning. Thus, real property being developed or being sold today to a large extent represents planning based on the more stable situation that existed in the past.

However, the planning necessary for the continuing needs of the industry is being severely retarded by frequent and particularly the recent unusually adverse changes, such as the sharply rising costs of development and operation and the severe mortgage credit crisis. Consequently, it is important to the real estate industry that greater stability be returned to the American economy. The NATIONAL ASSOCIATION OF REALTORS strongly urges that the Senate only consider measures which will achieve economic stability for our economy.

Tax Increase Proposals

We urge the Senate to consider legislation affecting the real estate industry within the context of today's serious declines in housing starts, construction permits and slumping real estate sales. Also, the Senate should make clear that any proposed changes will operate only prospectively, so that the changes will not interfere with the bona fide advance arrangements which must be made in order for the real estate industry to properly function and to avoid stagnation. Finally, we request that the Senate not impose any changes in the tax laws which would discriminate against the real estate industry and in favor of other industries.

Because of this element of discrimination against the real estate industry, our Association has found undesirable, and therefore opposes, the Treasury Department's proposal made last year for a limitation on artificial accounting losses (LAL) and for a minimum taxable income (MTI). These proposals would particularly discriminate against the real estate industry.

The proposed Senate floor amendments to increase the Minimum Tax on Tax Preferences would adversely affect real estate and we strongly oppose them.

On the other hand, the existing Minimum Tax, despite its many imperfections, has now become a familiar part of the law. If changes are in fact considered essential, the Minimum Tax as presently constituted may perhaps present an approach that does the least harm. However, if the Senate considers changes to the Minimum Tax, we feel it is essential that the inherent nature of that tax not be changed and that its present burdensome imperfections be recognized. For example, the Senate should recognize that the present list of tax preference items is not complete, and that by omitting other preference items this tax is weighted heavily against the real estate industry.

There are many other imperfections in the Minimum Tax, such as the failure to provide a proper adjustment to tax basis for depreciation subject to this tax. The need for correcting these imperfections will become even more essential if the present rate of this tax is increased, thereby magnifying the burden resulting from the imperfections inherent in the present law. We urge that there be no change in the rate structure of the Minimum Tax.

Furthermore, any change in the Minimum Tax should not remove the present deduction of the regular income tax paid for the current year which is allowed in computing items subject to tax. This deduction is essential in order for this to remain in fact a "minimum tax." If this deduction is not allowed, the "minimum tax" would then clearly become a surcharge or surtax. Such result would be dramatically inconsistent with the stated purpose of the original enactment of the Minimum Tax, which was to insure that everyone paid some tax.

In connection with the Minimum Tax we also note that there has been some discussion of including certain construction period deductions as items of tax preference. As you know, the Treasury also included construction period items in its "LAL" recommendation to the House Ways and Means Committee last year. The experience of our industry is that the current deduction of these construction period expenses must be continued if risk capital is to be available for development, new construction, rehabilitation, maintenance and repair. The alternative to risk capital would be direct government subsidies, and our experience has shown that the nation is better served when risk capital is furnished by the private sector, rather than through direct government subsidies.

In reviewing the Minimum Tax and related tax changes made in recent years, the Senate should consider the fact that the adverse provisions enacted for so-called "excess investment interest" do not achieve the purpose for which these provisions were intended. These provisions have the unusual effect in the real estate industry of discriminating against the small or the new entrepreneur and in favor of corporations and established investors. Furthermore, these provisions create administrative complexities of unusual difficulty. If the Senate plans to make changes in existing laws, we believe the original policy of the Congress would be better served by an outright repeal of these provisions.

General Revenue Reduction Proposals

The NATIONAL ASSOCIATION OF REALTORS® has considered the proposals for a general revenue reduction at this time. We strongly oppose this action because it would contribute to the present inflationary spiral.

In response to the present inflationary spiral, the Federal Reserve Board has imposed a restrictive monetary policy. In order to successfully combat inflation, it is necessary to balance this approach with a sound fiscal policy which includes maintaining the flow of tax revenues while effecting reductions in government spending. Revenue reductions at this time would fuel the inflation, require a further tightening of monetary controls, and force interest rates up above current record levels.

When interest rates rise, it is our experience that funds move out of the financial institutions which provide the necessary money for housing and real estate development. When the supply of funds necessary for our industry is substantially reduced, housing starts, housing transfers, and real estate development decrease and the rate of construction slows. Our industry would become stagnant and be forced to bear a disproportionately high concentration of unemployment. In light of this situation, we oppose a general revenue reduction at this time.

We would be pleased to discuss further any of the foregoing matters with the Committee or with members of the staff, or to submit additional information.

Mr. Chairman, on behalf of the NATIONAL ASSOCIATION OF REALTORS, we appreciate this opportunity to present our views on the tax increase proposals for amendment of H.R. 8217 which are the subject of these hearings. We respectfully hope that our comments will be of help to the Committee and the Senate when it considers this legislation. We assure you of our continued efforts to cooperate to the fullest extent with the Committee's consideration of the application of the tax laws to the real estate industry.

Senator HARTKE. Mr. Edwin Locke, president of the American Paper Institute. All right, you are going to be the last one.

STATEMENT OF EDWIN A. LOCKE, JR., PRESIDENT OF THE AMERICAN PAPER INSTITUTE. ACCOMPANIED BY THOMAS R. LONG, ASSOCIATE GENERAL COUNSEL OF WESTVACO CORP. AND IMMEDIATE PAST CHAIRMAN OF THE AMERICAN PAPER INSTITUTE COMMITTEE ON TAX AFFAIRS

Mr. LOCKE. Mr. Chairman, I am Edwin A. Locke, Jr., president of the American Paper Institute. I am accompanied by Thomas R. Long, associate general counsel of Westvaco Corp., immediate past chairman of the Institute's Committee on Tax Affairs.

May I depart for just a moment, Mr. Chairman, from my prepared text, to bring you from New York the very cordial greetings of your good friend and great admirer Elliott Janeway, who has been a long-time friend of mine.

Senator HARTKE. Eliot Janeway is a good friend and a wonderful person, and if you are a friend of Mr. Janeway's you are a friend of mine.

Mr. LOCKE. Thank you.

The American Paper Institute represents the pulp, paper and paperboard producers who comprise one of the Nation's largest industries. The industry includes many companies with 6,000 plants in 49 States and employs more than 700,000 people. In 1973, its outlays for wages, salaries, and benefits came to over $8 billion. Last year its Federal taxes alone amounted to more than $1 billion.

We are grateful for this opportunity to testify. We commend your chairman, Senator Long, and you, Senator Hartke, and the other members of the Senate Committee on Finance for calling these hearings on various pending tax increase proposals which in all likelihood, we understand, will be offered on the Senate floor in the near future.

The formulation of tax policy is complex, involving issues of revenue, equity and management of the economy. Although extensive hearings have been held in the past, the Nation's economic picture has changed substantially in the last year. Inflation has become virulent and shortages have developed which at times have disrupted operations of industries. This suggests the need for an unusually careful approach to the formulation of tax policy.

EFFECT OF PROPOSED TAX INCREASES ON THE PAPER INDUSTRY

We believe that tax proposals involving billions of dollars of revenue and with the potential for a heavy impact on the Nation's consumers should not be enacted without more extensive committee hearings, currently, in both the House and Senate. We nevertheless appreciate this opportunity to provide your committee with up-to-date information on the possible impact of the proposed tax increases on the paper industry, and the industry's position on each of several specific proposals.

The products of the American paper industry are an essential part of modern living and are used in virtually every segment of the economy. For 1973, the industry operated on the average at 96 percent of capacity, which is in effect the practical limit. The industry's jobs, wages, income, and taxes were at all-time highs.

However, shortages have emerged. Prices are increasing. The clear solution to these problems is additional capital investment in production capacity, which will eliminate shortages and stabilize prices, while further increasing jobs, total wages and taxes.

I would like to interject a comment here, Mr. Chairman, to the effect that Treasury Secretary Simon's article in today's issue of U.S. News and World Report as reported in this morning's New York Times appeals to us greatly. The Secretary is apparently thinking of recommending tax incentives that would encourage production in the United States. He mentioned in particular products that are in short supply or may soon be, such as fuels, paper and steel. He is quoted as having said that expanded production in the United States will assure the consumer that he can get commodities at a reasonable price.

Under existing conditions, there is already a projected shortfall in necessary capital investment. Paper production capacity increases are estimated to average under 3 percent annually in the 1973–76 period, while increases in demand for paper and paperboard products are estimated to average over 4 percent yearly.

Any increase in the tax burden, which reduces profits and cash flow, is bound to slow down these badly needed increases in capacity and thus widen the gap between supply and demand, resulting in price increases to consumers.

The paper industry is highly capital intensive, requiring approximately $2 of capital investment for each dollar of sales. In 1973, the paper industry spent approximately $1.9 billion on plant and equipment. This large amount, although substantially in excess of income, resulted in less than a 3 percent increase in capacity. In 1974, the expenditure figure is estimated to be $2.6 billion and the increased capacity at about 2.6 percent.

The reasons were manifold. Inflation has considerably eroded the value of industry investment dollars, with costs of construction having increased over 100 percent in the last few years.

Moreover, substantial amounts have had to be spent at higher prices simply to replace old or inefficient capacity. Finally, close to 23 percent of the total, or about $440 million, was spent to protect the environment, which diverted funds that would otherwise have been available to maintain or increase productive capacity.

Add to that the prospect that the cost burden of changes in technology and environmental requirements will increase in the immediate future, and that timberlands are becoming harder to find and much more expensive, and it is easy to see that the capital requirements of the industry are going to increase significantly this year and in the years immediately ahead.

The paper industry has its roots in the forest. The forests of this country are a renewable resource. They provide environmental benefits, and can serve as a relatively inexpensive source of lumber, plywood, paper and related products for the American people and for world markets, thus increasing jobs and improving our balance of payments.

But the key ingredient in the realization of these benefits is the capital investment to increase forest productivity and to maintain and expand plant and equipment.

We are convinced that all the tax proposals carry a strong anti-capital bias. I would like now to turn to a discussion of the tax proposals which would have a significant impact on the paper industry.

By way of summary, let me simply say that the paper industry supports the continuation of the full 7-percent investment tax credit, depreciation permitted under the Asset Depreciation Range system, the foreign tax credit, and deferral of taxes on overseas income including such income of a Domestic International Sales Corporation. We oppose the continued application of the minimum tax to corporations. If such treatment continues, the deduction for taxes paid should be retained and capital gains should be eliminated as an item of preference income.

Mr. Chairman, in the interest of time I would like to request that the remainder of our statement, which elaborates our views on each of these items, be included in the record.

Senator HARTKE. They will be, yes, sir.

INCENTIVES FOR USE OF WASTE PAPER

Would you be in favor of depletion allowance for recycled paper?

Mr. LOCKE. We have made some very specific suggestions, Senator Hartke, for a tax credit incentive for the use of more waste paper. These have been made to the Ways and Means Committee and the House, and involve a dollar credit based on the amount of tonnage of waste paper used by the manufacturer.

Senator HARTKE. I have no further questions for you. Thank you.

The committee stands adjourned until tomorrow morning at 10 o'clock.

[The prepared statement of Mr. Locke follows:]

TESTIMONY

OF

THE AMERICAN PAPER INSTITUTE

BEFORE THE

COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

JUNE 10, 1974

I am Edwin A Locke, Jr., President of the American Paper Institute. I am accompanied by Thomas R. Long, Associate General Counsel of Westvaco Corporation, past Chairman of the Institute's Committee on Tax Affairs.

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We are grateful for this opportunity to testify. We commend your Chairman, Senator Long, and the other members of the Senate Committee on Finance for calling these hearings on various pending tax increase proposals which in all likelihood will be offered on the Senate floor in the near future.

The formulation of tax policy is complex, involving issues of revenue, equity and management of the economy. Although extensive hearings have been held in the past, the nation's economic picture has changed substantially in the last year. Inflation has become virulent and shortages have developed which at times have disrupted operations of industries. This suggests the need for an unusually careful approach to the formulation of tax policy. We believe that tax proposals involving billions of dollars of revenue and with the potential for a heavy impact on the nation's consumers should ~~not be~~ enacted without more extensive Committee hearings, currently, in both the House and Senate.

We nevertheless appreciate this opportunity to provide your Committee with up to date information on the possible impact of the proposed tax increases on the paper industry, and the industry's position on each of several specific proposals.

Background Information on Paper Industry

The products of the American paper industry are an essential part of modern living and are used in virtually every segment of the economy. For 1973 the industry operated on the average at 96% of capacity which is in effect the practical limit. The industry's jobs, wages, income and taxes were at all time highs. However, shortages have emerged. Prices are increasing. The clear solution to these problems is additional capital investment in productive capacity which will eliminate shortages and stabilize prices, while further increasing jobs, total wages and taxes.

Under existing conditions, there is already a projected shortfall in necessary capital investment. Paper production capacity increases are estimated to average under 3% annually in the 1973-1976 period while increases in demand for paper and paperboard products are estimated to average over 4% yearly. Any increase in the tax burden, which reduces profits and cash flow, is bound to slow down these badly needed increases in capacity and thus widen the gap between supply and demand resulting in price increases to consumers.

The paper industry is capital intensive requiring approximately \$2 of capital investment for each \$1 of sales. In 1973 the paper industry spent approximately \$1.9 billion on plant and equipment. This large amount, although substantially in excess of income, resulted in less than a 3% increase in capacity. The reasons were many fold. Inflation has considerably eroded the value of industry investment dollars, with costs of construction having increased over 100% in the last few years. Moreover, substantial amounts have had to be spent at higher prices simply to replace old or inefficient capacity. Finally, close to 23% of the total or about $440 million was spent to protect the environment, which diverted funds that would otherwise have been available to maintain or increase productive capacity. Add to that the prospect that the cost burden of changes in technology and environmental requirements will increase in the immediate future, and that timberlands are becoming scarcer and much more expensive, and it is easy to see that the capital requirements of the industry are going to increase significantly this year and in the years immediately ahead.

To sum up, the paper industry has its roots in the forest. The forests of this country are a renewable resource. They provide environmental benefits and can serve as a relatively inexpensive source of lumber, plywood, paper and related products for the American people and for world markets, thus increasing jobs and improving our balance of payments. But the key ingredient in the realization of these benefits is capital investment to increase forest productivity and to maintain and expand plant and equipment.

We are concerned that all the tax proposals carry a strong anti-capital bias. I would like now to turn to a discussion of the tax proposals which would have a significant impact on the paper industry.

MAJOR TAX INCREASE PROPOSALS AFFECTING THE PAPER INDUSTRY

SUMMARY

The American Paper Institute supports the continuation of the full 7% investment tax credit, depreciation permitted under the Asset Depreciation Range (ADR) system, the foreign tax credit, and deferral of taxes on overseas income including such income of a Domestic International Sales Corporation (DISC). We oppose the continued application of the minimum tax to corporations. If such treatment continues, the deduction for taxes paid should be retained and capital gains should be eliminated as an item of preference income.

The 7% investment tax credit and the ADR system of depreciation should be retained. Both measures combine to provide capital cost recovery at a rate which at least to a certain degree, realistically reflects current economic conditions. The need by American industry for the cash flow generated from these two provisions is greater now than at any time in our history. We would like to emphasize the importance to the paper industry of a sound, stable and permanent system of capital cost recovery. An on-again, off-again approach is not conducive to supporting our large and continuing capital expenditures which must be planned for and executed over a period of years.

The foreign tax credit should be retained. We strongly urge retention of the credit for foreign income taxes paid in order to avoid near confiscatory double taxation of foreign source income. We also strongly support retention of the option to use the overall limitation. United States companies compete abroad with foreign concerns. They should not have to pay any more taxes than are paid by these competitors. Any reduction in the foreign tax credit would cause United States companies to pay higher taxes on income earned abroad than their foreign competitors and would, in effect, put American companies at a decided competitive disadvantage.

Unremitted earnings of foreign subsidiaries of U. S. companies should not be taxed currently. Elimination or limitation of deferral of taxes on foreign source income will result in serious dislocations in the flow of investment capital between parent and subsidiary corporations. Less funds will be available for capital investments in overseas markets to sustain or strengthen their competitive positions which in many cases serve as markets for U. S. goods. As a result, these markets will be captured by foreign competitors with consequent negative long-run impact on our balance of trade and balance of payments.

Domestic International Sales Corporation (DISC)

The Treasury Department recently reported that for 1972 the weighted average growth rate for all U. S. DISC exports was about

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29% (based on the 166 firms out of 2,249 who reported the value of their corporate group exports for 1971), as compared with an overall export growth for the nation of 12.4%.

Many of our member companies have formed or are currently operating under the DISC provisions. Based on continuing discussions with a number of these companies we are convinced that the availability of DISC's is causing increasing attention to export possibilities in their marketing plans for the future. Of particular significance, we believe, is the fact that DISC's are causing more smaller and medium sized companies to study export markets and to make firm plans for expansion in that direction. For these reasons, and in order to meet increasing competition in foreign markets, we strongly support continuation of the Domestic International Sales Corporation provisions.

<u>We oppose the continued application of the minimum tax on preference income to corporations</u>. As Assistant Secretary of the Treasury Edwin S. Cohen pointed out in 1969:

> "We are not now recommending that LTP and allocation be applied to corporations. A major difference is that in the corporate area, the characteristic problem is not an unintended combination of tax preferences, but simply intensive use usually of a particular preference which the Congress deliberately legislated as an incentive measure for certain kinds of business."

In the paper industry the tax works against efforts to encourage and facilitate investment in pollution control facilities, productive facilities and forestry programs.

If the minimum tax is applied to corporations, we urge that the deduction for taxes paid be retained. The effect of eliminating this deduction would fall most heavily on those already paying the highest effective tax rates. Serious consideration should be given to eliminating capital gains as an item of preference income. Capital gains are taxed at the full statutory rate and the minimum tax imposes an additional burden in a situation where the tax rate was already increased over 20% in 1969.

This concludes our presentation and we would be pleased to answer any questions the members of the Committee may have.

[Whereupon, at 3:30 p.m., the hearing was adjourned, to reconvene at 10 a.m. on Tuesday, June 11, 1974.]

TAX INCREASE PROPOSALS

TUESDAY, JUNE 11, 1974

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

The committee met, pursuant to recess, at 10:10 a.m., in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Bennett, Curtis, Fannin, Hansen, and Dole.

The CHAIRMAN. The committee will be in order.

We are pleased to have as the first witness this morning the Honorable Edwin Cohen, formerly Under Secretary of the Treasury.

Mr. Cohen, we very much appreciate the thoughtful and profound advice you have given this committee while you served with the Government, and prior to that time. We are delighted to welcome you back.

STATEMENT OF HON. EDWIN COHEN, FORMERLY UNDER SECRETARY OF THE TREASURY; PRESENTLY PROFESSOR OF LAW, UNIVERSITY OF VIRGINIA

Mr. COHEN. Thank you, Mr. Chairman. It is a great pleasure to be here.

As you may know, I am now professor of law at the University of Virginia, and I am of counsel to the law firm of Covington & Burling in Washington.

I would like to discuss a number of pending amendments which I understand were to be offered to H.R. 8217, but I now understand from your earlier comment that they will be offered to the debt ceiling bill when it reaches the Senate floor.

MINIMUM INCOME TAX PROPOSALS

First, if I might refer to the proposals relating to the minimum tax and to the amendments that have been offered in an effort that has been said to strengthen the minimum tax. The minimum tax was born out of a desire to see that those persons who use so-called preferences or incentives in the income tax law to eliminate much or all of their income tax, will nonetheless pay some minimum amount in support of the Government. I do not think that the proposals that are pending in the Senate to amend the minimum tax will make significant progress toward that goal, but instead will have the principal effect of simply increasing the tax on long-term capital gains that are realized by individuals.

The pending amendments modify the tax by reducing the present $30,000 of exemptions——

Senator HANSEN. Mr. Chairman, if I could interrupt our distinguished witness, I am pleased to be here. My concern is, as so oftentimes happens, we have two hearings going on at the same time. The issue in Wyoming, I mean the issue before the Interior Committee is coal slurry pipeline. Now, we have a lot of coal out in Wyoming, and in order to move that coal by slurry, it would require water, and Senator Fannin and I were just trying to decide who should go which way.

If I may, I will ask to be excused here to go down there.

The CHAIRMAN. Please permit me to explain. I do not object to the two of you getting your heads together, because I know you would not do it if it was not essential, but I wanted the witness to have a chance to be heard by you because——

Senator HANSEN. I apologize to my distinguished and dear friend, Dr. Cohen.

The CHAIRMAN. Because at that particular moment, he had only one prospect for his proposition with me listening, and I thought he would be better off to wait until he could get the attention of three people. That way he would have three prospects rather than one.

Dr. COHEN. If you had to listen to two simultaneous hearings, Senator Hansen, I hope I would not be the one contributing double talk.

Senator FANNIN. Our sincere apologies.

Senator HANSEN. I will be very interested in reading the record, Dr. Cohen, I assure you, sir.

Dr. COHEN. Thank you, Senator.

The CHAIRMAN. I just wanted to let the witness wait until you had concluded your conference so that he would have the attention of as many people as possible.

Thank you.

Go right ahead.

Dr. COHEN. If I may proceed, Mr. Chairman——

The CHAIRMAN. Why do you not start over again about the minimum tax, because I think that you have been giving a lot of thought to this matter. I do not know what your conclusion is, but you were here when it was enacted; you helped mold what we have got. I think you know what is good about it and what is bad about it, and if we change it, I hope we do not change it for the worse. It is bad enough the way it is now.

Dr. COHEN. Well, I think it could stand a lot of improvement, Mr. Chairman, as you say, but I am inclined to think that these two pending changes would not further the goals which we set out to attain.

The CHAIRMAN. You think that they would tend to move in the opposition direction rather than the purpose we had in mind.

Dr. COHEN. I think that they would largely have the effect of increasing the capital gains tax on individuals in an unfortunate way. As Senator Bayh said when he introduced this amendment on May 21, 1974, the 1969 action in the minimum tax—

> recognized a basic inequity in permitting a relatively few wealthy taxpayers to escape liability entirely by investing their resources solely in tax-free, income-producing assets.

Now, the present minimum tax lists nine preferences. Under present law, a person totals the amounts of his nine preferences, then he subtracts from the total a $30,000 exemption, then he subtracts his regular income tax, and then he applies a rate of 10 percent to the balance. The two proposed amendments that are pending would be first, to reduce the $30,000 exemption to $10,000, and second, to eliminate the deduction from the regular income tax.

Now, the first of these amendments to reduce the exemption from $30,000 to $10,000 with a 10-percent rate obviously means that it would not increase the tax burden on any individual by more than $2,000. A tax bill of not more than $2,000 is not going to have a material effect upon a wealthy taxpayer. On the other hand, I think it would have the effect of bringing the minimum tax into the picture for middle income persons who are not in this category of the relatively few wealthy taxpayers with which we are dealing.

Now, the more significant change would be the termination of the deduction for the regular income tax, and it is that change which I think will have the effect of making the amendments bear so heavily upon capital gains of individuals.

The statistics of income for 1970 and 1971 returns, which are the only ones that we have published to date on this point, show that of the nine preferences, only four have any significance with respect to individuals. Of those four, roughly 85 percent of the amount of preferences relates to capital gains. The other three are equally divided between depletion, stock options and accelerated depreciation on real estate; and the Ways and Means Committee has tentatively announced decisions even to eliminate for all practical purposes stock options, and has proposals to change percentage depletion.

But whether or not these latter changes are made, the vast bulk of the effect of the pending Senate amendment would fall on capital gains, which already make up more than 85 percent of the total preferences. Capital gains are in broad effect under present law subject at least to a tax on half of the gains at the regular rates, with a ceiling of 25 percent on the first $25,000.

Now, as I say, the primary effect of these proposed amendments to the minimum tax pending on the floor would be to levy an additional flat tax of 5 percent on net long term capital gains exceeding $20,000 a year. That is the net effect of imposing a 10-percent tax on the excluded half of capital gains above $10,000. Applied to the gross amount of the capital gains, it is a 5-percent tax on the gross amount of the capital gains above $20,000.

This would bring the minimum tax into the area of middle income persons. I think it would be difficult indeed to explain the wisdom of imposing this additional flat rate tax on persons who after 30 years sell their businesses or their homes or their farms. It surprised me to note that the statistics of income published by IRS show that in each of the years 1960 through 1972, more than half the amount of net long term capital gains of individuals has been realized by individuals with adjusted gross income of under $50,000.

Now, it is particularly difficult to deal with the case of persons who have held assets over a long period of time and then sell them in a single year. If we were to apply a substantial minimum tax on capital gains. I think either we ought to have some carryback or carryforward system to measure the minimum tax over a substantial period of time, or else we should limit the minimum tax to capital gains on assets held for a much shorter period, say 3 to 5 years, but not to the longer periods, which I think is its major effect.

Now, the Ways and Means Committee is presently at work on various proposals for revision of the minimum tax, including those that have been offered by Dr. Woodworth, the distinguished chief of staff of the Joint Committee on Internal Revenue Taxation, and by the Treasury Department, and I think it would be somewhat confusing at this point to consider the pending amendment on the Senate floor while others that affect the base of the tax and the structure of the tax are on the way for consideration in the general tax bill.

If I may move to some other subjects——

Senator BENNETT. Mr. Chairman, before Mr. Cohen moves to something else, is it not particularly dangerous to make this drastic change to capital gains at a time of high inflation? This would actually tend to reduce the value that the person has left after you apply this proposed tax rate—actually, his capital gain may not really be a capital gain. It may simply be a transfer of one asset to another.

Mr. COHEN. Well, this is certainly an important factor, Senator Bennett. Let me see if I can offer just a simple illustration.

If you take a person, say, with $20,000 of adjusted gross income from salary, wage, and farming income, and if you assume that in a single year he sells his farm or his business in which he invested $20,000 some 20 or 30 years ago, it would be worth say $70,000 today due to inflation. Now, he has realized a $50,000 long-term capital gain, of which only half is included in income, so he has $45,000 of adjusted gross income for the year. I think he pays a regular income tax in the neighborhood of $12,000. If we were to adopt this proposed amendment to the minimum tax, this man has a so-called preference of $25,000, half of his $50,000 long-term capital gain; and you take that $25,000 of his preference, being half the capital gain, subtract a $10,000 exemption, and he would have $15,000 subject to a 10-percent tax, that would be $1,500 additional minimum tax on a man who has already paid $12,000 in regular tax.

Now, I do not think this is the kind of wealthy taxpayer who is escaping tax liability to whom we should direct the minimum tax.

The CHAIRMAN. One more thing about the minimum tax is this: I think it is just about impossible for any taxpayer who has not been to law school—and even if he has been to law school, if he has not had a course in taxation—or who is not an accountant, to fill out his tax return if he has to pay the minimum income tax. He has just got to go to somebody to fill it out for him because it is impossible to figure it all out, and pay it. At least that is my experience.

If you limit this to a relatively small number of wealthy people who have made a lot of money and paid very little taxes, those kind of people have lawyers and accountants anyway. But when you send all of these middle income people down to the courthouse looking for a Federal revenue agent or out looking for tax lawyers and accountants to try to show them how to do this, other people are going to be outraged.

They are going to show it at the polls, for anybody that votes to do this. It may sound like a good idea, up until you see who all is angry about it, and at that point I think that those that voted for it are not going to be very happy about that situation.

Mr. COHEN. Well, that is certainly my feeling, Mr. Chairman, and that is why I am concerned, because it zeros in on the wrong group.

Now, you can change it around by adding other preferences and making other adjustments, but to adopt this kind of a change at this time I think would be moving in the wrong direction toward the wrong objective, and at the wrong group of people.

The CHAIRMAN. Please proceed, sir.

ADR INVESTMENT CREDIT PROPOSALS DISCUSSED

Mr. COHEN. If I may move to the proposals to repeal the asset depreciation range system that was adopted in 1971, and to restore the old 1962 depreciation guideline lives and the so-called reserve ratio test, and to the proposal to phase out the investment credit on equipment costing more than $50,000, I am sure that others have emphasized and explained to this committee in recent days far better than I can that the need for capital formation and investment in productive machinery and equipment is at least as great if not greater than it has ever been.

Now, the history of the past dozen years provides dramatic evidence of the roller coaster effect of changing the system of depreciation allowances and investment credit. I have attached at the back of my statement, Mr. Chairman, a chart that appeared in the Senate Finance Committee report accompanying the 1971 Revenue Act, at which time the chart went through the year 1970, and it has been extended here to 1974.

If one looks at the ups and downs of that chart with respect to domestic new orders for machine tools by quarters from 1960 to the present time, one sees that in 1962 when the depreciation lives were shortened and the investment credit was adopted, there began a steady rise (broken only by a brief period in 1964) until the early part of 1966. When there occurred a suspension of the investment credit for some 6 months, these orders took a nosedive. When the credit was restored in the spring of 1967, they rose until the spring of 1969 when they passed an alltime peak. When the investment credit was repealed as of April 23, I think it was, 1969, these orders again took a nosedive down to approximately the 1962 levels. Since we adopted ADR and reinstated the investment credit in 1971, the orders have risen until they have now reached an alltime peak.

I think in the light of that roller coaster history, it would be most unwise to abandon the present system and go back to where we were prior to 1971. Before the changes were made in 1971, the Treasury estimates showed that our income tax laws made the capital cost of business equipment higher than that of any other major industrialized nation in the Western World. Even after these changes, I think that we are below those of any other major countries except France and the Netherlands. To go back to the period prior to 1971 when we were behind every other nation in the world in the capital cost of productive equipment I think would be a grave error.

To return to the guideline lives for equipment set in 1962 on the basis of data that was assembled from 1959 and 1960, more than 15 years ago, I think would be a mistake. I do not think we should use data 15 years old on the basis of which to determine depreciation for present assets now being bought, especially in the light of the technological changes that have occurred in the meantime and the increased obsolescence that those changes have produced.

The pending amendments would require a return to the reserve ratio test. In 1971 when we abandoned that test, we issued a lengthy Treasury report, after an intensive study, as to the reasons why we thought it was unworkable and impracticable. The IRS took a survey of some 3,500 experienced revenue agents, and the survey showed that 87 percent of them thought that the reserve ratio test was unworkable and impractical and should be abandoned. We substituted a system that I firmly believe is far superior to the old. To return to the reserve ratio test after more than 3 years in which it has not been in existence would produce a situation that I think would be a little short of chaotic.

So I would hope that the Congress would not adopt this proposed amendment to the depreciation provisions.

With respect to the proposal to phase out the investment credit on assets costing more than $50,000, I think that would be most unwise, but particularly I think it would be if not unworkable, certainly a system involving the gravest administrative complexities. It would require that the credit be determined by the cost of each particular piece of equipment. One would have to know what was a single piece of equipment and what were multiple pieces of equipment. It would introduce new and untried competitive factors between a single piece of equipment of a large nature, and two or more smaller pieces of equipment that could accomplish the same task.

For example, it could change the competitive situation between buses, which I assume would be below the $50,000 or $100,000 limit in cost, and airplanes, which would be above the limit. One would have the credit and the other would not, though they would be in competition in the transportation area.

I think it would require a host of administrative rules to determine whether particular equipment represented a single item or multiple items, to determine what to do with persons who bought parts separately and assembled them in a particular piece of equipment, to determine what to do about additions that were made to existing equipment, and so forth.

I think the proposal would be unwise in policy but I particularly suggest that it would involve the utmost administrative complexity, and I would hope it would not be adopted.

If I may turn to another subject, there are proposals pending——

Senator BENNETT. May I break in again?

Mr. COHEN. Yes, Senator.

TRYING TO BASE A DEPRECIATION SYSTEM ON REPLACEMENT COST

Senator BENNETT. I am a little slow today. A suggestion was made in the hearing yesterday that we should go to a system based on the replacement cost. Is it humanly possible to determine when you buy a piece of machinery what its replacement cost will be, 5, 10, 50 years from now, and how can you base a depreciation system on replacement cost?

Mr. COHEN. Well, Senator, I have heard this suggestion offered and debated over many years, and I do not know all of its ramifications. I guess the thought would be that one would not try to predict the future price rise at the time the equipment was bought, but one would adjust the depreciation each year by applying the depreciation rate to the new replacement cost of that equipment as prices indicated it would cost in the year in which the depreciation were taken. So you might be depreciating one amount in the first year and another one based on the price rise in the second year, another based on the third year.

Senator BENNETT. But in the end, on that basis, you would never arrive at an amount that would actually equal the amount that you would have to replace. Would you have a right to take a balloon at the end of a period and catch up with everything you have missed?

Mr. COHEN. You would not necessarily have to have just the balloon at the end. You might see it coming and adjust toward the end.

I think that it would be feasible mathematically to do this, but I have personally not been able to come to the conclusion that this is a wise system for the tax law. But I do think that it is a major factor to be taken into account in the overall appraisal of the depreciation system. If you are going to base depreciation upon original cost and you should give the taxpayer some room, some leeway in his estimate as to how soon the equipment would be obsolete or have to be replaced. I think the likelihood of price rises is a factor to be taken into account in your overall appraisal of the depreciation structure. I think other countries have done this, as we have done it.

Senator BENNETT. Are there other countries that operate on this sliding scale basis?

Mr. COHEN. Based upon the cost of replacement? None that I know of, Senator, but I have not made the survey.

Senator BENNETT. I see Dan Smith behind you is nodding his head.

Mr. SMITH. France. France had it at one time.

Senator BENNETT. You said France had it at one time?

Have they abandoned it? Are they still with it?

Mr. SMITH. Not to my knowledge. I think they still have it.

Senator BENNETT. I would hate to be a taxpayer dealing across the table with a revenue agent having to defend his estimate every year as the possible increase in the value of his machine on the basis of replacement cost. I would think that would create interminable arguments with the Service.

Mr. COHEN. Well, I think it would, particularly if I may suggest, because of the technological changes that occur, you do not replace the old widget with the same widget. You have to replace it with a different kind of widget, perhaps with a computer operation, which would be a completely different, more efficient machine.

So I would think that the problems would be quite substantial.

Senator BENNETT. Well, this was put into the record yesterday, and I am anxious to get a professional comment. Theoretically it is a wonderful idea if you could actually forecast what it is going to cost you to replace a machine, ideally, and it should be fair for you to accumulate over that the life of the old machine, but I do not see how anybody can calculate it in advance and arrive at the right answer.

Mr. COHEN. Nor can anyone tell with any reasonable degree of certainty how long the existing equipment is going to last.

One of the troubles with the old reserve ratio test was that we looked to the lives of old equipment in order to predict what would be the life of the new type of equipment, and there is no necessary bearing because the new equipment is different from the old.

Senator BENNETT. That is all, Mr. Chairman. Thank you.

TAXATION OF U.S. SHAREHOLDERS IN CERTAIN FOREIGN CORPORATIONS

Mr. COHEN. Mr. Chairman, one of the important pending amendments would require U.S. shareholders in foreign corporations that are more than 50 percent controlled by United States persons to include currently in their income their pro rata shares of the undistributed earnings and profits of the foreign corporation. To the best of my knowledge, no other country in the world seeks to do this, and I think to enact such a measure unilaterally, without some assurance of comparable efforts by other countries, would put American business in a distinct disadvantage in world competition.

It has been estimated that this proposal would raise an additional $350 million of additional revenue. My understanding is that more than a third of that amount would come from U.S. controlled foreign shipping companies. Now, most of the nations of the world impose little or no income tax on shipping companies controlled by their residents, and a 48-percent tax on the shipping income of U.S. controlled companies would place them at an extreme disadvantage, and would lead either to the sale of the ships or at least the passage of control to foreign persons in order to eliminate the tax.

With respect to subsidiaries that operate in developed countries, where corporate tax rates are substantial, the combination of the foreign corporate tax and the withholding tax that would be paid on dividends brought back to the United States to pay the U.S. taxes would in general exceed the U.S. tax. In those cases where companies are operating in developed companies, the net effect will be in general not to collect U.S. revenue, but simply to require the payment of additional withholding taxes to foreign countries.

Now, in the less developed countries, the rates are often less than ours because the rates are often set as inducements to bring industry into the country. If we were to tax the undistributed profits of foreign subsidiaries operating in the less developed countries, it would have the effect of nullifying the tax inducements that these countries have offered to attract industry. They would still be available to foreign businesses, but they would no longer have any attraction for U.S. business.

Whether this is right or wrong is a deep-seated policy question of an economic and political nature with regard to our relations with the less developed countries and requires thorough, deliberate consideration.

Now, there are also technical defects that I will mention briefly.

For example, we have encouraged these foreign companies to borrow money abroad to finance their operations. The American parents would be subject to tax on the undistributed earnings even though loan commitments or other business contracts would forbid the distribution of dividends while those loans were outstanding. No relief is provided where the company has prior commitments that make distribution impossible to remit the funds with which to pay the tax.

In the case of individual shareholders of these companies, while American corporate shareholders are given credit for the foreign tax paid by the foreign corporation, individual shareholders would be subject to taxes up to 70 percent on the undistributed earnings, with no credit for the foreign tax paid by the corporation. I think this would be unfair. In 1962 when we enacted tax legislation regarding tax havens we made special provisions with respect to individual shareholders to see that they were treated no more harshly than corporate shareholders.

I think there would be other technical problems in the present draft that would require further work. The bill would require tax be paid on undistributed earnings and profits—not on statutorially defined income, but on earnings and profits—and that is a term as to which there is much dispute in many instances. It has little definition in the Code. All that this bill says is that the earnings and profits of the foreign corporation shall be "determined according to rules substantially similar to those applicable to domestic corporations." But that is a vague basis for laying taxes, particularly when the domestic rules themselves are uncertain.

I think there would be particularly difficult problems when there would be more than one class of stock, and there would be questions as to who would get a dividend if it were paid; and problems where there are minority stockholders in other countries who would not be under this system of treating distributions as paid to U.S. shareholders when they were not in fact paid. I refer to a number of other technical points in my statement that I will not now elaborate.

I think both on policy grounds and on technical grounds I would strongly oppose that proposal.

DISC Should Be Retained

Last, if I may, I will refer to the DISC. There are proposals sending to repeal the DISC, some of these to repeal DISC as of the beginning of 1974.

Now, the DISC provisions were designed to eliminate the disadvantages which existed under the prior income tax law to U.S. corporations engaged in export activities as compared with those that manufactured abroad through foreign subsidiaries. It was designed to keep jobs at home.

Since the adoption of the DISC at the end of 1971, our exports have increased to an enormous and unprecedented extent. There are some differences in the data that I have seen, but I believe that, in general, exports, both in total amounts and with respect to manufactured goods, have increased on the order of 50 percent in the intervening period since the end of 1971. Now, of course, in that intervening period there have been many changes in the international scene. We have had two dollar devaluations, we have witnessed the arrival of floating exchange rates and the world energy situation. Hence we cannot say to what extent DISC has been a reason for this vast increase in exports. I think it is just too early to appraise the effectiveness of DISC among other factors in increasing exports to maintain jobs at home.

When DISC was pending before this committee in 1971, the committee adopted a provision which would cause the DISC to terminate at the end of 10 years in order to force a reconsideration of it at the end of that time in the light of experience. On the floor of the Senate, Senator Fulbright offered an amendment, which was adopted with the understanding it would be taken to conference, to cut that period from 10 years to 5 years. It was deleted in conference so that there would be no terminal date in the statute. My understanding of the reason for that decision was that it was felt that since we were trying to get American companies to locate and continue to locate their manufacturing plants in the United States rather than abroad, they had to have some assurance that DISC would last for some reasonable period of time when they made their commitment, because there is a leadtime in building plants and in bringing them into operation and in making them profitable.

If we were now to repeal DISC now, only 2 years after it had been in effect, this would be even a far shorter period than the 5 years that Senator Fulbright suggested or the 10 years that this committee suggested. I think it would be most unfair to American business, who took DISC into consideration in the determination of their manufacturing operations in selecting a location.

Now, DISC can be improved in some respects, I think particularly by removing its application to raw materials and to goods that are subject to export control. But in particular, without going into the details, prior to the enactment of DISC, we had the most rigorous and extensive income tax statute and regulations of any country in the world with respect to export sales to affiliated foreign corporations. So far as I know, no country other than Germany has adopted provisions comparable to our subpart F, relating to business profits from sales and services, in the dozen years that have intervened since we adopted subpart F in 1962, and even the German law is not as strict as ours. We have offered in the OECD and elsewhere to enter into multilateral treaties or a series of bilateral treaties with other countries in order to try to obtain some uniformity in the income tax laws of the world regarding the treatment of export transactions.

We are met constantly with statements abroad that their principles of law are based upon a territoriality principle, and that other countries cannot tax the undistributed profits of corporations organized abroad by their citizens because those corporations are beyond their territory and cannot be reached by them even though they are controlled by persons within their country. Despite untold arguments and lengthy discussions in which I have participated on frequent occassions, only in the case of this one instance of the German law has any significant change been made.

I think if we are going to change our rules, we ought to change by trying to get a multilateral treaty, or a series of bilateral treaties, so that our own industries are not at a disadvantage in world competition.

So, I would hope that the DISC would be retained, certainly until we have further information available.

Low Income Allowance

Mr. Chairman, if I may, I should like to add a few words about the thought that has produced, I think, this debate in the Senate, and that is the desire to reduce the burden, particularly on low-income people, because of the inflation that has occurred.

One of the first principles that I urged in the administration in 1969 was the introduction of the low-income allowance, which would remove from the tax rolls substantially everyone below the poverty level. It seems to me to be an anomaly to collect a tax, an income tax from a person who qualifies for welfare because he is below the poverty level. And so we recommended in 1969 that, for example, the minimum level for taxing single persons be raised from $900 to $1,700. And I think the figure finally picked was $1,750. We made comparable changes with respect to families of different size. In 1971, you will recall that the minimum level for an individual was raised to $2,050 and comparable raises were made for families.

I do believe that we should constantly adjust these figures as inflation and other changes occur. I would endorse that principle. I think we should not lose sight, however, of the plight not just at the bottom but also of the middle-income people who, as inflation occurs, are shoved up into higher brackets constantly. So, I do think we have to consider not just the low-income allowance or the personal exemption, but the rate schedule, in the gamut of problems.

Tax Bills Should Not Be Written on the Floor

I would hope that we would await a general tax revision bill, where you can make various changes and balance them off, I would certainly hope that that would be done in the time-honored congressional procedures in which you have available a bill on which public witnesses can comment and call to your attention problems that frequently arise unintentionally in the drafting; and where you have in the committee meetings the invaluable services of the distinguished Dr. Laurence Woodworth and his able staff and the staff of this committee and of the Treasury. While they can be of assistance in floor debate, they may not speak to offer their opinions. I would hope that the Senate would not attempt to write a major tax bill in floor debate without these orderly procedures having been followed.

In my almost 40 years at the bar, I can recall no other occasion in which tax legislation of the proportions here envisaged has been attempted on the floor of either body; and I would hope and would earnestly suggest that the traditional procedures be followed.

The Chairman. Thank you very much, Mr. Cohen.

I think most of us have asked the questions that we wanted to ask as you went along.

Senator Curtis, did you have a question?

Senator Curtis. Mr. Cohen, I have scanned your statement and the various items that you covered, and I also noted your conclusion with respect to each one. I do appreciate that you, with your wide and scholarly experience, have taken time to give this committee the benefit of your thoughts.

UNCERTAINTIES DISTURBING BUSINESS

I would like to ask you this: How important is it for American industry, which after all provides the jobs, to have a feeling of reliance and stability and permanence to our tax structure, from the standpoint of expansion, new jobs, competing in the world? How important is it that these things are not subject to rapid change without notice?

Mr. COHEN. Well, Senator, I do not think it is possible to overestimate the importance of one being able to assume with some reasonable assurance, over some reasonable period, that the major provisions of the tax law will remain in place.

I referred to the chart at the back of my paper, about what happened to machine tool orders and more or less the roller coaster effect it shows as investment credit and depreciation rules have been changed.

My experience in practicing law in New York, nearby the stock exchange for almost 30 years, indicated that there is nothing that disturbs the market as much as uncertainty. So many important programs that produce plants and improve our productive equipment and bring money into the marketplace to finance new industries and provide jobs depend upon some reasonable degree of assurance to the investor as to what the tax structure, with its high rates, will provide. There are so many risks attached to investments and to business in any event. But if you do not know from time to time or day to day whether a provision enacted in the closing days of 1971 is now going to be pulled out from under the rug of business decisions, the results can become almost chaotic. Obviously, you cannot stand still, and we are not going to have the same tax law for years and years. But we should be most hesitant about making fundamental up and down changes that would affect investment and business decisions that have been made in reliance upon a congressional decision after much debate just several years ago, 2½ years ago.

So, I would certainly urge, Senator, that this is a most important consideration.

Senator CURTIS. And it bears directly upon employment and the economic well-being of the country.

Mr. COHEN. Most important. I think that the provision of jobs and improvement in our industrial base, in our technological efforts in competition in the world, is of the utmost importance.

Senator CURTIS. In other words, take for instance the DISC provision. After the Congress passed that, if a company was going to avail itself of the benefits of it, it would call for considerable reorganization within; it may call for an additional set up of an office; it may call for an additional plant; it may call for tooling up to meet particular foreign market; it may even call for labeling of products in a foreign land—on the basis that here is an act of Congress, intended to promote our foreign exports; and someone undertakes all of the preliminary steps to do that under the plan, the objective of which is to keep the jobs in this country. Then it is rather breaking faith with our people when that is totally taken away abruptly, is it not?

Mr. COHEN. I started to use that expression in my statement, but instead I said it was most unfair; but I feel, really, it would be breaking faith, and particularly in view of the history that I recited that this committee voted a 10-year limit on DISC, and a 5-year limit was considered, and the limit was intentionally dropped.

Senator CURTIS. I feel that tax reform, if properly defined as an effort to eliminate injustices, should be a constant responsibility of a Congress with due notice to all of the parties, because we should constantly strive for such improvements so as to promote justice.

But here we have an exercise in granting an entire new tax benefit or inducement, and then totally withdrawing it. It is quite different from the gradual and necessary improvements of tax law that the Congress rightfully should be engaged in.

Mr. COHEN. In essence, I suppose it is fair to say that most of these proposals represent simply a new vote on proposals that were made in 1962 and 1971. Votes were taken in both Houses, and now it is just going to vote again. And I would agree with you that it is unfair to business investors and those who have been trying to keep the jobs at home and make America more productive.

Senator CURTIS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

Glad to see you again, Mr. Cohen; welcome aboard.

Mr. COHEN. It is a pleasure to be here, Senator.

Senator BYRD. I was a little late, because I was talking with one of your former colleagues, Prof. Mumford Boyd——

Mr. COHEN. Oh, yes.

Senator BYRD. Do you see him frequently in Charlottesville?

Mr. COHEN. I do, indeed; not as frequently as I would like, since he has retired from the faculty at the law school; but he is actively practicing law, and I am always delighted that we have him as one of our distinguished citizens and residents in the community.

Senator BYRD. He is a good man. I talked with him twice this morning. I am going to Charlottesville on a matter that he is interested in.

COMPETITIVE ASPECTS OF INVESTMENT CREDIT PHASEOUT

Your statement is a good one. You brought out a new point that I frankly had not thought about, in regard to the investment tax-credit; the proposal to limit it to $100,000 and phase it out—between $50,000 and $100,000. You bring out what effect it would have on the competitive factor, which I must say had not previously occurred to me. It seems to me that is a very important point, and one that the committee will need to take into consideration in considering any change in the investment tax credit.

Mr. COHEN. I think it would have repercussions in many respects. The bus and the airplane illustration occurred to me—I assume that a bus would cost less than $100,000, and an airplane would cost more—certainly some of them would. And it would affect their competitive positions. It would involve a difference too in machine tools, where one large piece of equipment might compete in the marketplace with several smaller ones, and the credit would differ. There would be hosts of problems. I thought of the question, if one were going to buy a train—some trains, I guess, come streamlined as a unit, so one could buy the locomotive and all of the cars together as a unit—would that be a single unit which would not qualify for the credit but there would be multiple units that would qualify if one bought the locomotive separately and then bought the cars separately? Would they be separate items of equipment? Could you buy them on different days and get different delivery dates? I think the problems are just manifold. I think the competitive conditions in the marketplace would be quite severe.

Senator BYRD. I think that is an important point you raise.

I want to concur in your view that you have expressed also, that it is not very desirable to attempt to write complicated tax legislation on the floor of the Senate. I think that is about the worst place to write a tax bill.

Mr. COHEN. Well, I have never had the opportunity of trying on the floor of the Senate, but I have participated in efforts to try it on the floor of the American Bar Association, other legal associations. I do not think that would be a happy indication of what occurs.

Senator BYRD. Thank you, Mr. Cohen. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Fannin, do you have any questions for the witness?

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Cohen, I am sorry that I had to leave. I certainly commend you for an excellent statement.

COMPARING THE U.S. PRODUCTION FACILITIES AND INCENTIVES WITH OTHER INDUSTRIAL NATIONS

It is my understanding, and I think your testimony brought out, that the United States has the lowest capital recovery tax allowance of any of the industrial nations. And the United States has the highest percentage of overage obsolete production facilities and has the lowest ratio of investment in production facilities in relation to gross national product of any of the industrial nations. Is that information correct? I do not know whether you have it all in your statement, but I think you have made statements to that effect.

Mr. COHEN. Well, I do not know that my statement was as comprehensive as that. I do not necessarily disagree. I do not have all of that data. What I indicated was that in 1971, when I was at the Treasury, our studies, when we made a thorough review of the foreign systems, showed that the capital cost of equipment, business equipment, in the United States was higher than that of any other major industrialized nation in the Western World.

After we made the ADR and the investment credit changes in 1972, our figures show that we were behind all of the other countries except Canada, France, and The Netherlands. Now I understand Canada has given greater allowances; so I would have to make an exception for France and the Netherlands at the present time. I have not studied the matter in the last 2 years, but that is my understanding. Perhaps others have made a more recent study than I have.

Senator FANNIN. But the general understanding is we are falling behind the other countries, some of the leading countries of the world, as far as modernizing our equipment and plant facilities?

Mr. COHEN. Yes. And if we were to take these steps to take us back to the pre-1971 situation, we would be vastly behind the others.

Senator FANNIN. And so certainly it would be economically sound and only practical to continue the investment credit and further liberalize the depreciation deduction—if that could be done. Would you agree with that?

Mr. COHEN. Well, when you say "further liberalize it," I do not know the current data, having been outside the Treasury for more than a year. I think that changes in the present system could be in order. I would hope, for example, that one could simplify further the present systems, particularly for smaller businesses, and I know that the Treasury, through its Office of Industrial Economics, which was set up in 1971, has a continuing project to up-date and simplify the system.

CAPITAL LOSS DEDUCTION INCREASE

Senator FANNIN. Mr. Cohen, I have introduced a bill that provides for a sliding scale capital gains tax, and also increases a deduction for a capital loss from $1,000 to $4,000 against ordinary income.

With the vast needs for capital for industry in the coming decade, I would like to have your thoughts on the concept.

Mr. COHEN. Well, I do not have revenue estimates on the effect of increasing the capital loss deduction. I do think it is terribly important to take into the account, the treatment of capital losses along with the many pending proposals to increase the tax on capital gains, including the effect of the minimum tax proposal. You might take into account that the present law allows only a $1,000 deduction—and heads, the Government wins; tails, the taxpayer loses, on capital investments. You cannot make a ready assumption that anyone who makes an investment in stocks or real estate is going to make money. Frequently money is lost and the system is unfair to them. So, I agree that should be adjusted. Whether $4,000 is the right figure or not, Senator, I do not know. I think there are some other possibilities and some precedents in prior law for being fairer with losses than we are at the present time.

I think particularly it is interesting that half—according to the data that I was familiar with when I was in the Treasury—half of capital gains are derived on sale of stocks. In the case of stocks, we do not have a system for avoiding double taxation of corporate income. France, Germany, the United Kingdom and Canada have systems to allow at least some partial integration of the corporate and individual income tax. Since we need stock investment to provide equity capital for American industry, we should take into account the fact that there is a double tax on corporate income in considering the tax treatment of capital gains and losses.

Senator FANNIN. I certainly agree with that, Mr. Cohen. It was my understanding that the minimum tax was proposed to assess individuals paying no tax, and you brought out quite a few items on that. I was not here to hear all of them, but if we eliminate the deduction for taxes paid, are we not penalizing those taxpayers that are presently paying tax?

Mr. COHEN. Well, you would be penalizing those taxpayers if they have preferences in excess of the regular tax that they have paid. I think that it is a better principle to go after those persons who are not paying regular taxes, and in the minimum tax make an adjustment for the amount of the regular tax that is paid. So I think the existing system in this regard is far preferable to that which is proposed in these pending amendments.

Senator FANNIN. Thank you.

TAXATION OF FOREIGN INCOME

You talked about the foreign taxes. Even if all income earned by a foreign subsidiary were distributed and remitted during the year following the year in which the income was earned, U.S. dollar funds would in many cases not be available for tax payments by the due date of the U.S. return, and of course, this gets to the problems arising out of blocked foreign income, and the fact that in various countries, remittance of dividends is delayed under exchange control laws until local income tax returns have been audited and assessed. The underlying assumption seems to be that all income earned by a foreign subsidiary is currently remittable, an assumption which is often contrary to the facts of business life outside the United States.

Do you agree with that statement?

Mr. COHEN. Well, the bill that is pending, Senator, contains a provision that would not require current payment of tax where remittance is forbidden by foreign exchange laws or other laws of foreign countries. So it could be that under that provision where there is a delay in remittance, that the existance of that foreign exchange control would provide relief. The proposed amendment says that the taxable earnings shall not include any amount of earnings and profits which could not have been distributed by such corporation because of currency or other foreign restrictions or limtations imposed under the laws of any foreign country.

I would take it that earnings would not be subject to tax under that language until they could be distributed, if distribution was prohibited by currency or other restrictions or limitations under the foreign laws. Wherether a foreign regulation would be a law or not, I do not know, but I think this is an illustration of something that would require further clarification and elaboration.

As I pointed out, there can be other reasons for inability to distribute earnings. For example, we have encouraged our foreign subsidiaries to borrow abroad the large amounts of money they may need. I am sure that many of those loan agreements restrict the payment of dividends until the loans have been paid off, but such a restriction that would prohibit the payment of dividends would not be imposed under a law, but it would be under a prior contract. When in the past we have adopted similar statutory provisions in the personal holding company field, we have always made an exception for distributions forbidden by contract.

Now, there are many such problems here that would have to be dealt with, in my judgment.

Senator FANNIN. That was my understanding, that so many of the laws of the foreign countries have been written in accordance with what exists as far as our laws are concerned.

Mr. COHEN. I do not know what would happen if some countries, for example, we had this provision by law prohibited distributions so as to make the U.S. tax inapplicable. The country itself might by law intentionally prohibit the distribution back to the United States. If the country did that, the effect of this provision would be nullified

Senator FANNIN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dole?

Senator DOLE. I have no questions.

EFFECT OF HIGH TAXES ON INDIVIDUALS AND BUSINESSES

The CHAIRMAN. I just want to ask about one thing that occurs to me. When we strike down the depreciation provisions, the depletion allowance, the investment tax credit, and if we do all this whole package that we have here, raising the minimum tax and disallowing the credit for the tax that has already been paid and cutting the deduction down from $30,000 to $10,000—we are going to be seeking to make people pay taxes in about a 70 percent bracket if they are making $100,000 income, that is, for an individual. I think you get up to that marginal tax rate pretty quick, do you not? At what point is the marginal rate 70 percent for an individual?

Thanks to inflation, in other words, what we did not do to take the taxpayer's money away from him, inflation pretty well followed through and achieved for us.

Mr. COHEN. Well, a single person, an unmarried individual hits the 50 percent bracket at $32,000 of taxable income, after his——

Senator CURTIS. Is that earned income?

Mr. COHEN. Pardon?

Senator CURTIS. Is that earned income?

The CHAIRMAN. That is any taxable income.

Mr. COHEN. It is net taxable income, after allowance of deductions, personal deductions and exemptions. The rate bracket for single persons reaches 50 percent at $32,000 and for married people on joint returns, reaches 50 percent at $44,000, but say roughly $50,000.

The CHAIRMAN. At $100,000, it hits the 70 percent rate, and that is not counting any State income taxes he is paying.

Now, if he is paying a State income tax, that would add about 6 percent more in Louisiana, for example. Of course, Louisiana is very generous. They only tax you on what you have got left after you pay the Federal Government. A lot of States do not do it that way. They tax you on your whole income without giving you any consideration for what you have paid the Federal Government.

Now, I think most people tend to think when the Government puts a tax above 50 percent, the Government regards that as antisocial conduct and that therefore you ought to find a different way of doing business. They usually proceed to find ways of doing business in some other fashion, do they not, when the tax rate gets high enough?

In other words, when people are paying more than half of their income in taxes, do you gain the impression that they start trying to find ways to do business in a different fashion, either not to do as much business or not to make as much income, to defer it, postpone it, or find some way to change their way of doing business?

Mr. COHEN. I think that is a tendency of many people, Senator. I was surprised when I was at the Treasury, while I seldom saw any individual tax returns, I saw analysis of them, and we tried particularly to find out whether high income people would pay 70 percent taxes and so on. I found that many of these people paid very high taxes. I understood from conversations with many members of the bar who had substantial incomes, that they just paid high taxes. They practiced law and they did not get into investment situations that might reduce tax but would require time and energy and detract from the time that they devoted to practicing law.

So there are people who are paying, not 70 percent effective rates, but paying effective tax rates on their income of 45, 50 percent and more. But there is certainly the tendency that you suggest that people in high brackets will go into such ventures. If a taxpayer has one successful business, the thing to do may be to start another business which in its early years will lose money and reduce his taxes but which if he manages it carefully, after a few years would turn into a profitable venture.

I do not see how one can in a highly progressive income tax system seek to stop that. Indeed, I question whether one should try to stop it.

The CHAIRMAN. Well, there are just all kinds of ways. For example, if people say, I do not want to give 70 percent away to the Government, I would rather give it to my favorite charity, they set up a foundation and they give everything they make more than a certain amount to their foundation. Assuming that the foundation has a proper purpose and it is properly run, that is a deduction. And you can borrow the money to buy a piece of land, and put money into improving it, and that has the effect of giving one a deduction for the time being and deferring the income to further on down the road, when the trees grow and you are ready to begin to harvest trees off the improvements and things of that sort.

Now, with regard to the oil industry, that industry has been working on the theory that tax considerations were such that you ought to go ahead and produce the oil as rapidly and as efficiently as you can. Their contracts are geared that way. But when they reach a point that the Government is taking 70 percent of what they make as individuals, does it not stand to reason that they will start drafting their leases and contracts in a different fashion geared to the new situation?

For example, the thought occurs to me that if I were a farmer sitting out there on a large piece of property and someone wanted to lease my land, if there was oil down there I would not want to pay 70 percent of my resources to the Government. I would try to find a way to keep more of it, and I think I would want a contract that would say that I was a partner in the drilling so that I would have the benefit of the intangible drilling expenses of drilling the well. And then I wouldn't want him to take out so much oil a year that it would prevent me from keeping at least 50 percent of what was my oil after taxes. So I think I would want it put in the contract that we would drill the well, and that after the driller got his money back, I would want the contract to say he would put me in there for a share rather than as a royalty owner, put me in the working interest, but require him to obtain for me a nonrecourse loan so that I would be in for a share of the working interest. Then after the cost of drilling the well had been recovered, we would then have it in the contract that we would come into agreement as to how much oil we would take out each year, because I would not want the Government to get 70 percent of it. I would want to take out so much and then just leave the rest there, just not take any more out until next year, and by doing that, one could space his income over a long period of time, depending upon what deductions he had from other things.

Now, that to me is just a logical way to do business in the oil industry. It certainly is as far as that farmer is concerned, in the event that he loses his depletion allowance.

Now, people do not tend to see those things when they vote on a tax law, but it oftentimes works out that way.

We voted a provision about social services some years ago. I think it was supposed to have cost about $75 million a year, to provide 75 percent matching for social services rather than 50 percent, and in just a few years it was threatening to cost us $5 billion a year instead of $75 million The reason is that it was attractive to people simply to shift all of their welfare money over into something that they could call social services. They were even getting around to building highways and calling it a social service.

The same general thing tends to happen in economics. When you write your laws in such a fashion that it is desirable for a person to change his way of doing business, he will change it.

Does that not frequently happen?

Mr. COHEN. Oh, constantly. I think that in a system of taxes that are 48 ~~percent~~ for corporations and up to 70 percent for individuals, anyone planning business investments must do so on the basis of after-tax effects and not before-tax effects. The taxes are just too high to ignore. That's the essence of the problem.

The CHAIRMAN. It would appear to me that Congress is in the process of changing laws to make it advantageous for people to defer their production in the minerals industry, and when they do, since we are in prospect of a shortage of energy already, it seems to me that Congress will then be in a position to take credit for a much greater shortage of energy when its laws go into effect. I think that is a rather foolish thing to do. People do not have to have any foresight, but usually the Nation is better off if they do.

Thank you very much.

Mr. COHEN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Cohen follows:]

Statement of Edwin S. Cohen
before the
Senate Finance Committee
June 11, 1974

My name is Edwin S. Cohen. I am a professor of law at the University of Virginia and am of counsel to the law firm of Covington & Burling, Washington, D. C.

I am pleased to have the opportunity to appear before you this morning and to comment briefly upon some of the major tax increase proposals now pending on the floor of the Senate as amendments to H.R. 8217, a tariff measure dealing with certain ship repairs. I shall try to indicate a few important reasons why I strongly believe the proposals should not be adopted, and particularly so without the benefit of adequate public hearings, staff consideration of public comments and objections, and mark-up sessions of this Committee.

Minimum Tax

The concept of a minimum tax was born out of a desire to see that those persons who use "preferences" or "incentives" in the income tax law to eliminate much or all of their income tax will nonetheless pay some reasonable minimum amount in support of the federal government. I do not think that the proposals pending in the Senate to amend the minimum tax will make significant progress toward that goal, but instead will have the principal effect of simply increasing the tax on long-term capital gains realized by individuals.

In introducing this proposed amendment on May 21, 1974, Senator Bayh stated its objective as follows:

> "Strengthening the minimum tax: Our goal here is to make more effective the minimum tax, which was passed as part of the Tax Reform Act of 1969. Each year there are taxpayers who have substantial income which is not included in their regular tax base because of income exclusions thought to be justified for social or economic reasons. While Congress continued to recognize a need for these exclusions, we also recognized a basic inequity in permitting a relatively few wealthy taxpayers to escape liability entirely by investing their resources solely in tax-free, income-producing assets." (Cong. Rec. p. S8700.) (Underscoring supplied)

While I agree with the objective, I respectfully submit that the proposed amendment would be largely wide of its mark, and that when changes are made in the minimum tax, they should be of a different type.

The minimum tax concept was originally developed by the Treasury staff in 1968, and was modified in some respects by the incoming Treasury in 1969 and in the House version of the 1969 Act to take the form of a limit on tax preferences, but it was completely revised in 1969 in the Senate to assume substantially its present form. As it now exists, it requires individuals and corporations first to total the amounts of nine enumerated preferences reflected in their tax returns; second, to subtract from the total an exemption of $30,000; then to subtract the amount of the regular income tax; and finally to apply a tax rate of 10% to the balance.

The pending amendment in the Senate would modify this present formula (1) by reducing the $30,000 exemption to $10,000 and (2) by eliminating the deduction for the regular tax.

At the 10% minimum tax rate, the $20,000 reduction in exemption would not increase the burden on any person beyond $2,000. Obviously, it would substantially increase the number of persons who would be subjected to the tax and make it applicable to middle income persons who are not in the category of "a relatively few wealthy taxpayers."

The proposed elimination of the deduction for the regular income tax would, however, have a substantial effect, but that effect would primarily be to make the minimum tax on individuals be an additional flat rate tax on capital gains above the exemption level.

Of the nine preferences covered by the present minimum tax, the IRS Statistics of Income data for 1970 and 1971, which contain the latest such data that has been published, show that only four were of significance on individual returns. Roughly 85% of the amounts of these preferences consisted of the excluded half of net long-term capital gains. The balance was roughly evenly divided among depletion, stock options and accelerated depreciation and amortization on real estate.

Under the existing law the vast bulk of the effect of the minimum tax on individuals falls on capital gains, and almost the entire impact of the proposed stiffening of the minimum tax in the amendment pending on the Senate floor will fall on capital gains. This seems a major shift of the high purposes with which we set out some five years ago in an effort to see that all high-income individuals pay some minimum tax. Capital gains are in broad effect under present law subject at least to tax on half the regular rates, with a ceiling rate of 25% on the first $50,000 of gains. The primary effect of the proposed amendment to the minimum tax would be to levy an additional flat tax of 5% on net long-term capital gains exceeding $20,000. That would be the net effect of imposing a 10% tax on the excluded half of capital gains after a $10,000 exemption.

It would be difficult indeed to explain the wisdom of this to persons who after thirty years sell their businesses or their homes or their farms. It is important to note that, according to the IRS Statistics of Income, in each of the years 1960 through 1972 more than half of the amount of net capital gains has been realized by individuals with adjusted gross income under $50,000.

It is particularly difficult to devise an adequate means of caring for cases in which capital gains have accrued over a long period of time and are realized in a single year by a person who has had little or no realized gains for many years, such as a person who sells his business once in a lifetime upon retirement. If a substantial minimum tax is applied to capital gains, either a system of carry-backs and/or carry-forwards should be devised, or else perhaps the minimum tax might be limited to gains on assets held for less than three or five years.

In the case of corporations I understand from the available published data that a high proportion of the minimum tax has been occasioned by percentage depletion. But pending legislation in the House would phase out or perhaps eliminate most of percentage depletion, as would other proposed amendments pending on the Senate floor. Until that matter is disposed of, it is not possible to judge the overall effect of the pending minimum tax amendment on corporations.

The Ways and Means Committee has proposed major changes affecting the preferences that form the base of the minimum tax, either in the pending energy tax bill that it has reported, or in tentative decisions it has already announced on general tax reform legislation. It is currently reviewing the proposals of the Treasury and those of the Joint Committee staff for a basic revision of the minimum tax. I respectfully suggest that it would be confusing and unproductive to take up on the floor of the Senate the proposed minimum tax amendment, without adequate committee consideration, while basic changes in the preference base and the structure of the minimum tax are being dealt with in the traditional Congressional procedure.

As I have noted, the original concept of the minimum tax was that it would insure the payment at least of some minimum amount of tax by those who avail themselves to an unreasonable extent of the preferences or incentives provided by Congress in the tax law. As such, it was designed so that the taxpayer would compute his tax under the regular method, and then compute an alternative tax with the preference items added back to income, and pay the larger of the two taxes so calculated. As finally adopted in 1969 it is not an alternative minimum tax but an added tax on the preferences, to be paid over and above the regular income tax. By allowing a deduction for the regular income tax, the present form of minimum tax at least preserves to a considerable extent the original concept that it should apply to those not already paying a substantial amount of tax in support of the government. It is to the latter group that I believe the minimum tax should be aimed, and unless the minimum tax is altered by more basic changes that are being considered in the House, I would submit that the deduction for the regular income tax should be retained.

Asset Depreciation Range (ADR) System
and Investment Credit

Several of the pending amendments would repeal the Asset Depreciation Range system (or ADR) that was adopted in 1971 and restore the old, 1962 depreciation guidelines and the so-called "reserve ratio test;" and another would eliminate the 7% investment credit on assets costing more than $100,000, with gradual reductions in the credit for assets costing between $50,000 and $100,000. Both for important policy reasons and technical and administrative reasons, I believe it would be a grave mistake to adopt these proposals.

The need for capital formations and investment in productive machinery and equipment is at least as great, if not greater, than it has ever been. We have vast requirements to keep pace with accelerating technological changes, to make essential investments for prevention of air and water pollution, to create new plants and equipment to satisfy domestic energy and other needs, to keep pace with increased efficiency in the productive facilities of other nations and the increased competition they provide, and to maintain jobs for our expanding labor force.

The history of the past dozen years provides us with dramatic evidence of the roller-coaster effect of changing the system of depreciation allowances and the investment credit. When the ADR system was enacted and the investment credit was restored in the 1971 Act, the Senate Finance Committee report (p. 9) contained a chart showing domestic new orders for machine tools for quarterly periods from 1960 through 1970. I am attaching to this statement an extension of this table to the present time. The table shows:

- The reduction in depreciation lives and the enactment of the investment credit in 1962 marked the beginning of a sharp rise in such orders until 1966, subject to a brief setback in mid-year 1964.
- When the investment credit was suspended in the fall of 1966, a precipitate decline in such orders occurred.
- Following restoration of the investment credit in the spring of 1967, orders rose until in early 1969 they passed the 1966 peak.

- When the investment credit was repealed as of April, 1969, another precipitate decline in such orders ensued until at the end of 1970 they reached the low levels of early 1962.

- When the ADR system was announced in January, 1971 and the investment credit was restored as of April 1, 1971, orders commenced a sharp climb that has taken them now above the levels of early 1969.

Obviously other factors, including changes in interest rates, had their effect, but the coincidence of these dramatic fluctuations in machine tool orders with changes in capital cost tax allowances demonstrates the great risk to the economy and to jobs that would be involved in any major reduction in those allowances at this time. This is particularly true since the announcement last week by the Department of Commerce that capital spending for plant and equipment for the year 1974 is expected now to rise less than was anticipated three months ago, and that these outlays will rise in the second half of the year by only 5% over the first half instead of the 7.2% earlier projected.

Before the depreciation and investment credit changes were made in 1971, Treasury estimates showed that our income tax laws made the capital cost of business equipment higher than that of any other major industrialized nation in the Western world. The 1971 changes restored American business in this regard to a position somewhat more favorable than Canada, France and the Netherlands, but still behind West Germany, Japan, the United Kingdom and others of our principal competitors in the world markets.

I understand that subsequent changes in Canadian law make our allowances less favorable than theirs. In the highly competitive world business situation, I think it would be a grave error to go back to the pre-1971 status that would make the capital cost of modernizing and expanding our productive facilities greater than that of all our major competitors.

The pending amendments to repeal ADR would require that we return to the guidelines lives of equipment set in 1962 by Revenue Procedure 62-21 on the basis of data from 1959 or 1960 sources. In the light of vast technological and scientific changes and resulting increased obsolescence that have occurred in the meantime, it would seem most unwise to make a peremptory decision to return to equipment lives established from data now some fifteen years old.

Moreover, the pending amendments would specifically require reinstitution of the so-called "reserve ratio test" that was adopted in Rev. Proc. 62-21 and substantially modified in 1965. The 1962 test was quite complex but was adopted with a three year moratorium; in 1965 further complex tests were added to the 1962 rules so that their effect would not seriously be felt until some five years later. When one managed to comprehend the tests, it became clear that they had major fundamental weaknesses, including favoring new businesses over established companies, penalizing the retention of old equipment for standby use, and reliance upon the past history of old assets as the guide for predicting the future life of modern technologically different new equipment. In an IRS survey in May 1971 of 3,500 experienced IRS employees, 87% of the experienced revenue agents stated that the reserve ratio test was unworkable and impractical, and 88% favored abandoning it.

On June 22, 1971 the Treasury issued a lengthy analysis of the problems and defects in the reserve ratio test, both of a logical and administrative nature, and the reasons for abandoning it. The results of suddenly restoring it would, I believe, be little short of chaotic.

The ADR system can, of course, stand continuing study and for this purpose an Office of Industrial Economics was established in the Treasury in 1971. Improvements can be made from time to time as experience indicates, and hopefully some simplifications can be introduced to reduce accounting expense for smaller businesses. But sudden abandonment of the system and turning the clock back a dozen years to outmoded data and an unworkable and unfair reserve ratio test would be a grave error.

The proposal to limit the investment credit to equipment costing less than $100,000, and to phase it out for equipment between $50,000 and $100,000, would be unsound in policy and, I fear, an administrative problem of major proportions. Since the credit would be determined by the dollar cost of each piece of equipment, it would not be a small business provision; it would be available to large businesses as well as small, so long as individual equipment purchases were below the cost limit. It would introduce new and untried competitive factors between a single large piece of equipment and two or more smaller pieces of equipment that could accomplish the same task. It could, for example, change the competitive position between buses and airplanes, since buses would be below the limit and airplanes above it. It would require a host of rules in an effort to determine whether particular equipment represented a single item or multiple items; whether parts purchased separately and assembled by a taxpayer should be treated as a single item or different items; whether additions to existing equipment should be aggregated with the original cost, etc. It would seem to be extremely difficult to apply such a rule in a fair and equitable manner.

For these briefly stated reasons, among others, I would strongly urge that the pending proposals for depreciation and investment credit changes not be adopted.

Taxing Undistributed Profits of U.S. Controlled Foreign Subsidiaries

One of the important pending amendments would require United States shareholders in foreign corporations that are more than fifty percent controlled by United States persons to include currently in their income their pro rata shares of the undistributed earnings and profits of the foreign corporation.

This is a proposal that was rejected after thorough consideration by the Congress in 1961 and 1962. It involves deep-seated policy considerations and enormous technical complexities. I shall not attempt in this brief statement to review the many important reasons why I would oppose the proposal, but shall note only a few of the many significant aspects.

- To the best of my knowledge no other country in the world seeks to impose tax currently on the undistributed earnings of foreign subsidiaries from business operations. To enact such a measure unilaterally without some assurance of comparable efforts by other industrialized countries would put U.S. businesses at a significant disadvantage in world competition.

- I understand that of the some $350 million of additional revenue that is estimated would be produced by the proposal, more than one-third would come from U.S. controlled foreign shipping companies. Since other countries now impose little or no income tax on shipping companies controlled by their residents, American controlled shipping would be put at a distinct competitive disadvantage by a 48% tax. The result could be to force sales or passage of control of these ships to foreign persons.

- With respect to subsidiaries operating in developed countries, which generally have substantial corporate tax rates, the corporate tax paid in those countries together with withholding taxes on dividends paid to U.S. shareholders will generally equal or exceed the U.S. tax, resulting in such cases in no U.S. income tax after allowance of the foreign tax credit. In such cases the effect of the proposal would be not to increase U.S. revenue but to cause payment of withholding taxes to foreign governments.

- With respect to subsidiaries operating in less developed countries, which frequently have lower rates of tax to attract industry, the proposal would nullify those tax inducements while leaving them available to businesses from other developed countries. This problem involves an important policy issue in our industrial and political relations with less developed countries that should have thorough review.*

*For an interesting and informative recent discussion of our tax relationships with these nations, see "U.S. Income Tax Treaties and Developing Countries" by Nathan N. Gordon, Deputy to the Assistant Secretary of the Treasury for Tax Policy (International Tax Policy), in "Essays on Taxation, Contributed in Memory of Colin F. Stam", Chapter XIII, published by Tax Foundation, Inc., 1974.

- U.S. shareholders would be taxable on the undistributed earnings of foreign corporations even though the foreign company might be forbidden by loan agreements or other contractual commitments to distribute the money to defray the amount of the tax. The proposed amendment contains relief where foreign exchange restrictions or other foreign laws prohibit dividend payments, but not where they are forbidden by existing contracts. This would seem most unfair.

- U.S. corporate shareholders of a controlled foreign corporation would be subject to a maximum U.S. tax of 48% on the undistributed earnings and would be allowed credit for the foreign corporate income tax paid; but U.S. individuals who are shareholders would be subject to U.S. tax up to 70% without any credit for the foreign corporate tax paid. This too would be unfair. In the existing Subpart F, dealing with so-called tax haven foreign corporations, special provisions give individuals tax treatment comparable to corporations.

- Capital gains of controlled foreign corporations would be taxed to U.S. shareholders as ordinary income.

- There would be especially difficult technical problems where the foreign corporation has more than one class of stock owned by different persons and where there are minority stockholders in other countries. Moreover, the U.S. shareholders would be taxed not on statutorily defined "income" of the foreign corporation, but on "earnings and profits," a term not adequately defined in existing law or the proposed amendment. The proposed amendment says that the earnings and profits shall be "determined according to rules substantially similar to those applicable to domestic corporations," but such a provision is a vague basis for laying taxes, especially when the domestic rules are uncertain in many respects. While these problems exist to an extent under existing law with respect to the foreign tax credit and foreign tax haven operations, the problems would be far more pervasive if applied to all U.S. controlled foreign corporations on all their current earnings. They would, I believe, require much greater elaboration in the statute than is contained in the proposed amendment. Even if elaborated, they would involve grave problems and complexities.

These are but a few illustrations of extremely difficult policy issues and technical problems that would be involved in the proposal and that have caused me to oppose its adoption, as I have since it was first advanced in 1961. In any event, I respectfully submit that the proposal should not be dealt with in floor debate without adequate opportunity for public hearings before this committee, followed by executive sessions and extensive staff work.

Domestic International Sales Corporation (DISC)

Another pending amendment would terminate as of the beginning of 1974 the provisions enacted in the Revenue Act of 1971 relating to domestic international sales corporations (DISCs). While I think experience indicates that some amendments of the DISC provisions are in order -- and some tentative decisions to make changes in them have been announced by the Ways and Means Committee -- I think it would be most unwise to repe the provisions at this time.

The DISC provisions were designed to eliminate the disadvantages which existed under the prior income tax law to U.S. corporations engaged in export activities as compared with those that manufactured abroad through foreign subsidiaries. It was designed to keep jobs at home. Since adoption of DISC our exports have increased to an enormous and unprecedent extent. Of course, in the 2-1/2 year interval since the enactment of DISC, there have been momentous changes in the international economic scene, including dollar devaluations, floating exchange rates and the world energy situation. It is too early to appraise the effect of DISC in the total expanding export picture to terminate it by precipitous action. The United States must maintain its exports and continue its efforts to keep jobs at home.

When the 1971 Act was pending in the Finance Committee, a provision was inserted in the DISC sections to make it inapplicable after 1981 in order to insure a review of its operation and effect over an initial ten-year period. On the Senate floor this period was shortened to five years. In conference, however, the time limit was deleted. I understand the time limit was dropped by the conferees because U.S. companies in deciding whether to locate manufacturing facilities in the United States or abroad should not be faced with the possibility of early termination of DISC, or else the provision would not have its intended effect in encouraging them to produce here for export. This was particularly true in view of the lead time required to plan and complete construction of facilities and to operate them profitably.

If the DISC were now to be repealed as of the beginning of 1974, only two years after it took effect, the termination would occur far sooner than was even suggested as a possibility in 1971. Such action would be most unfair to the many companies that have relied upon it in making decisions to locate plants here for export rather than to manufacture abroad.

It is far too early to appraise the effectiveness of DISC as a factor in the vast increase in our exports that has occurred since its enactment. Preliminary data has only become available for the year 1972, when there were some 2,200 DISCs. I understand there are now more than 5,300 DISCs. It is important that we make a thorough appraisal, and make it with data over a period substantially longer than a single year, before contemplating repeal of the provisions.

Prior to the enactment of DISC, the United States had the most rigorous and extensive income tax statute and regulations of any country in the world with respect to export sales to affiliated foreign corporations. So far as I know, no country other than Germany has adopted provisions comparable to our Subpart F relating to business profits from sales and services in the dozen years that have intervened since we enacted it in 1962. We have offered, in the O.E.C.D. and elsewhere, to enter into multilateral treaties, or a series of bilateral treaties, with major nations to treat such international export transactions on a comparable basis under the various income tax laws, but to little avail. In the highly competitive international area, it is essential, I think, that we not abandon DISC until other nations impose income tax rules on international sales between affiliates on a basis roughly comparable to those that would apply to American companies. We should not ask our companies to compete through exports under income tax rules and requlations that place them at a distinct disadvantage.

The DISC accomplishes two principal objectives. First, it permits an affiliated sales corporation to have an American charter with the same effect as if it had a foreign charter. This is not an essential change, but it greatly simplifies IRS audits to have the company's book and records kept in the United States rather than abroad, and it reduces complications both for the company and the government. Second, and more important, it provides specific statutory rules for determining the amount of manufacturing profit that is to be taxed currently and the amount of foreign sales profit that is not to be taxed until distributed to shareholders. In broad terms 75% of the total profit is taxed currently as manufacturing profit and the balance is treated as deferred foreign sales profit.

If we were to terminate DISC we would be back in the same position that we were in before the 1971 Act, under which affiliates would be organized and operated abroad and the allocation of total profit on exports between manufacturing profit taxed currently in the U.S. and the sales profit of the foreign subsidiary, which would not be taxed currently in the U.S., would be the subject of lengthy and complex disputes on IRS audits. The statutory DISC allocation formula, under which roughly 75% of the total profit is currently taxed in the U.S. as the manufacturing profit, provides a reasonable and convenient rule of thumb to avoid costly and protracted disputes.

While the DISC could be improved in some respects by amendments, such as by removing its application to raw materials and goods subject to export control, I would strongly urge that it not be repealed at this early date. In particular, we should await further evidence upon which we can base an informed judgment and further efforts to secure some standardization of income tax rules in this regard among the major industrialized nations.

Tax Burdens and the Legislative Process

These and other pending tax increase proposals on business and investments have been advanced simultaneously with proposals to reduce personal income taxes because of the effects of inflation. changes in the level of individual income taxes to take account of inflation and other factors, particularly among the low income groups. A major item in the Administration's tax reform proposals presented to the Congress in April 1969 was the introduction of the Low Income Allowance, designed to remove from the Federal income tax rolls substantially all individuals who were below the estimated poverty level. As I said in my statement before the Committee on Ways and Means on April 23, 1969:

> "First priority for reducing the present burdens of federal income tax should be given to removing the tax on people in poverty."

It seemed to me that it was anomalous to be collecting income taxes from those who qualified for welfare relief. Accordingly, we recommended that the minimum level for imposing individual income taxes be raised for single persons from \$900 to \$1,700, and for a family of four from \$3,000 to \$3,500. In the Revenue Act of 1971 the levels were increased to \$2,050 and \$4,300 as poverty levels rose.

I believe this is a sound principle to follow and that adjustments are required from time to time so long as inflation causes income and essential living costs to rise. At the same time, however, attention must be given not only to these minimum levels but to the entire spectrum of individual taxes, including the tax rate schedule itself.

The ratio of aggregate personal income taxes to so-called taxable personal income has remained relatively steady at about 11% for the past 20 years, primarily as a result of the successive tax reductions made in the 1964, 1969 and 1971 laws. But only once in the past 20 years has there been a substantial change in the tax rate structure; that occurred in 1964 when rates were reduced approximately 20% across the board. Inflation has affected not only the low income groups but middle income groups as well. If substantial changes in the tax structure are to be made because of inflation, the rate structure deserves to be reexamined along with personal exemptions and standard deductions. Otherwise, an already highly progressive structure is constantly steepened as middle income groups in particular are shoved up into higher tax brackets, although their actual purchasing power has not increased.

I respectfully suggest to the Committee that it would be unwise to attempt to write major tax legislation on these important subjects in floor debate without prior Committee meetings and report. The Congress is blessed with the services of the distinguished Dr. Laurence N. Woodworth and his able staff of the Joint Committee on Internal Revenue Taxation, as well as having available the highly competent advisers and technicians on the Committee staffs in both Houses and in the Treasury. Their comments, advice and assistance in committee meetings are of inestimable value. In the floor debate, however, while these experts are available for consultation, they may not state their views or participate in the discussion. In a statute so interlaced with delicate but vital complexities, with important provisions so interdependent and replete with cross-references, I think it would be most inadvisable to attempt to write such legislation without the benefit of the services of these experts in mark-up sessions of the committees. I cannot recall an occasion in my almost 40 years at the bar in which income tax provisions of the magnitude now proposed have been written in floor debate.

Our founding fathers stipulated in the Constitution that revenue measures should originate in the House of Representatives, although, of course, the Senate has the right of amendment or rejection. The opportunity for comment and protest in public hearings by taxpayers on major tax legislation has historically been preserved in both Houses and particularly by this Committee. It serves the most useful purpose of permitting the public to express its views and particularly to permit taxpayers the opportunity of pointing out inequities and hardships, frequently unintentional, which tax legislation can produce. The Ways and Means Committee is now in the midst of meetings on a major tax reform measure, but its public hearings were concluded more than a year ago before significant changes occurred in economic conditions.

When the bill that the Ways and Means Committee is preparing is introduced and passed by the House, it will be a matter of prime importance that the public, including taxpayers affected or aggrieved, be given the opportunity to appear before this Committee and call attention to specific needs for revision, not merely on broad policy issues but on the specific drafts of statutory language.

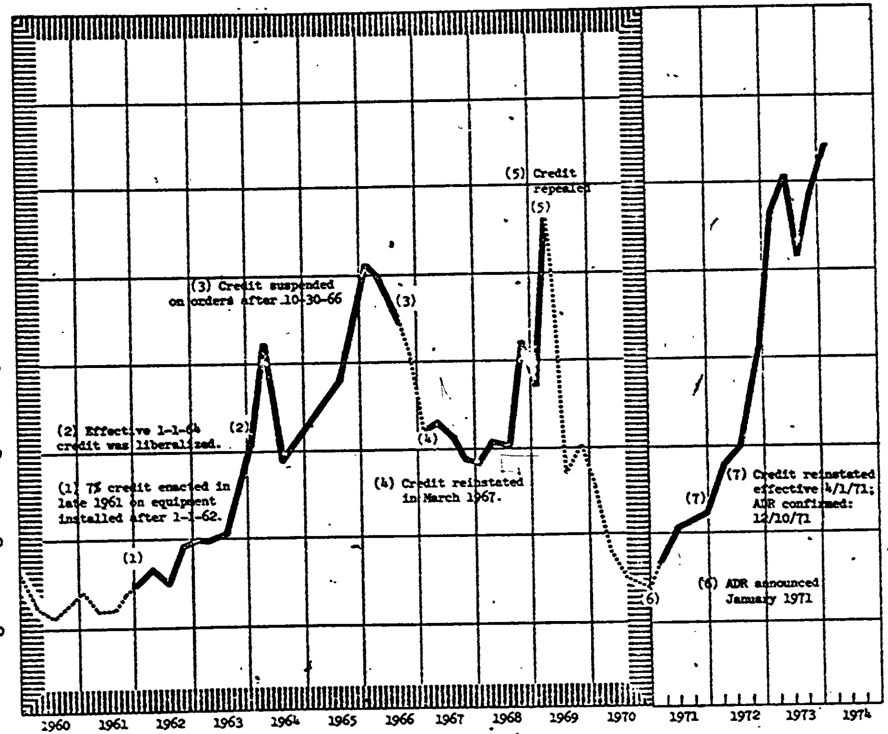
Adequate opportunity should surely be given for public scrutiny of the bill, for the airing of suggestions for change and for markup of the bill by this Committee with a report to the Senate before floor debate begins. There cannot be sufficient opportunity for this to take place during conference with the House, if the full Senate acts now.

I respectfully suggest to you that public confidence in the legislative process for enacting fundamental tax changes must be maintained. That confidence would be endangered if the opportunity for adequate public hearings and Committee consideration with staff assistance were forfeited by impatient action on the floor of the Senate.

MACHINE TOOLS - Domestic New Orders

Quarterly

Millions of Dollars



Source: National Machine Tool Builders' Association

June 1974

The CHAIRMAN. Next we will have Mr. Frank Ikard, accompanied by Mr. Richard Gonzales, for the American Petroleum Institute.

We are certainly happy to have you here, Mr. Ikard. I know you can add something to the general area in which this committee has been struggling for some time, and I am sure that your associate, Mr. Gonzales—I believe you are an economist professionally, Mr. Gonzales?

Mr. GONZALES. Yes, Mr. Chairman.

The CHAIRMAN. I am sure you will be able to provide us some useful information.

STATEMENTS OF FRANK N. IKARD, PRESIDENT, AMERICAN PETROLEUM INSTITUTE, AND RICHARD GONZALES, AMERICAN PETROLEUM INSTITUTE

Mr. IKARD. Thank you, Mr. Chairman.

Dr. Gonzales and myself both have short statements to deliver.

Just for the record, my name is Frank Ikard. I am President of the American Petroleum Institute, which is a trade association representing a cross section of the petroleum industry, from the very smallest operators to the very largest firms.

The key point I wish to stress is that the imposition of heavy additional taxes on the petroleum industry will prove a harmful burden to consumers very quickly, it will perpetuate oil shortages, it will aggravate inflation, and will weaken the position of the Nation in its economic security and its international relations.

OIL COMPANY PROFITS

Let me say emphatically that those who think that additional taxes can be paid out of the profits of the industry without affecting supplies and prices are wrong. The very harsh business realities are that the huge expension of investments required to overcome shortages of oil and gas and meet the needs of a prosperous and growing economy can be made only if the rates of return on new ventures, after all costs including taxes, appear attractive to investors in relation to the alternative opportunities, most of which would involve much less risk, and provide a higher rate of return.

The appearance of sharply increased profits for the oil industry, as for many other corporations, reflects the distorting effects of inflation. As a result of the abnormal rise in prices, depreciation charges based on book investments fall far short of covering the replacement costs necessary to maintain reserves and productive capacity. In addition, apparent gains resulting from the sale of older, low-cost inventories and replacement by higher cost new stocks are of no real value to an individual company or to a company's stockholders because they must all be kept in the business to finance the inventories required to maintain operations at existing levels.

We can compare this situation, I think, to that of a family which acquired a home for $20,000 in 1960, and assume that in 1970 the head of the family was transferred to another city. We will say he sold the house for $30,000 that had cost him originally only $20,000, but he had to pay $30,000 to buy an equivalent house in the new community.

Under those circumstances, which parallel the experience of the petroleum industry, the appearance of a large windfall profit does not measure correctly the real economic facts.

In considering this much-publicized subject of oil industry profits, I think another point also needs clarification. Devaluation of the dollar distorted the appearance of 1973 earnings. Part of what looked like a great increase in profits of international companies was actually only an increase resulting from the larger number of dollars considered to be equivalent to the earnings on foreign operations. The Chase Manhattan Bank reports that almost one-fourth of the worldwide increase in oil company earnings could be attributed to this one factor in 1973.

The inadequate level of oil and gas prices and profits during the past decade is demonstrated clearly by the decline that has taken place in proved U.S. reserves available to meet current needs and by the way in which productive capacity has lagged far behind increasing demand for natural gas and petroleum products, fuels that are environmentally superior to coal.

That undesirable situation occurred because profits on petroleum operations were kept too low by Government regulation of natural gas prices that also limited prices for competing fuels. The controlled price of natural gas at the wellhead unbelievably has been the equivalent of fuel oil at about 3 cents a gallon. As a result of these artificially low prices, many small operators quit looking for oil and gas in the United States and the larger firms could not justify expansion in their efforts.

When I hear the clamor about today's oil company profits, I cannot help but wish that there had been something like this din on the other side during the late 1950's and 1960's. In 10 of the 15 years from 1959 through 1973, oil company rates of return were less than the average for all other manufacturing. In light of the high risks and uncertainties in the petroleum industry, one would have expected the situation to be just the reverse.

The return on shareholders' equity in the oil industry from 1959 through 1972 was in the range of 10 percent to 12.9 percent. It did not exceed 12.9 percent until 1973 when it reached 15.6 percent. And even in 1973, it was only one percentage point higher than the average for all other manufacturing.

The long profit pinch was a primary cause of a major decline in drilling, which pushed the number of well completions in 1973 below the levels of 1946. As a result, a widening gap between domestic oil supply and demand became inevitable. Substantial new oil and gas reserves are not found when the risk of loss is great and the opportunity for reward is well below average.

During the period when oil company profits were depressed, warning voices were raised about the threat this posed for our future energy supply. But their numbers were few and their audiences generally unreceptive. They were, indeed, crying in the wilderness.

Possible Effect of Higher Taxation of Oil Companies

Now the House will begin consideration, is the last word I heard, tomorrow of a bill proposed by the Committee on Ways and Means that is estimated to increase taxes on U.S. oil and gas producing operations by almost $13 billion for the years from 1974 through 1979, with the annual cost rising steadily.

Such additional taxes must be taken into account by every operator planning to invest in new wells and in improved recovery projects to increase production of oil and gas. Unless the prospects are very great that the higher taxes will be recovered through steadily rising prices, the ventures that can be undertaken and financed to expand capacity will have sharply reduced.

This committee should review the record of what happened to exploration and drilling for oil and gas in the United States when percentage depletion was cut from 27½ percent to 22 percent by the Tax Reform Act of 1969. The expansion of these efforts, which had begun to take place in response to the deteriorating U.S. oil and gas position, was choked off, and these efforts set back several years until rising prices once again offered some prospect of reasonable rewards in keeping with the costs and risks.

Some proposals go even further than the bill reported by the Committee on Ways and Means. One would wipe out percentage depletion in one stroke. The proponents of this abrupt, one-shot approach for abolishing percentage depletion on oil and gas have estimated that the additional cost to the industry of this proposal would be $2.6 billion this year, $2.8 billion in 1975, $3.2 billion in 1976, $3.5 billion in 1977, $3.7 billion in 1978, and $3.8 billion in 1979.

To wipe out percentage depletion at one stroke, retroactively to January 1, 1974, would be a sure way to tell investors around the country that Congress does not want them to expand investments for new oil and natural gas supplies.

Elimination of depletion would have an even greater impact on independent producers than on the large companies. As the Oil and Gas Journal pointed out last week:

> Eliminating depletion would be a powerful blow to the domestic industry, especially the independent wildcatter who needs percentage depletion to stay in business. Any hopes of coming even close to energy independence would be wiped out if depletion were killed.

Elimination of percentage depletion even gradually would prove detrimental to the necessary expansion of exploration and drilling unless prices respond immediately to the higher tax costs.

It is not generally understood, I think, that the total taxes paid by oil companies to Federal, State and local governments within the United States are already very large. Studies conducted by the Petroleum Industry Research Foundation over the years have consistently found that the total direct Federal, State and local tax burden of the petroleum industry ranges higher in relation to gross revenue, than the comparable tax burden of all other U.S. business corporations. In 1971, for instance, the latest year for such a study, the domestic tax burden of the petroleum industry on its earnings, operations and properties averaged 5.6 cents per dollar of gross revenue. And this figure does not include excise taxes. By comparison, the figure for all other U.S. business corporations was 4.2 cents.

In the field of foreign operations by U.S. oil companies, proposals to impose additional taxes are most likely to lead to a situation in which U.S. companies will be placed at such a disadvantage that they will not be able to compete effectively abroad with the British, the French, the German, the Japanese, and the other foreign companies. That development would also be disadvantageous to the United States ~~because it would~~ reduce earnings working in favor of our balance of payments and make the Nation increasingly dependent for oil supplies on companies of other countries, companies beyond the control and influence of our Government.

The importance of the foreign operations of U.S. oil companies to the U.S. balance of payments must not be overlooked. In the 7 years from 1966 through 1972, the contribution of these operations to the U.S. balance of payments totaled nearly $10 billion.

As for the question of how much tax revenue the U.S. Government would raise by eliminating the foreign tax credit for American oil companies, it is really academic. The long term tax revenue effect would be negligible because American oil companies would not be doing much business overseas simply because they could not stay competitive.

Much is being said about the need for proposed tax changes because of the so-called windfall profits. I wish more attention were paid to the shortfall of earnings that faces the industry today in financing the search for urgently needed new oil and gas reserves and the facilities to transport, process and distribute these fuels to the consuming public.

The Chase Manhattan Bank has estimated that, over the 15-year period ending in 1985, the petroleum industry faces worldwide financial outlays of considerably more than a trillion dollars for finding and producing oil and natural gas and providing refineries, pipelines, terminals, and other facilities needed to meet the needs of consumers in the United States and other non-Communist countries. The bank estimates that the domestic U.S. portion of this total spending requirement will exceed half a trillion dollars. Economists of the bank have expressed doubts about the ability of the petroleum industry to raise these stupendous amounts of money over such a relatively short period of time.

Finally, I want to say that it seems less than candid to go to the public citing figures on billions of dollars in oil industry profits without making any mention at all of the hundreds upon hundreds of billions this industry will have to raise within the next few years if the American people are to have the energy they need to carry on their daily lives in comfort, security and economic well-being.

By the same standard, I believe the people should have the whole story of these tax proposals now being considered. Not merely the revenue that these measures are expected to wring out of the petroleum industry, but also the effect of those tax changes on petroleum prices and the U.S. balance of payments and the impact on energy investment and energy supplies over the years ahead.

There is simply no bottomless pool of profits which will pay for these proposed tax changes. Those who advocate them are in reality advocating higher prices for the consumer, reduced energy supplies, and a worsening of the U.S. balance of payments.

Thank you very much.

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

Getting the Oil Industry Message to the Public

I have been somewhat amazed that the oil industry, particularly those of you who represent, considering all of the news programs that they pay for, has been able to get so little of this message across to the American people. In view of the fact that they would pay for news programs where news commentators in general make the oil companies sound like an unsavory group of people, if you looked at what is being said on the program by the commentator, plus the statements that are being presented by others on the program, and that in the advertising portion your members have been unable even to tell their side of the story on the program that they are paying for. I assume if you think the advertising is paying for the program, why is it that the industry has not been able to tell the American people the message you have here in your statement, at least in the advertising period of time that they have been paying for all of these new programs?

Mr. Ikard. Mr. Chairman, there is no question but what our biggest basic problem in my view—and I agree with you—is one of communications. There has been considerable effort made to get this kind of information, particularly on the networks, and I am sure you are aware of this fact. There is currently a debate going on between some of the companies and the networks regarding the fact that the networks have refused to take certain advertising material, even though the companies have agreed to pay for equivalent time for those that might disagree with their material.

This is a serious problem, and I can only assure you that we recognize the shortcomings of the way we have communicated our position to the public to date, and we hope to vastly improve our effort within the immediate future, but I also know that time is running out.

Higher Taxes on Oil Industry Would Be Passed to the Consumer

The Chairman. Well, I am concerned because I think there is a great deal of merit to your argument and to what you have said. I also think that a major tax increase on the industry—and that is all the repeal of the depletion allowance would be—is just a major tax increase, will have to be passed on to the public.

Now, am I right or wrong about that?

Mr. Ikard. I think you are unquestionably right. There are only two alternatives, either to pass it on, in which case it translates into something on the order of between 3½ and 4 cents a gallon of oil, or if it is not passed on, accept the other alternative which is to sharply reduce our operations directed toward discovery of new reserves, and simply to deplete our present reserves. In either case, we can look for a marked increase in price to the consumer.

The Chairman. I do not see any way as I heard you say on television on one occasion, that you can sustain a big tax increase without raising the price of the product. I know we have price controls, but is it possible for the government to require you to sell a product below your cost?

Mr. Ikard. No, sir, I do not think so, certainly no company could stay in business very long under those circumstances and I do not think they can do it.

The CHAIRMAN. Well, I would think that even the Constitution——

Mr. IKARD. I think it would be confiscatory to the point that it would be——

The CHAIRMAN. Well, that is my impression. The Constitution will not let you confiscate a man's property, and if that is the case, I do not think they could make you sell something below cost.

Mr. IKARD. I do not either, sir.

The CHAIRMAN. And as a practical matter, it cannot be done very long, can it?

Mr. IKARD. That is right.

The CHAIRMAN. Because after awhile you are broke, and when you are broke, all you can do is shut the doors and tell labor to go home.

Mr. IKARD. That is right.

OIL INDUSTRY PROFITS

The CHAIRMAN. Now, I saw you make the statement one time on television—I think that is the nearest they came to giving your industry equal time, even though you were paying for it—that the profit on a gallon of gas works out to about 2 cents per gallon, so that if a person is paying 64 cents for the gas, the company that manufactures that gas and puts it in the operator's tank for sale is making 2 cents out of that 64.

Is that correct?

Mr. IKARD. Yes, sir, on an average that is correct.

The CHAIRMAN. The rest of it goes to other people. It may go to the filling station, if the owner is independent. He might be making some profit in his little operation, enough to stay in business anyway, and——

Mr. IKARD. The biggest single slice of it probably goes for taxes.

The CHAIRMAN. Right.

Now, my understanding is that most of the large companies are actually investing in trying to find more oil or expand their refinery capacities even more than that 2 cents, and trying to produce more oil and refine more and to make more available to the consumer.

Is that correct?

Mr. IKARD. Yes, sir. If my memory serves me correctly, the domestic profits in 1973 were something on the order of $4.4 billion, and the estimated investment was something around $8.5 billion. So roughly they are investing in capital improvements in this country alone about twice the amount they made in profits. This is done through borrowing, through the reinvestment of recaptured capital funds, through depreciation and through foreign profits that are invested in this country.

So the domestic industry is, just in round figures, investing about $2 for every $1 that they make in this country.

The CHAIRMAN. You made the statement that you think that a repeal of depletion allowance means an increase at the pump of 3½ to 4 cents a gallon.

Would you mind telling us how you calculate that?

Mr. IKARD. Well, as you know, Senator, there are many variables in this, but I will give you my calculations.

Assuming that the average cost of domestic oil is $7 a barrel, and the maximum depletion that can be taken on that would be $7 times 22, which would be $1.54, according to my calculations. If depletion is removed, the increased tax payments are equal to 74 cents, and in order to recoup that, assuming you were in a 50 percent bracket or approaching that level, you need to increase your price at least $1.42. If you divide this $1.42 by the 42 gallons in the standard barrel, you come out with about 3.4, according to my calculations. Of course, this type of calculation has all sorts of variables, as I am sure you are aware, depending on the tax bracket the individual is in. But, for the most part, I think this is a good average.

The CHAIRMAN. Well, the argument will be made, of course, that if you do that, the Government should, by price controls, keep the industry from raising its price even though it is paying more taxes.

What is your response to that?

Mr. IKARD. Well, then, in effect, we would have a rollback in the price of crude, and presently, our average price in this country is something on the order of $4 below the world market. We simply cannot, with the inflationary forces such as they are, and with the need to develop synthetics and other things, bring on the additional reserves this Nation needs. Oil that is priced somewhere at the $5.25–$5.50 level, just will not do it. I do not think the economics of such a situation will allow it.

COST OF FINDING NEW OIL

The CHAIRMAN. Can you give me the best estimate that you and Professor Gonzalez have on the cost of finding and producing new oil today? I am not talking about the old oil that has already been found; but to go out to get more oil to replace what you have in inventory. In effect, what is the cost of it in this country?

Mr. GONZALEZ. We can only say with certainty that the cost is a great deal higher than it has been in the past; and I am going to cite a few examples if I may, Senator Long.

The CHAIRMAN. Yes, sir.

Mr. GONZALEZ. In Oklahoma, we used traditionally to look for gas at about 6,000 feet. And that gas we could find and develop fairly cheaply. Today in Oklahoma, the wells looking for gas are being drilled between 20,000 and 30,000 feet. These wells, of course, are a great deal more expensive than the ones that we are currently producing gas from. The cost of these wells goes up geometrically with depth, so that a well that is 24,000 feet is a great deal more than four times as expensive as a 6,000-foot well. This has led to a very sharp rise in the replacement cost of gas.

Let me illustrate by pointing out that the Interior Department is now basing its estimates of the minimum bonus that it should realize on offshore leases on the assumption that the price of natural gas on those leases offshore will be 65 cent per 1,000 cubic feet, compared with an average price that the producer has been realizing on his old gas of about 22 cents. So roughly, you have a tripling of the estimated cost of natural gas.

Now, it is very difficult to tell what it is going to cost for oil or gas because no one knows what the size of the new discoveries will be. But generally, I think we would have to expect that the cost of replacement of crude oil is going to be between two and three times what we have been selling crude oil for in the last few years, of approximately $3.50 a barrel. This means that we are going to have to look at a replacement cost in the range, probably, of $7.50 to $10 a barrel, depending on what happens to our success in finding and our general rate of inflation—which, of course, affects the cost of wells in steel and labor and all other aspects.

Oil Prices

The Chairman. Well, if the Arabs are telling us now that the price that they are going to charge for oil in the future is going to be based on what it costs us to produce it here—that is what I understand they are saying, is it not?

Mr. Gonzalez. Yes.

The Chairman. If that is the case, then why should not any producer who has the power of decision—that is, who owns all of the land, for example, under which the oil is being produced, as some fortunate people do—why should he not think in the same terms? That is, that the price for which he is going to sell his oil will be based not on what it cost to discover it several years ago or many years ago, but on what it would cost to produce the oil now.

Mr. Gonzalez. I think there would be a great temptation for producers to feel that they are selling their oil too cheaply today, and they would be better advised to hold their production in the ground and wait until the price goes up. But as you know, the system of allocation of production means that in any field where you have a number of different producers, if one of them chooses to go ahead and produce, then the others are more or less forced to produce in order to prevent drainage from their property, which would affect the life of their leases. So our system of proration, which has been so greatly criticized in the consuming area, is actually working to provide the consumers now with a lot of oil at $5.25 a barrel, under price controls, which many producers would keep in the ground if they had a choice.

Possible After Effects of Increased Taxation on the Oil Industry

The Chairman. But would not a new tax on oil and gas change their way of doing business? To the extent that the producers—and I am talking about the independents as well as the majors—feel they are being treated very unfairly, and the royalty owners, the landowners, would feel the same way, this would tend to lead to a new type of contract. This new type would be geared to the new economic situation, unlike the old type of contract, which assumes that it is to your advantage to produce the oil as rapidly as you can produce it and sell it.

Mr. Gonzalez. Yes; I think there would be many efforts made to try and realize the fair market value of this commodity. But the most important effect is that money would not be invested in new wells and new exploration efforts and therefore, we would very quickly suffer a serious decline in productive capacity in this country.

As you know, the majority of production of oil in this country is from fields that are now 30 and 40 years old, discovered back in the

1930's. And these fields are now long past their prime; their production is declining. Therefore, in order to offset that substantial decline, we must drill a great many new wells.

Mr. Ikard's testimony pointed out, for example, that our well completions in 1973 were less than they were in 1946 when we were producing and consuming a great deal less oil and gas than we are now. Now we are faced with the major expansion of drilling operations which will only occur if the price reflects the replacement costs. Moreover, we are also faced with the problem of paying the higher cost to increase recovery from our existing leases. In many cases, we have numerous old so-called stripper wells with high-cost production, and there is no way those wells can be kept in operation or their production expanded unless we do have prices which will cover the replacement cost.

Passthrough to the Consumer of Increased Taxes on Gas

The Chairman. Now let me ask you about gas. Most of the gas being delivered to housewives in this country is being regulated by the Federal Power Commission.

Does the Federal Power Commission have any alternative whatever, basing its price on gas on cost factors as it does today, to permitting the gas producers and pipelines to pass this increased tax resulting from a repeal of the depletion allowance, on through to the housewife in the price of the product that she is buying?

Mr. Gonzalez. As long as we have controls on the price of gas based on the cost, there is no question that any increase in taxes would have to be recognized by the Federal Power Commission as a cost to be passed on to the consumer.

The Chairman. Now, can you give me some estimate as to how much of an increase that is to the consumer of gas, the household consumer? Could you give me any guess as to what that amounts to?

Mr. Gonzalez. It depends on the price currently being realized by the producer. But let us take a sample figure and say the producer is realizing 25 cents per 1,000 cubic feet on which the current depletion rate would be 22 percent. On that kind of figure, you would have roughly 5½ cents, and that is the increase that would have to occur in the price to the producer for him to realize as much as he did before.

The Chairman. Well, if he has to receive 5½ cents more, then does that mean that the housewife is going to have to pay 5½ cents more for the gas she is burning at the burner point?

Mr. Gonzalez. I am afraid it would, and this, of course, is one of the key things in this whole question of how Congress goes about imposing additional taxes. It has tended to think that the change in depletion would simply come out of the profits of producers. This simply is not the case. The profits of the producers are not that adequate. The change in depletion would have to affect the supply and the price?

Mr. Ikard. Mr. Chairman, may I make a further comment on this?

The Chairman. Yes.

Mr. Ikard. Regarding this gas situation which Dr. Gonzalez mentioned; on the passthrough, you would have, in some areas, a tax that comes at the burner tip, in effect a tax on the passed through amount, which would culminate in a much higher price to the consumer.

I also think, in regard to your statement that there would be a tendency to develop new kinds of production contracts, one thing that is overlooked when the argument concerning percentage depletion is raised and this is even if it is repealed, you would still have cost depletion, which would trigger, as a very distinguished previous witness stated, all kinds of new devices to do business from a production standpoint, and, as you have indicated, Mr. Chairman, revenue results probably would not be as substantial as some of the estimates have indicated.

The CHAIRMAN. Would you submit for the record your calculations of how you arrive at 5.5-percent increase in the price of 25 cent gas, for Federal Power Commission purposes?

Mr. GONZALEZ. I would be glad to do that, Mr. Chairman.

(The following information was subsequently supplied for the record:)

AMERICAN PETROLEUM INSTITUTE,
Washington, D.C., June 14, 1974.

Hon. RUSSELL LONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: At the hearings on Tax Increase Proposals before the Senate Committee on Finance, June 11, 1974, we were asked to respond to the following questions.

Question 1. If the depletion allowance of 22 per cent were eliminated, what effect would this have on the price of natural gas to the consumer?

Answer. The general formula for obtaining the minimum effect of the elimination of the depletion allowance on the price of natural gas is as follows:

$$\frac{\text{Tax Rate}}{100-\text{Tax Rate}} \times \text{depletion rate} \times \text{price of natural gas at wellhead}$$

Assuming that the price of natural gas at the wellhead is 25 cents per mcf, and the producer is in the 50 per cent income tax bracket, the elimination of the depletion allowance of 22 per cent would result in an increase in the producer's income exposed to the federal income tax of at least 5.5 cents per mcf. If the producer is to maintain the profit margin existing under present percentage depletion rates, the price per mcf would have to be increased by at least 5.5 cents in order to offset the loss of the tax saving from the depletion allowance.

The actual increase more likely would be about 6.9 cents per mcf since there would also be an increase in royalty payments and severance taxes which are based on value. It should be noted that for an independent producer subject to a 70 per cent tax, the increase in the price per mcf required to maintain his profit margin would be at least 13 cents.

Question 2. What effect would the increase in price of natural gas have on the price of electricity to residential consumers?

Answer. In plants located in Louisiana and Texas (where most electrical power is generated by natural gas) it take approximately 11,000 BTU's of natural gas to generate one kilowatt hour of electricity. Since one cubic foot of natural gas contains approximately 1,035 BTUs, a Gulf Coast utility must consume 10.6271 cubic feet of natural gas to produce one kilowatt hour of electricity. A price increase of 6.9 cents per mcf, therefore, would result in an increase of $0.00073 in the cost of fuel required to produce one kilowatt hour of electrical energy.

If it is assumed that the average residential monthly bill in the Gulf Coast area currently averages $50 per month (for 2000 kwh), an increase of 6.9 cents per mcf would result in an increase of at least $1.46 per month or $17.52 per year in the average consumer's bill. This would be an increase of at least 2.9 per cent. Because of differences in rate structures for industrial and residential users, the increase in the cost of electrical energy used for industrial purposes would be at least 5 per cent.

Sincerely,

FRANK IKARD.

The CHAIRMAN. All right.

Now, with regard to the electric power companies, in my part of the country, they are operating on gas. They will have to pay more for gas, and that means they will have to pass this on to the consumer in the price of the electricity.

Would you be so kind, Professor Gonzalez, as to calculate and provide for the record—unless you have it at your fingertips already—your estimate of how much that would require an increase in the price of energy, and how much the consumer will have to pay as a rate increase when that is passed on through to the consumer of the electricity?

Mr. GONZALEZ. Obviously it will increase the cost of fuel to the utilities; and we will be glad to see if we can give you an estimate of how much that would mean to the consumer of electric power.

I think it is important to remember here that oil and gas are alternative fuels to coal, which has many environmental problems; and we have been selling oil and gas really cheaper in relation to coal. This is why we have had such a shift from coal to oil and gas. Now, we are concerned about the quality of the environment and have handicapped our ability to use coal. We passed a Mine Health Safety Act which has raised the cost of mining coal, and so we have enhanced the premium value of oil and gas. Unless we recognize this fact, we will continue to be short of oil and gas, since people will not use coal.

The CHAIRMAN. Thank you very much.

I am going to ask Senator Fannin to take charge. I have to return an important phone call. At the conclusion of Senator Fannin's examination, we will stand in recess until 2 o'clock this afternoon.

Senator FANNIN (presiding). Thank you, Mr. Chairman.

IMPORTANCE OF OIL AND GAS INDUSTRY IN SOLVING THE ENERGY CRISIS

Mr. Ikard and Mr. Gonzalez, I think the Chairman has well covered most of the questions I had in mind. I think we all have a common goal and I think the public has lost sight of that common goal, and that is to solve this energy problem. They do not realize, at least they do not seem to recognize by the statements that have been made and by the coverage in the press, the tremendous importance of the oil and gas industry toward solving this problem. To my way of thinking, there is no other way of solving the problem in the foreseeable future than to increase our supply of oil and gas.

Now, how dependent are we on oil and gas? Percentagewise, what dependency do we have on oil and gas as far as energy is concerned?

Mr. IKARD. Well currently, Senator, the oil and gas industry is supplying over 77 percent of our energy needs in this country. And about 35 percent of our oil requirement is being furnished from overseas sources through imports. So, as we see the immediate future—and that is the next 5 to 10 years—our principal reliance will have to be on oil and gas.

Senator FANNIN. And as I understand it, Mr. Ikard, the dependency upon coal has reduced rather than increased in the last few years although now we are trying—we have a concerted effort to try to increase the coal.

Mr. IKARD. That is right.

Senator FANNIN. But as I have been told and as I think the statistics will indicate, this is a slow process. The conversion cannot come about overnight.

Mr. IKARD. That is right.

Senator FANNIN. So we also talk about nuclear——

Mr. IKARD. And synthetics. I think it is interesting to go into the price situation regarding synthetics. When you speak of liquifaction of coal and the gasification of coal, or synthetic gas from coal, the studies we have seen indicate a cost of about $1.85 per MCF, and between $8 and $10 for a barrel for oil. The Atomic Energy Commission in their survey has indicated the price for oil at $7.20; the Bureau of Mines at $8.60; and other industry studies fall within the range from $8 to $10. We are therefore speaking of prices in this magnitude when we talk about synthetics.

Senator FANNIN. I think what you have stated illustrates the fallacy of saying that we can furnish these products at their cost of production; in other words, gas comes out of the ground, so it costs very little, so it can be sold at a very little price. But is there not a real problem of replacement cost?

Mr. IKARD. Yes, sir.

Senator FANNIN. Because if we are utilizing that gas, as we are in many instances, very inefficiently, then we have to think about the years ahead. We will just have to pay a premium because of what is being done today. And then, too, are we not quite dependent upon the oil industry in the petrochemical field for many, many items that the housewife uses daily?

Mr. IKARD. Yes, yes.

Senator FANNIN. In fact, that we all use daily, whether we are talking about tires or whether we are talking about textiles, clothing, whether we are talking about food; we still have this tremendous dependency. But the general public, I do not think, realizes just how dependent we are, and perhaps that is one reason that the publicity that you are talking about is not accepted to a greater extent.

EXPLAINING INDUSTRY PROFITS

I am very conscious of what is happening, especially since we have been making these studies. I happen to come from a nonoil State, but we have a great copper industry and it is certainly dependent upon the petroleum industry if they are going to continue to operate. So, I do feel that it is essential that we place in proper perspective, then, just what has happened—as your dialogue with the chairman has brought out—that we do have serious problems. For example, as much as 20 percent of the profit increase in the first quarter is due to currency exchange—the gain from currency exchange.

Mr. IKARD. Yes, sir.

Senator FANNIN. And another 20 percent is due to adherence to old depreciation schedules which ignored soaring replacement costs. That gets another 20 percent; and approximately another 20 percent is due to an inventory accounting method—and you, of course, know it well: FIFO; first in, first out. And this, of course, has made a distortion also. So the so-called windfall profits, if they are really placed in proper perspective, have not been nearly as out of line as has been considered.

But I know we have a great problem trying to explain profits at any time in industry, and suddenly without profits, we do not have jobs and people do not realize that the wheels do not turn, things do not happen. But when we further analyze the alleged high profits from the oil companies, we discover the return on investment does not reach acceptable standards. In fact, until 1973, I think, as you brought out, both of you have brought out, that when news reports stated companies' profits are up 100 percent this could occur because returns on investment might have gone from 2 percent to 4 percent in 1 year. Now, is that not one of the great problems we face?

Mr. GONZALEZ. Yes, the great problem we face is that the rate of return on the petroleum industry has been inadequate over the last decade, and therefore it has to rise very sharply before it will attract more capital to expand the supplies.

Senator FANNIN. Well, this is something that we do not seem to be able to get over. And of course, the headlines always come out—and I heard the press come out with the large percentage increase. You take the auto industry, an industry they always complained about were making such extreme profits. You take General Motors and now compare what they are doing in these months, in fact, perhaps a year, that they are down so greatly because of the change coming about; and then let them come back to a normal profit. I heard it said if you can take those figures, then you can come out with a 560 percent increase in profits that they made; whereas in reality, they are just coming back to the level that gave them a return on their investment.

So, I wish we could get the press to publicize factual information in that regard. I do not want to mispresent the facts. But I just hope that we can get out the true information that is involved.

Mr. GONZALEZ. Unfortunately, the emphasis always seems to be on increases in profits, with no emphasis at all on the decline in profits. A corporation can have a 50-percent decline in profit; then when it goes back to where it was, that is a 100-percent increase since it is measured from a lower base. This creates a distortion which makes it appear that profits always increase more than they decrease.

DEPENDENCE ON FOREIGN OIL

Senator FANNIN. So many people think that we can depend on foreign sources for our petroleum products in the future and we do not have to worry. And of course, you brought out about the balance of payments. That it is certainly a great factor involved in the benefits we have by having our petroleum countries that have developed these resources, and apparently many countries of the world have gone forward just because our American companies have developed their resources and given them the assistance financially, and furnished the technology that was needed.

Now, we have, for instance, Iran, the Shah says that before too many years he wants to have only finished products; that he will not export crude. This could be a very serious problem for us if we get into a position where our people are not going to be employed because all of these jobs are going to be done outside of this country; is that not something of a consideration in developing our oil resources?

Mr. GONZALEZ. Very definitely. In fact, many of the developing countries have taken a position that they do not want to be just raw material suppliers. They want to use their resources to attract industrialization. Then, one of the first things they think of is requiring you to refine their production in their country. This aggravates the balance of payments problem since we must then have not only the jobs that are exported, but bear the total cost of the finished product.

Senator FANNIN. And job exports—what would happen if those industries are developed in those countries in the world that do have the large resources of petroleum products? That would have a tremendous effect upon this country. As I understand it, that would affect the textile industry, as stated earlier; in fact, most every petrochemical industry.

Mr. GONZALEZ. It certainly would affect the petrochemical industry very significantly.

Senator FANNIN. Well, I realize the tremendous problems that exist, and you gentlemen have certainly brought out very forcefully what needs to be carried to the American people. Unfortunately, the press is not picking up that story, and I feel that, as the chairman has stated, that some way or another, the petroleum companies, the oil companies, must get their story to the people. I believe the people, properly informed, would react favorably, because I do not think that there are very many housewives who realize how dependent they are upon the oil in this country; I do not think there are too many people who realize their paycheck is a result of the success or failure of the oil companies.

Mr. IKARD. We appreciate that, Senator, and I can assure you we are going to do everything possible to better communicate what we consider to be the facts to the public.

Senator FANNIN. Well, thank you, gentlemen.

Mr. IKARD. Mr. Chairman, before we recess—Dr. Gonzalez has a statement. We hoped that he could file it.

Senator FANNIN. If he wants to cover it——

Mr. GONZALEZ. No, just file it.

Mr. IKARD. If we could file it for the record, we would appreciate it. And also, I have some other data here that deal with the areas we have discussed which I would like to file for the record.

Senator FANNIN. Fine.

The complete statement of Dr. Gonzalez will be made a part of the record.

[The prepared statements of Messrs. Gonzalez and Ikard and the other materials referred to follow. Hearings continued on page 698.]

Statement

of

FRANK N. IKARD
PRESIDENT
AMERICAN PETROLEUM INSTITUTE

before the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

Washington, D.C.

June 11, 1974

My name is Frank N. Ikard. I am President of the American Petroleum Institute, a trade association representing a cross section of the industry -- from small operators to the largest firms.

The key point I wish to stress is that the imposition of heavy additional taxes on the petroleum industry will prove a harmful burden to consumers very quickly, will perpetuate oil shortages, will aggravate inflation, and will weaken the position of the nation in its economic security and its international relations.

Let me say emphatically that those who think that additional taxes can be paid out of the profits of the industry without affecting supplies and prices are wrong. The harsh business realities are that the huge expansion of investments required to overcome shortages of oil and gas and meet the needs of a prosperous and growing economy can be made only if the rates of return on new ventures, after all costs including taxes, appear attractive to investors in relation to alternative opportunities, most of which would involve much less risk.

The appearance of sharply increased profits for the oil industry, as for many other corporations, reflects the distorting effects of inflation. As a result of the abnormal rise in prices, depreciation charges based on book investments fall far short of covering the replacement costs necessary to maintain reserves and productive capacity. In addition, apparent gains resulting from the sale of older, low-cost inventories and replacement by higher cost new stocks are of no real value to an individual company or to a company's stockholders because they must all be kept in the business to finance the inventories required to maintain operations at existing levels.

We can compare this situation to that of a family which acquired a home for $20,000 in 1960. Assume that in 1970 the head of the family was transferred to another city. We will say he sold for $30,000 the house that had cost him only $20,000. But he had to pay $30,000 to buy an equivalent house in the new community. Under those circumstances, which parallel the experience of the petroleum industry, the appearance of a large "windfall" profit does not measure correctly the real economic facts.

In considering this much-publicized subject of oil industry profits, another point also needs clarification. Devaluation of the dollar distorted the appearance of 1973 earnings. Part of what looked like a great increase in profits of international companies was actually only an increase resulting from the larger number of dollars considered to be equivalent to the earnings on foreign operations. The Chase Manhattan Bank reports that almost one-fourth of the worldwide increase in oil company earnings can be attributed to this one factor alone.

The inadequate level of oil and gas prices and profits during the past decade is demonstrated clearly by the decline that has taken place in proved U.S. reserves available to meet current needs and by the way in which productive capacity has lagged far behind increasing demand for natural gas and petroleum products, fuels that are environmentally superior to coal.

That undesirable situation occurred because profits on petroleum operations were kept too low by government regulation of natural gas prices that also limited prices for competing fuels. The controlled price of natural gas at the wellhead has been the equivalent of fuel oil at about three cents a gallon. As a result of these artificially low prices, many small operators quit looking for oil and gas in the U.S. and the larger firms could not justify expansion in their efforts.

When I hear the clamor about today's oil company profits, I cannot help but wish that there had been something like this din on the other side during the late 1950's and 1960's. In ten of the 15 years from 1959 through 1973, oil company rates of return were less than the average for all other manufacturing. In light of the high risks and uncertainties in the petroleum industry, one would have expected the situation to be just the reverse.

The return on shareholders' equity in the oil industry from 1959 through 1972 was in the range of 10 percent to 12.9 percent.

It did not exceed 12.9 percent until 1973 when it reached 15.6 percent. Even in 1973, it was only one percentage point higher than the average for other manufacturing.

The long profit pinch was a primary cause of a major decline in drilling, which pushed the number of well completions in 1973 below the levels of 1946. As a result, a widening gap between domestic oil supply and demand became inevitable. Substantial new oil and gas reserves are not found when the risk of loss is great and the opportunity for reward is below average.

During the period when oil company profits were depressed, warning voices were raised about the threat this posed for future energy supply. But their numbers were few and their audiences generally unreceptive. They were, indeed, crying in the wilderness.

The House will begin consideration tomorrow of a bill proposed by the Committee on Ways and Means that is estimated to increase taxes on U.S. oil and gas producing operations by almost $13 billion for the years from 1974 through 1979, with the annual cost rising steadily.

Such additional taxes must be taken into account by every operator planning to invest in new wells and in improved recovery projects to increase production of oil and gas. Unless the prospects are very great that the higher taxes will be recovered through steadily rising prices, the ventures that can be undertaken and financed to expand capacity will be sharply reduced.

This committee should review the record of what happened to exploration and drilling for oil and gas in the U.S. when percentage depletion was cut from 27½ percent to 22 percent by the Tax Reform Act of 1969. The expansion of these efforts, which had begun to take place in response to the deteriorating U.S. oil and gas position, was choked off, and these efforts set back several years until rising prices once again offered some prospect of rewards in keeping with the costs and risks.

Some proposals go even further than the bill reported by the Committee on Ways and Means. One would wipe out percentage depletion in one stroke. The proponents of this abrupt, one-shot approach for abolishing percentage depletion on oil and gas have estimated that the additional cost to the industry of this proposal would be $2.6 billion this year, $2.8 billion in 1975, $3.2 billion in 1976, $3.5 billion in 1977, $3.7 billion in 1978, and $3.8 billion in 1979.

To wipe out percentage depletion at one stroke, retroactively to January 1, 1974, would be a sure way to tell investors that Congress does not want them to expand investments for new oil and natural gas supplies,

Elimination of depletion would have an even greater impact on independent producers than on the large companies. As the Oil and Gas Journal pointed out last week: "Eliminating depletion would be a powerful blow to the domestic industry, especially the independent wildcatter who needs percentage depletion to stay in business. Any hopes of coming even close to energy independence would be wiped out if depletion were killed."

Elimination of percentage depletion even gradually would prove detrimental to the necessary expansion of exploration and drilling unless prices respond immediately to the higher tax costs.

It is not generally understood that the total taxes paid by oil companies to federal, state and local governments within the United States are already very large. Studies conducted by the Petroleum Industry Research Foundation over the years have consistently found that the total direct federal, state and local tax burden of the petroleum industry ranges higher, in relation to gross revenue, than the comparable tax burden of all other U.S. business corporations. In 1971, for instance (the latest year for such a study), the domestic tax burden of the petroleum industry on its earnings, operations and properties averaged 5.6 cents per dollar of gross revenue. And this figure does not include excise taxes. By comparison, the figure for all other U.S. business corporations was 4.2 cents.

In the field of foreign operations by U.S. oil companies, proposals to impose additional taxes are most likely to lead to a situation in which U.S. companies will be placed at such a disadvantage that they will not be able to compete effectively abroad with British, French, German, Japanese, and other foreign companies. That development also would be disadvantageous to the U.S. because it would reduce earnings working in favor of our balance of payments and make the nation increasingly dependent for oil supplies on companies of other countries, companies beyond the control and influence of our government.

The importance of the foreign operations of U.S. oil companies to the U.S. balance of payments must not be overlooked. In the seven years from 1966 through 1972, the contribution of these operations to the U.S. balance of payments totaled nearly $10 billion.

As for the question of how much tax revenue the U.S. government would raise by eliminating the foreign tax credit for American oil companies, it is really academic. The long-term tax revenue effect would be negligible because American oil companies would not be doing much business abroad.

Much is being said about the need for the proposed tax changes because of what are called windfall profits. I wish more attention were paid to the shortfall of earnings that faces the industry today in financing the search for urgently needed new oil and gas reserves and the facilities to transport, process and distribute these fuels to the consuming public.

The Chase Manhattan Bank has estimated that, over the 15-year period ending in 1985, the petroleum industry faces world-wide financial outlays of considerably more than a trillion dollars for finding and producing oil and natural gas and providing refineries, pipelines, terminals and other facilities needed to meet the needs of consumers in the U.S. and other non-Communist countries. The bank estimates that the domestic U.S. portion of this total spending requirement will exceed half a trillion dollars. Economists of the bank have expressed doubts about the ability of the petroleum industry to raise these stupendous amounts of money over such a relatively short period of time.

Finally, I want to say that it seems less than candid to go to the public citing figures on billions of dollars in oil industry profits without making any mention at all of the hundreds upon hundreds of billions this industry will have to raise in the years ahead -- if the American people are to have the energy they need to carry on their daily lives in comfort, security and economic well-being.

By the same standard, I believe the people should have the whole story of these tax proposals now being considered. Not merely the revenue that these measures are expected to wring out of the petroleum industry, but also the effect of those tax changes on petroleum prices and the U.S. balance of payments, and the impact on energy investment and energy supplies over the years ahead.

There is no bottomless pool of profits which will pay for these proposed tax changes. Those who advocate them are, in reality, advocating:

-- A worsening of the U.S. balance of payments

-- Reduced energy supplies, and

-- Higher prices for consumers.

TESTIMONY OF

RICHARD J. GONZALEZ

AT

HEARINGS ON TAX INCREASE PROPOSALS

SENATE COMMITTEE ON FINANCE

JUNE 11, 1974

My name is Richard J. Gonzalez. I am an economist with a background as a professor of economics at two universities and with many years of association as economic advisor, director, and treasurer of Humble Oil & Refining Company, now known as Exxon U.S.A. I have been a consulting economist since leaving Humble in 1965.

The taxation of petroleum and other minerals has been a field of special interest for me. I have testified a number of times before committees of the Senate and House on this subject. In my judgment, the actions of Congress with respect to differential tax treatment of mineral production has always been of great importance for economic welfare and progress. The decisions to be made on this subject now will be of grave importance for the future of this nation and for the price of energy throughout the world.

This nation is fortunate in having a good natural endowment of potential energy resources. However, potential resources are of no economic significance until they are discovered, developed, and made available to consumers through human ingenuity and the enterprise of investors motivated by the expectation of realizing rewards in keeping with the risks taken and the success realized.

In the past, Congress has recognized that discoveries of new mineral resources have made a contribution to society that deserves differential income tax treatment. The long established differentials were designed to avoid taxation as ordinary income of rewards for production of these resources in order to maintain the capital values that must be kept in the business. Such differential treatment has had a favorable influence on supply and prices to consumers and on the economic development of the nation. There has been some loss of tax revenues to the U.S. Treasury resulting from this differential tax treatment, but the fact that investors place a high psychological value on the feeling of reducing or deferring income tax payments means that the benefits gained by consumers could exceed the loss of tax revenue.

A major issue that Congress must consider in connection with changes in petroleum taxation is the interrelation of differential tax treatment of oil and gas production with the supply and price of these fuels. The need to increase U.S. supplies of oil and gas is generally accepted, even if it is necessary to convert coal into synthetic oil and gas at higher prices than required to encourage the necessary expansion in output of crude oil and natural gas. Supplies of crude oil and natural gas, which are discovered and developed jointly, can be increased only if it is economically attractive for companies to expand both exploration and drilling for new reserves and the installation of improved recovery facilities in existing fields.

The motivation for additional investment in any industry comes from the prospects of adequate returns on the capital risked determined by profits after taxes on the new ventures. Under present percentage depletion provisions, the prices required to overcome shortages by restoring the balance of supply with demand will be less than if percentage depletion is eliminated. Specifically, if the present average U.S. crude oil price of about $7.00 a barrel, which is well below the cost of imported oil, were near the level required to balance U.S. demand and supply for the long run, the loss of 22 per cent depletion would have to be offset by a price increase at least equal to the revenue of $1.54 now exempted, or by about 3.7 cents per gallon, assuming a 50 per cent income tax rate. Investors are likely to require even a higher price premium than indicated by these calculations to the extent of the value they place on the psychological satisfaction of deferring or reducing tax payments by undertaking the risks of exploration and drilling. For investors who judge that the long term equilibrium price may be $9.00 per barrel of crude oil, the price increase required to offset loss of percentage depletion would be at least 4.7 cents per gallon.

Consideration should be given to the choice between raising petroleum prices directly by imposing excise taxes on crude oil or refined products rather than indirectly by changing percentage depletion. The first method has several advantages: first, it avoids creating false expectations that taxes on production can be increased without affecting supply and price adversely; second, it encourages more careful use of energy to dampen the rate of growth in demand and thereby lessens the marginal cost required to balance supply with demand; third, it maintains the psychological attraction of the long standing percentage depletion provisions that seem especially important at a time when it is necessary to bring about a major increase in the flow of risk capital into petroleum exploration and drilling.

The imposition of minimum tax rates on so called preferences in the tax laws, including percentage depletion, operates to raise the required rate of return before taxes and to limit the capital that can be attracted into the mineral industries from alternative opportunities. Therefore, any increase in the rate of such minimum tax will also tend to prolong shortages of oil and gas or force prices higher than would otherwise be necessary.

The so-called excess profits tax that has been proposed on the amount by which realizations exceed specified crude oil price levels is undesirable for several reasons. First, it would encourage producers to postpone efforts to expand production until after the tax no longer exists a few years hence. Second, it would have the most discouraging influence on the higher cost operators whose production comes largely from the older stripper wells producing less than ten barrels a day.

The current expensing of intangible development costs incurred in drilling oil and gas wells plays a key role in making possible the financing of large capital outlays, especially by firms that are currently utilizing fully their ability to borrow money to finance their efforts to expand reserves and supplies. Any change in this provision would not only add to costs and prices but also work to prolong the period of shortages during which prices may rise above their long term equilibrium level. Larger firms might be able to adjust to the change by reducing capital spending or by additional borrowing, but only at the cost of slower expansion of capacity or additional pressures on capital markets and interest rates. Smaller independent producers would find such changes particularly onerous and harmful to their efforts to expand drilling.

As for the taxation of the foreign operations of American companies, the critical point is that taxes which merely handicap U.S. corporations relative to their foreign competitors cannot be advantageous to the nation in terms of either tax revenues or energy supplies. American companies already pay the same heavy tax burdens on foreign oil production as their competitors. If the income taxes paid on foreign oil operations, which are in addition to the normal royalties, should be disallowed as a foreign tax credit under provisions applicable to the foreign operations of all U.S. corporations, the added tax burden would place American oil companies at a disadvantage in conducting operations to provide supplies for the U.S. and for foreign markets. Such a change would hurt the international balance of payments of the U.S. and also lessen the control of American companies over the flow of oil in international trade.

The preceding points summarize my views on the economic consequences that must be considered in arriving at rational rather than emotional decisions as to changes in the tax treatment of the petroleum industry. I believe that consumers are now paying a high price for past mistakes in U.S. energy policies, such as Federal control of the price of natural gas and the adverse changes made in the Tax Reform Act of 1969. The seriousness of the current and prospective U.S. energy situation calls for the most careful efforts to move in a manner that will be helpful rather than detrimental to the interests of consumers and the nation now and for the future. We must do everything possible to evaluate all the consequences of proposed changes in petroleum taxation and to follow the course that will best serve the national interest.

ADDITIONAL MATERIAL

1. A document entitled "Energy Profits, Supply, and Taxation," which is a compilation of prepared testimony presented before this committee on February 14, 1974.

2. The April 1974 special petroleum report of the Chase Manhattan Bank captioned "The Profit Situation."[1]

3. A memorandum pertaining to petroleum industry cash flow and capital requirements for self-sufficiency. And

4. A study prepared by the Petroleum Industry Research Foundation, Inc., entitled "The Foreign Tax Credit and the U.S. Oil Industry".

Mr. Chairman, in submitting these documents, I do so confident in the view that the information contained in this material will be helpful to the committee.

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[1] Reprinted in this hearing at pp. 67 ff.

ENERGY PROFITS, SUPPLY, AND TAXATION

COMPILER'S NOTE

On February 14, 1974, four petroleum industry witnesses appeared as a panel before the Senate Committee on Finance to testify on Federal tax policy affecting the energy outlook. The witnesses appeared in behalf of the American Petroleum Institute, Mid-Continent Oil and Gas Association, Rocky Mountain Oil and Gas Association, and Western Oil and Gas Association. This booklet contains the presentations of the four witnesses and includes their formal statements preceded by a summary in the case of each statement.

A Foreword by President Frank N. Ikard of the American Petroleum Institute follows this page.

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ENERGY PROFITS, SUPPLY, AND TAXATION

Foreword

Solving the energy shortage is one of the most critical problems facing Americans today.

Like all complex problems, this one requires knowledge and comprehension for progress to be made toward a solution. The mistaken attitudes and policies that caused the Nation to drift into its present energy supply predicament must be corrected. Otherwise the future can only hold aggravated shortages, deterioration of the economy, spreading unemployment, and intensifying hardships for consumers.

It seems ironic that the mass communications methods available today have resulted in the spread of much erroneous information about the nature and causes of the shortages of oil, natural gas, and other energy sources. Solutions to these problems have been impeded because the people and their representatives in government have been bombarded by confusing claims that do not accord with the facts.

Yet accurate and useful information is available on every aspect of this question. Such information was provided in well-documented detail at hearings held on February 13 and 14, 1974, before the Senate Committee on Finance.

Petroleum industry witnesses at these hearings shared with the Committee their expert knowledge of the causes of the present energy supply shortfall and the prospects for solving the problem in the years ahead. They gave specific and constructive recommendations about what must be done. They exposed the fallacies in mistaken charges and beliefs now circulating on this problem.

These witnesses addressed themselves to the issue of the tax treatment of petroleum companies at home and overseas. They outlined the logic behind existing tax incentives, and they explained how those incentives can contribute to replenishing the Nation's energy supply. Thoroughly documented comparisons were made between tax treatment of foreign source income by the United States and other leading industrial nations. Widely held misconceptions about the application of the foreign tax credit to overseas operations of American oil companies were refuted.

The testimony also provided detailed information on oil industry profitability and described the scale of investment required in coming years if the Nation's energy needs are to be met over the long term.

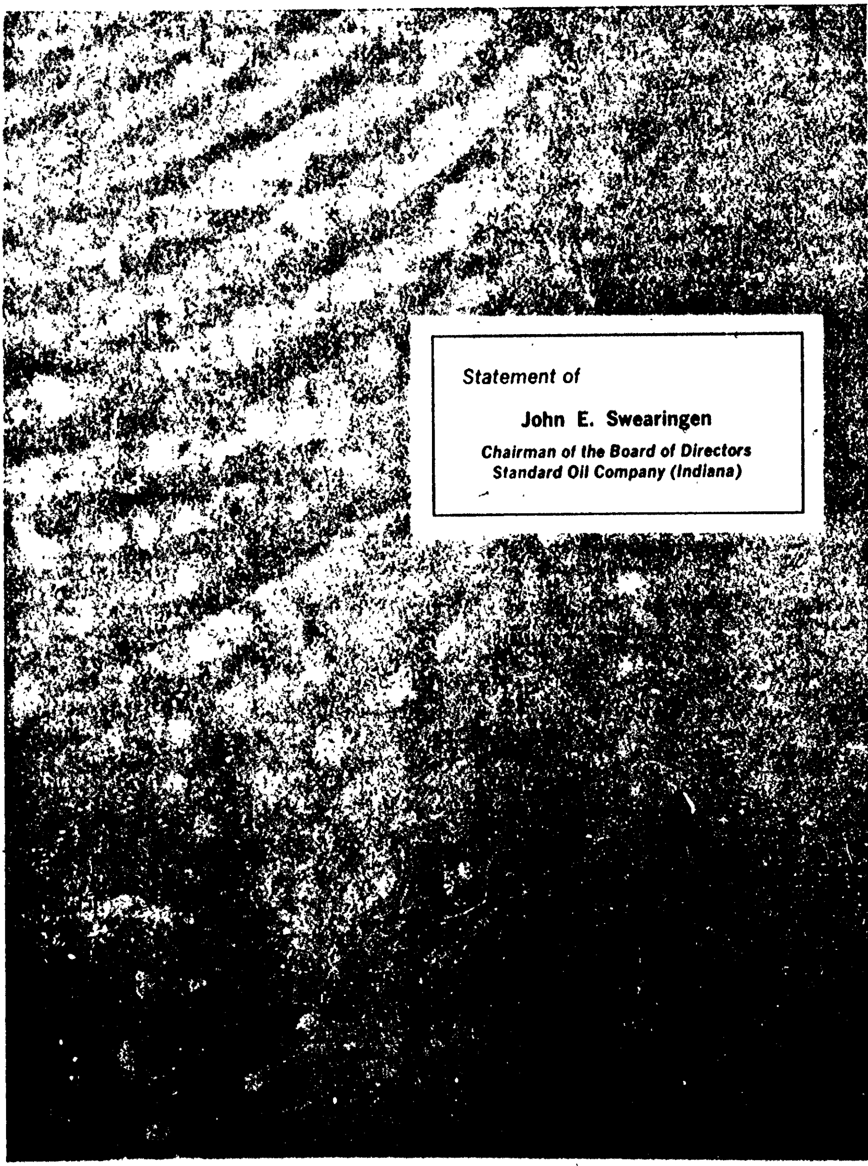
This booklet contains a compilation of testimony of the four witnesses who spoke on behalf of the American Petroleum Institute, Mid-Continent Oil and Gas Association, Rocky Mountain Oil and Gas Association, and Western Oil and Gas Association at the Senate Finance Committee hearings. These witnesses were: John E. Swearingen, Chairman of the Board of Standard Oil Company (Indiana); Robert G. Dunlop, Chairman of the Board of Sun Oil Company; H. A. True, Jr., a partner in True Drilling Company; and William L. Henry, Executive Vice President of Gulf Oil Corporation. The booklet has been compiled and issued in the conviction that material presented at these hearings deserves the widest possible circulation among those engaged in seeking to solve the energy problem.

The testimony of these four witnesses presented a well-rounded and thorough exposition of financial and fiscal aspects of the energy supply question, with additional information on a variety of matters, such as the trend of oil and gas discoveries and the outlook for synthetic fuels. The testimony clarifies many topics on which there is a degree of misunderstanding that could be detrimental to solving the energy supply problem.

It is my sincere belief these statements merit careful reading in their entirety because of the extensive background information they supply. The statements are also worth retaining and consulting as reliable and detailed reference sources. A wealth of statistical and background data on the petroleum industry is contained in these papers.

Frank N. Ikard

Frank N. Ikard
President
American Petroleum Institute



Statement of

John E. Swearingen

Chairman of the Board of Directors
Standard Oil Company (Indiana)

THE DOMESTIC ENERGY GAP

SUMMARY

1. The United States is facing the threat of a widespread shortage of fuels for the first time in its history, aside from temporary disruptions during periods of war. For a number of years, we have been consuming both petroleum liquids and natural gas at a faster rate than we have been adding to domestic reserves, and domestic producing rates have been declining. As a consequence, we have become increasingly reliant on imports to close the gap between shrinking supplies and rising demands. From 1970 through the first nine months of 1973, our crude imports doubled and refined product imports increased nearly 50 percent with total imports representing nearly 36 percent of total domestic consumption in 1973. In addition to the price this represents in lessened national security, the economic price of imported oil has risen sharply.
2. The relative stability in foreign crude oil prices which prevailed in the 1960's has vanished. Since 1970, the exporting nations have joined together to demand both higher taxes on production and substantial participation in the operations of the oil companies conducted within their territories. Between 1970 and the end of 1973, the share of production income commanded by the Persian Gulf nations for Arabian Light crude has risen from roughly \$1.00 per barrel to \$7.00. The government's take on Venezuelan oils has risen from slightly over \$1.00 per barrel to more than \$8.00. Canada has imposed an oil export tax, with the rate set at \$6.40 per barrel effective February 1.
3. Higher crude prices have resulted in higher product prices. Quoted wholesale prices at Rotterdam quadrupled during 1973. In the United States, the BLS Consumer Price Index indicates a rise of nearly 20 percent in gasoline prices and 47 percent in the case of fuel oil during 1973.
4. In the aftermath of the October war in the Middle East, the Arab oil exporting nations announced significant cutbacks in production, and embargoes on shipments to the United States. As a result, total U.S. imports declined from 6.5 million barrels a day in October, to 4.9 million in mid-January, a decline of some 30 percent. The sharpest decline was in crude imports, which fell from 3.7 million barrels a day to only 2.2 million barrels a day, a drop of over 40 percent.
5. A combination of physical shortages, higher prices, and conservation efforts—both voluntary and involuntary—have slowed the rates of growth in domestic consumption. From January through October of 1973, consumption steadily exceeded the 1972 levels month by month. By November, consumption had slowed to about the level of the prior year. By December, total consumption of 17.6 million barrels a day was more than 1 million barrels below the December 1972 level.
6. As for the near-term supply outlook, combined inventories of crude oil, gasoline, jet fuel, and residual oil as of January 18 were some 16 million barrels lower than they were a year ago. Only distillate inventories were significantly higher, mainly because of warmer-than-normal weather and conservation efforts. A severe cold spell in key consuming areas would draw down these inventories rapidly. Estimates of the average gross shortage of crude and refined products during the remainder of 1974 range as high as 2.5 million barrels a day.

Conclusion:

Events of the last year have demonstrated conclusively that the United States can never again be assured of unlimited supplies of foreign oil and that foreign suppliers are determined to exact the full value of their oil—which, in the long run, will be measured by the cost of alternative sources of energy, such as synthetics. For both the short and long term, the oil shortage is real.

INTRODUCTION

Mr. Chairman and Members of the Committee.

My name is John E. Swearingen. I am Chairman of the Board of Standard Oil Company (Indiana). Appearing with me are Mr. Robert G. Dunlop, Chairman of the Board of Directors, Sun Oil Company, Mr. H. A. True, Jr., Partner, True Drilling Company; and Mr. William L. Henry, Executive Vice President, Gulf Oil Corporation. We appear in behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association.

For purposes of reference, I might note that my own company ranks as the sixth largest oil company and the 12th largest industrial company in the United States, in terms of assets. Within the oil industry, we rank sixth in domestic oil production, fourth in gasoline, marketing, and among the top three in production of natural gas. Approximately 72 percent of our assets are concentrated in the United States, and, in 1973, 81 percent of our total revenues were derived from the United States, 3 percent from Canada, and 16 percent from overseas operations.

REVIEW OF ENERGY DEVELOPMENTS

Before addressing our present position in regard to energy supplies, I think it might be instructive to look back to the situation we faced last Summer. In testimony before the House Committee on Ways and Means on June 11, 1973, I noted that the United States was facing the threat of a widespread shortage of fuels for the first time in its history, aside from temporary disruptions during periods of war. As I pointed out at that time, for a number of years our Nation has been consuming both petroleum liquids and natural gas at a faster rate than we have been adding to our domestic reserves, and that domestic production rates were actually on the decline. As a consequence, we have become increasingly reliant on imports to close the gap between shrinking supplies and steadily rising energy demands. This has meant turning increasingly to the Middle East and North Africa, where nearly 80 percent of all the free world's proved oil reserves are located. In addition to the price this represented in terms of lessened national security, it was also becoming clear that the economic price of imported oil was undergoing a process of rapid escalation. The oil exporting nations had joined together to demand both higher taxes on production and substantial participation in the operations of the oil companies conducted within their territories.

The dangers were apparent. As I testified last June, "If U.S. dependence on imports is allowed to grow unchecked, we are likely to enter a new era in our dealings with our allies . . . For one thing, we will all be competing in the same markets for the supplies of energy we all must have to survive."

As I further stated, "The concentration of present reserves in the Middle East and North Africa, combined with our growing necessity to rely on imports over the next five to ten years at least, means exposure to the possibility of supply interruptions resulting from actions taken on political grounds. But there is also a growing possibility of supply interruptions based on purely economic considerations. We are dealing with a vital commodity likely to be in increasingly limited supply, while its price is rising. Many of the countries with the largest present reserves are already receiving oil-derived revenues too large to be effectively employed internally. In such circumstances, a producing country could decide to limit production in its own economic interest, and we have already had several demonstrations of such actions. All of these forces point to the necessity for the United States to do everything within its power to lessen our dependence on foreign supplies of energy."

I sincerely wish that subsequent events had demonstrated the concerns I expressed at that time to be unfounded. Unfortunately, the opposite has been the case, and our worst fears have materialized. Political considerations have resulted in an outright embargo on Arab oil exports to the United States and painful cutbacks in the quantities moving to Western Europe and Japan. The economic edge of the sword has cut even deeper. The price of Middle East crude has risen to the highest point in history, triggering price advances throughout the world. The exporting nations are now receiving more income from lower production. As a result, there is less incentive for them to increase production. They have expressed interest in making their oil reserves—which in many cases are the only significant national asset—last as long as possible.

These developments have dramatically altered the energy outlook for the entire industrialized world. All assumptions that Middle East oil would be available to fuel economic growth in Europe and Japan and to help make up the growing shortfall in U.S. energy supplies now have to be reexamined. Not only do spiralling prices threaten the ability of the importing nations to pay for the oil they require, but we now face the possibility that the full quantities desired may not be available at *any* price.

While the impact of these developments on the United States has not been as severe as it has on Western Europe and Japan, it has been sufficient to demonstrate that we have entered a new era. The days of unlimited cheap energy are over. We are going to have to pay more for energy and we are going to have to be less profligate in its use. As I testified in my last appearance before this Committee, it is important to remember that our own dilemma is man-made. The United States still has an abundance of potential energy sources to draw upon. In regard to oil and natural gas, we have a very large undeveloped resource base remaining offshore and in Alaska. There are also huge potential reserves in the shale deposits in the Rocky Mountain area. Our coal reserves are vast, and constitute a major future source of synthetic fuels through liquefaction or gasification.

Although the cost of either oil or gas from non-conventional sources will be higher than anything we have been accustomed to in the past, the point is that a secure resource base is there, awaiting development. In addition, our uranium reserves will support an accelerated program of nuclear electricity generation, and this source of power can be expected to take over a growing share of the load. However, it is likely to take at least a decade before we can look to non-conventional sources for an important contribution to the total energy flow. Meanwhile, we have the problem of immediate shortages of crude oil and refined products. I would like to try to summarize some of the principal challenges we face in this area and some of the forces behind our current dilemma. Pertinent data are included in a series of appendices, which will be referred to in the course of the statement.

INCREASED SHARE OF INCOME COMMANDED BY EXPORTING NATIONS

The relative stability in foreign crude oil prices which prevailed in the 1960's has vanished. *Appendix A* shows the estimated increase in oil production income going to the exporting nations over the past four years. In the case of Arabian Light crude from the Persian Gulf, the host nations in 1970 were realizing slightly less than $1.00 per barrel as their share of the income from production owned by the private companies, as distinguished from the share owned by the host country. The share commanded by the Persian Gulf host nations rose in gradual stages to an estimated $1.70 per barrel in mid-1973—an increase of roughly 70 percent. By October 1, 1973, it had reached $1.77 per barrel.

Then, by unilateral decision on the part of the key Middle Eastern producing countries, it rose to over $3.00 per barrel. Dramatic as this increase was, it was overshadowed by a subsequent rise to no less than $7.00 per barrel at the end of last year. In other words, we have seen a seven-fold increase in the take of the Persian Gulf producing nations within a period of three years—from roughly $1.00 to $7.00 per barrel.

Even these numbers fail to tell the full story. The equity crude, the share owned by private operators, has been a declining portion of total production. Under the so-called "participation" agreements enforced by the producing countries, they have taken over a rising share of the production. As their share has risen, so have the quantities they have to dispose of at any price the market will bear, and we have witnessed spot sales of limited quantities of these crudes at prices of more than $17.00 a barrel.

Not surprisingly, the success of these actions was felt beyond the Middle East. Venezuela is a major source of U.S. oil imports, and because of its closer proximity its exports to us have generally commanded a higher price than those from the Eastern Hemisphere. Inevitably, Venezuela—which is a member of the Organization of Petroleum Exporting Countries—followed the suit led by the Middle East. From an average of slightly over $1.00 per barrel in 1970, the government's take has been increased to more than $8.00 per barrel at the start of 1974.

While not shown in Appendix A, the cost of oil imported from Canada has also risen sharply, primarily through the imposition of successively higher export taxes. As recently as November of last year there was no such thing as an export tax on oil moving to the United States from the producing provinces in the west, where most of Canada's proven reserves are situated. At the same time, Canada relies on imports from Venezuela to meet most of its needs for petroleum in the east, where the bulk of its population is. Faced with its own problem of sharply higher costs for petroleum imports, Canada responded with a tax on its own petroleum exports.

Although the tax was first imposed at a nominal level, it has climbed sharply in successive stages. Effective on February 1 of this year, it has been set at $6.40 per barrel. Although this may appear to be less exacting than the $7.00-plus a barrel currently going to Middle East producing nations or the $8.00-plus going to Venezuela, it is comparable. Unlike the major oil exporting nations, Canada levies a series of other taxes on oil and gas production similar to those we have here in the United States. In the case of Canada, lease bonuses, royalties, lease rentals, income and other mineral taxes bring in additional revenues of nearly $1.00 per barrel on oil produced there. In combination with its new export taxes, the combined take at all levels of government is roughly on par with other petroleum exporters.

These external forces have also resulted in higher prices for domestic crude, a subject which will be dealt with in more detail in the testimony which will follow. At the same time, more realistic prices for domestic oil and gas are already generating a response—in the form of substantially accelerated expenditures and efforts to find and develop new petroleum reserves within the United States. As I noted earlier, we still have large potential undiscovered reserves, and we are going to need them badly. We are also going to have to be prepared to pay the price it will take to insure that they are brought into use.

INCREASED VOLUME AND VALUE OF U.S. PETROLEUM IMPORTS

Despite the alarming rise in the cost of imported oil, the United States has continued to increase the quantities brought in. When it comes to energy, we have no real option in the short term—nor do the rest of the industrialized countries. Energy is simply not a discretionary item in a modern society, and unless the flow continues we are not likely to have time to work out solutions for even our immediate problems, much less devise better formulas for the future. In our case, until we mount and carry through the effort that will be required to restore the Nation to its former position of energy self-sufficiency, we will have to rely on imports for assistance.

Appendix B shows the trend in U.S. imports of crude oil and refined products from 1970 through the first nine months of 1973. Over this period, crude imports have more than doubled, rising from a level of roughly 1.3 million barrels a day to 3.2 million barrels a day. Imports of refined products rose from slightly over two million barrels a day in 1970 to nearly three million in the comparable period of 1973—an increase of nearly 50 percent.

As a consequence, this Nation's combined imports of crude and refined products rose from approximately 23.5 percent of total domestic consumption in 1970 to nearly 36 percent in the same period of 1973. I personally find it disturbing to have imports of anything as vital to our economy as oil reaching even the 25 percent level. To see this reliance climb to the equivalent of one barrel out of every three we consume, as it did last year, should be enough to alarm every member of this Committee and the constituents they represent. I think this would be a matter of concern even if the continuation of supply were assured and we had some idea what the cost would be. Unfortunately, as we are discovering, neither an assured supply nor the cost seems to be within our control.

As to the cost of these imports, the value was a little over $2 billion in the first nine months of 1970, according to Commerce Department statistics. This figure does not include freight charges, however, and the tanker charges for moving crude oil from as far away as the Persian Gulf to the east or gulf coast of the United States or refined products from Europe can be a major item in the ultimate cost to the consumer. Even on the conservative basis reflected in the Commerce Department's calculations, the value of these oil imports has nearly doubled since 1970, and approximated $5 billion for the first nine months of last year. The indicated effect on our balance of trade position for the first three quarters of 1973 was a negative $1.9 billion, versus the prior year. This was approximately six times the negative impact of only $330 million sustained in 1971. In addition, the period does not even cover the final quarter of 1973, during which the largest increases in the cost of imported oil took place.

The inflationary effects of these recent increases on the economies of Japan and Europe are already evident. As for the underdeveloped, non-oil producing nations, it is estimated that the additional cost of oil imports is likely to be so great as to outweigh the total amount of foreign aid they can anticipate. In such circumstances, even the United States is going to be forced to take a look at its books. According to the Government's statistics, the value of the crude oil and products we imported in the first nine months of last year was nearly $5 billion, even before prices went through the ceiling. Can we afford the $15 to $20 billion now projected as our oil import bill this year? Not without serious repercussions on our trade balances and the rate of inflation to which we are going to be subjected.

INCREASED COST OF REFINED PRODUCTS

Some of the product price increases which have followed the increases in crude prices I have noted have been, predictably, breathtaking. Because of the nature of trading in any commodity in international demand—with hundreds of sellers and even greater numbers of potential buyers—it is literally impossible to know even what an average price is at a given time. This is particularly true of the oil business. There are more players in the game than is the case in any other industry I could name. Just in the marketing end of the oil business, the participants range from the proprietors of individual service stations to national governments. As a result, trying to determine prices with any degree of exactness is like trying to generalize about weather. At any given point, it might be 15 degrees below zero in the Rockies and 50 above in Washington, with the rest of the country at various other levels depending on location and circumstances. You can develop a series of "average mean temperatures" for the United States, just as you can develop "average" prices for crude oil and refined petroleum products—either in the United States or abroad. But in the nature of things, such artificially calculated prices have to be used with caution, and they do not represent the true state of affairs in any given locality at any given time. However, they can serve to indicate trends.

In regard to prices for refined oil products, the trend is definitely upward, and *Appendix C* documents some of the changes we have been exposed to in the past year regarding overseas supplies. Subject to the caveats I have noted, the price trend has been clearly upward. On the basis of quoted prices, the wholesale cost of the gasoline available for export from Rotterdam, which is the main source of imports of finished products to the United States from Europe, roughly quadrupled last year. On an FOB basis, disregarding tanker rates, you could have contracted for some barge lots of premium-grade gasoline for about 15 cents a gallon at the start of 1973. By December, the reported price was over 50 cents a gallon—an increase of nearly 300 percent, and the same was true in regard to regular grades. The quoted wholesale prices of low-sulfur heavy fuels increased even more rapidly. They rose from under nine cents a gallon (FOB) to nearly 50 cents a gallon.

With an increasing percentage of both crude and products coming from overseas, our domestic product prices also advanced, as indicated in *Appendix D*. During 1973, the weighted average price of gasoline used in the Consumer Price Index employed by the Bureau of Labor Statistics showed a rise from 37.3 to 44.7 cents per gallon in the case of gasoline, and from 19.8 cents per gallon to 29.1 cents in the case of Number 2 fuel oil. Overall, this represented an increase of nearly 20 percent in the price of gasoline and 47 percent in the case of fuel oil.

Appendix E shows the trends in domestic wholesale prices for refined products. Again, it is important to remember that these prices represent only spot sales, which are only a very small fraction of the total market since most sales are made on a contract basis. However, these spot sales indicate a clearly rising price trend. Between January and December of 1973, the wholesale price of premium grade gasoline rose from approximately 15 cents a gallon to around 25 cents—an increase of some 66 percent. Regular grade motor fuel rose from approximately 13 cents a gallon to about 23 cents—an increase of more than 75 percent. The price of Number 2 fuel oil rose approximately 90 percent, from roughly 11 cents a gallon in January to about 21 cents a gallon by December. These product

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prices reflect increases in crude oil costs which the Government allowed to be passed through as cost-justified price increases.

ARAB OIL PRODUCTION CUTBACKS

In the aftermath of the October war in the Middle East, the Arab oil exporting nations announced significant cutbacks in oil production, and these are detailed in *Appendix F*. With the single exception of Iraq, which has continued production at stable rates, the cutbacks have been generally observed.

Total production from this area in September of 1973 was at a level of approximately 20 million barrels a day. Reductions were announced in October, and throughout November and December production was reduced 25 percent from the September levels in all the major Arab producing countries except Iraq. Saudi Arabia, Kuwait, Libya, Abu Dhabi and Algeria—plus a number of minor producing areas—all observed the restrictions. The result was a drop of approximately 5 million barrels a day in exports at a time when demand for oil was rising steadily throughout most of the world. Production in Iran, the only major non-Arab producing nation in the Middle East, has continued at high levels.

Effective in January, the Arab cutbacks were relaxed, but production was only restored to 85 percent of the September levels, and there has been no indication when full production may be restored. As I noted earlier, there is little incentive to do so at this point, and a number of reasons not to do so.

RECENT DECLINE IN U.S. PETROLEUM IMPORTS

Even without the embargo on exports to the United States imposed by the Arab producing nations, this country would have felt the effects of the tightening in supplies abroad. However, it took some time before the effects became visible, in large part because of the 30 days required on the average to move cargoes from the Persian Gulf to U.S. ports. Shipments already under way were not affected by the embargoes.

Appendix G indicates the accumulating impact of the combined cutbacks and embargoes on U.S. petroleum imports. As we saw earlier, total U.S. imports of crude oil and refined products had risen steadily, year by year—nearly doubling between 1970 and 1973.

As the data indicate, our total imports reached a peak of 6,525,000 barrels a day in October of 1973, the month the cutbacks were announced. In November, the total volume declined to 6,281,000 barrels a day. Since then, imports have fallen to about 5,000,000 barrels a day. For the week ending on January 18 of this year, total import volume was only 4,982,000 barrels a day—a drop of about 30 percent below the October level. The decline was in crude imports, which fell from 3,739,000 barrels a day in October to only 2,171,000 barrels a day—a drop of more than 40 percent. The volume of refined product imports has remained relatively stable. On the basis of the most recent data available, product imports in the week ending January 18 averaged 2,811,000 barrels a day. This was slightly more than the October level, and only some 200,000 barrels a day below the peak level set to date. One of the major reasons for this better showing is that the partial restoration of Middle East production has freed supplies of refined products which otherwise would have moved to Europe from the Caribbean and other areas for use in the United States.

Nevertheless, the decline in total imports has serious implications, particularly since it had been the common assumption that we were going to be able to rely on foreign oil and products to close the widening gap between domestic supply and demand.

REDUCTION IN RATE OF GROWTH IN U.S. OIL CONSUMPTION

All of these factors—declining domestic production, cutbacks in imports, rising product prices, plus appeals for voluntary conservation followed by mandatory product allocations—have operated to slow the rate of growth in U.S. oil consumption.

As can be seen in *Appendix H*, total domestic consumption of refined products in 1972 averaged 16,367,000 barrels a day. In 1973, it averaged only 17,215,000 barrels a day—an increase of less than one million barrels a day, and well below the growth rates of recent years.

The month-by-month comparisons show the impact of the tightening in supplies even more clearly. From January through October of last year, monthly consumption steadily exceeded the 1972 levels by substantial margins. By November of 1973, total consumption was only slightly above the November, 1972 level. In December, consumption of 17.6 million barrels a day was more than one million barrels below the 1972 level of 18.7 million barrels a day.

An identical pattern can be seen in consumption of each of the major refined products—gasoline, middle distillates, and residual fuels. These are detailed separately in *Appendices I, J, and K*. In each case, the rate of growth in consumption slowed in November to about the level of the prior year, while December showed clear declines. Precisely how much of these declines to attribute to conservation, either voluntary or otherwise, how much to higher prices, and how much to physical shortages, is impossible to determine. In any event, the rates of growth to which we have been accustomed for so long have clearly been arrested.

CURRENT U.S. PETROLEUM INVENTORIES AND NEAR-TERM SUPPLY OUTLOOK

This brings us to the question of what lies ahead. *Appendix L* summarizes our inventory position for the most recent period for which data are at hand. As of

January 18, supplies of gasoline stood at 208 million barrels, or about 10 million barrels below the 1972 level. Inventories of jet fuel were slightly higher than they were at this point in 1972. Supplies of residual oil totalled 49 million barrels, slightly below the 53 million barrels in stock a year ago. Crude inventories amounted to 231 million barrels, or 5 million barrels less than we had at this point in 1972.

Only distillate inventories were significantly higher, with supplies of 188 million barrels on January 18 of this year versus 143 million barrels a year ago. Even this apparent margin is ephemeral, and results mainly from warmer-than-normal weather thus far. A severe cold spell in key consuming areas would draw down these inventories sharply in a very short period. If we exclude the temporarily high supplies of distillates from the calculations, our combined inventories of the remaining products and crude oil are actually some 16 million barrels lower than they were a year ago.

As for the outlook, there are nearly as many different predictions as there are forecasters. A great deal depends on the assumptions which go into the process. Within our own company, we have recently conducted a reappraisal of the prospects for 1974 and our projections point to continued shortages, although of different magnitudes depending on developments in the Middle East.

Assuming the selective oil embargo against the United States were to continue throughout 1974, we would expect the net shortage of crude and refined products to average approximately 2.5 million barrels a day for the full year. This is the estimated shortage compared with intrinsic demand—the quantities expected to be consumed if there were no restrictions on supply. According to our best estimates, it would be possible to offset this degree of shortages through a combination of voluntary and mandatory limits on consumption.

Assuming the embargo were to be lifted in mid-1974, it is our estimate that the shortage could be reduced to approximately one million barrels a day below intrinsic demand. If this were to be the case, most of the shortage could be offset through voluntary conservation efforts alone. While we would not have all the products we might want, it should be possible to get by with some determined belt-tightening.

CONCLUSION

I think recent events have underscored the dangers of any significant degree of reliance on foreign oil. In retrospect, it is clear that the Nation narrowly avoided disaster through the decision by the President in 1970 not to accept the recommendations made by the Special Cabinet Task Force on Oil Import Controls. It was the recommendation of a majority of the Task Force that we adopt a tariff program giving preference to oil from certain foreign countries, with the objective of forcing an increase in the use of then lower-cost imported oil—while bringing about an initial reduction of about 30 cents a barrel in the price of domestic crude, with further reductions envisioned down the road.

Among the assumptions made by the Task Force were that total U.S. imports from the Eastern Hemisphere by 1980 would be no higher than 500,000 barrels a day if no change were made in the existing system. These low estimates of future reliance on the Eastern Hemisphere were linked with a series of very optimistic estimates of potential supplies available from other Western Hemisphere [illegible]ces considered to be secure. Yet within the span of only three years, we have seen U.S. dependency on Middle East oil rise to over 2 million barrels a day, while its price has soared. Had the Task Force recommendations been followed, our present energy crisis would be more severe.

Just what course the exporting nations will follow over the longer run remains to be seen. The Shah of Iran recently suggested to the Persian Gulf members of OPEC that they set an oil price which would correspond to the minimum price that would have to be paid for shale oil or for liquefied or gasified coal, and he estimated this to equate currently with a minimum of $7.00 a barrel in government take for the Middle East producers.

This would appear to be a rational proposal. The major barrier thus far to development of these nonconventional energy sources has been the economic differential between their estimated cost and the lower cost of conventional fuels which has prevailed. It is now clear that we are going to have to employ all of our potential resources, including coal and oil shale, and it is encouraging that both the Administration and the Congress are now preparing to move in this direction.

While conservation measures can assist greatly in easing the immediate pinch, the urgent need is to expand our energy supplies to prevent more drastic shortages in the years ahead. However, in order to meet our expanding energy needs it is going to be necessary to rely heavily on oil imports—particularly over the near-term—with serious consequences in terms of national security and monetary stability. In these circumstances, it is essential that we maximize the extent to which our needs can be met from secure sources, both by increased development of domestic supplies of all types, and by increased efficiency of energy use.

What concerns me particularly at this point is Congressional failure to address the real issues before us. Our paramount national objective at this juncture should be to take the necessary steps to insure that we can increase the supplies of energy available from reliable sources. All other considerations must rank behind this central priority, and it applies particularly in the case of oil—our key fuel. Events of the past year have demonstrated conclusively that the United States cannot be assured of unlimited supplies of foreign oil and that foreign suppliers are determined to exact a full price for their oil—which, in the long run will be measured by the cost of alternative sources of energy, such as synthetics. For both the short and long term, the oil shortage is real.

However, in recent hearings before various Committees of the Congress, the discussion has been concerned mainly with trying to find someone to blame for our current energy shortages and with debates over the present tax provisions affecting the petroleum industry. This is avoiding the real issue. The principal problem we should be addressing is not whether the oil industry, or any other industry, is currently paying the right amount of taxes—or who has contributed most to getting us into our present predicament. The real challenge is to take the actions needed to assure the flow of energy the American economy has to have to function. Unless we succeed in doing this, we are going to face a serious decline in tax revenues from *all* of the revenue sources on which the Government relies to finance its activities.

Attempting to affix the blame for our present energy dilemma is a pointless endeavor, since all segments of society have contributed to it. The dangers of the course this Nation has been following were spelled out in the Report of the President's Materials Policy Commission, the Paley Commission, submitted to President Eisenhower in June of 1952. As that report concluded:

> "In area after area we encounter soaring demands, shrinking resources, the constant pressure toward rising real costs, the strong possibility of an arrest or decline in the standard of living we cherish and hope to share. As a Nation, we are threatened but not alert. . . ."

Part of the answer to the question as to why we disregarded this and other early signs of warning lies in the fact that, for generations unlimited supplies of low-cost energy have been taken for granted in this country. It has become a cliché to note that with only six percent of the world's population, the United States uses roughly one-third of the world's energy. It is difficult to convince people who have never been without fuel for their cars or heat and electricity in their homes that affluent America could really have an energy problem. The whole economy has been geared to provide ever-larger and more luxurious vehicles, more heat in the winter and more air-conditioning in the summer, and a range of power-consuming appliances that staggers even sophisticated Europeans.

Warnings that this joyride would have to come to an end have not been warmly received. For a number of years, spokesmen for the petroleum industry—myself included—have tried to call attention to what was happening. More often than not, such efforts were written off as self-serving, particularly since the only rational solutions we could see would lead to higher energy prices.

The oil industry can also be accused of a certain degree of over-optimism about its own affairs, although we could not reasonably have been expected to anticipate the impact on our operations of developments outside the industry and beyond our control. Five years ago, we were confident that oil would be moving to market from the Alaskan North Slope by now. In response to obvious needs for increased supplies of domestic oil and gas, we were convinced the frequency and size of Federal offshore lease sales would be greatly increased. Not only did this fail to come to pass, but a number of operating leases in the Santa Barbara Channel were shut down in 1969 after an oil spill.

Nor did anyone foresee the full impact of the increasingly stringent environment control requirements adopted by the Congress in 1970. The net effect of these measures was to reduce the supplies of available fuels, while simultaneously increasing fuel demand. As for the latest round of hostilities in the Middle East and its disruptive effects on oil supplies, this caught nearly everyone by surprise.

But the major fault throughout has been the failure of the entire governmental structure either to prepare the Nation for what it was going to face or to mobilize any effective response. Only the Government has the capacity to shape and direct a genuine national effort to come to grips with the complex problems involved in the flow of energy.

As the Paley Commission report stated over twenty years ago:

> "The Federal Government is not at present properly equipped to carry out its responsibilities for dealing single-mindedly with the many aspects of the problem. Dozens of Government organizations—departments and agencies, bureaus and offices, and interdependent committees—have an active concern in one or more aspects of the problem . . . some necessary jobs are not being done well enough; others are not being done at all; and the whole effort lacks sufficient coordination."

In most respects the report could have been written yesterday. Over the intervening twenty years, we have seen the world's leading energy producing and consuming country converted from our historic position of self-sufficiency into a candidate for membership among the have-not nations. All of us have helped contribute to this dilemma—government, industry, the media, and the public—and all of us are going to have to participate in efforts to work out a solution. Ex-post-facto attempts to assign culpability for what has happened will do nothing to get the Nation back on the track.

While the problems of energy supply and demand are admittedly complex, our most pressing need is clearly to increase the supply. Measures which promise to help to increase energy supplies will serve the national interest; measures which will impede an increase in energy supplies, whatever other merits that may appear to have, will do the Nation a profound and lasting disservice.

Appendix A

ESTIMATED OIL PRODUCTION INCOME TO EXPLORING NATIONS

(Dollars Per Barrel of Equity Crude)

Persian Gulf (Arabian Light - 34)	
Pre November 14, 1970	$0.91
November 14, 1970	0.98
January 1, 1971	0.99
February 15, 1971	1.26
June 1, 1971	1.33
January 20, 1972	1.44
January 1, 1973	1.51
April 1, 1973	1.61
June 1, 1973	1.70
July 1, 1973	1.73
August 1, 1973	1.80
October 1, 1973	1.77
October 16, 1973	3.04
November 1, 1973	3.08
December 1, 1973	2.99
January 1, 1974	7.00
Venezuelan Oils	
1967-69	0.95
1970 Average	1.03
1971 Average	1.30
1972 Average	1.62
(Period of sporadic increases)	
November 1, 1973	4.27
December 1, 1973	4.57
January 1, 1974	8.25

* Share of production owned by private operator

Appendix B

U.S. IMPORTS OF CRUDE OIL AND REFINED PRODUCTS

	First Nine Months			
	1973	*1972*	*1971*	*1970*
Crude Oil—MB/D [1]	3,205	2,122	1,569	1,322
Products—MB/D [1]	2,916	2,444	2,180	2,096
Total MB/D [1]	6,121	4,566	3,749	3,418
Percent of Domestic Consumption	35.7	28.6	25.0	23.5
Value—Millions [2] (excludes freight)	$4,982	$3,117	$2,384	$2,048
$ Per Bbl:	$ 2.98	$ 2.49	$ 2.33	$ 2.19
Percent Increase Vs. Prior Year.				
Volume	34.1	21.8	9.7	—
Value	59.8	30.7	16.4	—
Effect on Balance of Trade vs Prior Year Millions	$(1,865)	($733)	($336)	--

[1] Source—USBM
[2] Source—"Survey of Current Business," Commerce Dept.

Appendix C

PLATT'S IMPORT PRODUCT PRICES

(Barges FOB Rotterdam—Cents Per Gallon)
1973

	Gasoline Premium	Gasoline Regular	Heavy Fuel 1% S.
January	14.7 – 15.0	12.5 – 12.9	8.6 – 8.9
February	15.2 – 15.6	13.5 – 13.8	9.2 – 9.7
March	17.0 – 17.8	15.0 – 15.5	8.8 – 9.4
April	20.1 – 21.1	17.3 – 18.4	8.7 – 9.1
May	26.0 – 27.8	23.0 – 24.8	9.5 – 10.1
June	30.4 – 32.4	27.0 – 29.2	10.1 – 10.6
July	28.0 – 29.4	25.3 – 26.8	9.3 – 9.8
August	22.9 – 24.0	20.6 – 21.7	7.8 – 8.5
September	23.5 – 24.5	21.6 – 22.2	8.4 – 8.9
October	28.0 – 29.1	25.3 – 26.3	10.6 – 11.3
November	39.5 – 44.6	37.3 – 41.5	18.8 – 21.1
December	49.5 – 55.1	46.8 – 52.4	43.4 – 48.9

Appendix D

INCREASE IN U.S. REFINED PRODUCT PRICES [1]

(Cents Per Gallon)

	Motor Gasoline [2]	No. 2 Fuel Oil
December, 1972	37.3	19.8
June, 1973	40.1	22.1
December, 1973	44.7	29.1
Percent Increase, December 1973 Vs. December 1972	19.8	47.0

(1) Source: BLS Consumer Price Index
(2) Weighted Average of Regular and Premium Gasoline

Appendix E

PLATT'S CHICAGO WHOLESALE PRICES

(Cents Per Gallon)

1973	100 Oct. Premium	94 Oct. Regular	No. 2 Fuel Oil	No 6 Max. 1% S.
January	15.0 – 15.5	13.2 – 13.5	11.0 – 12.0	11.0 – 11.5
February	15.0 – 15.8	13.2 – 13.8	11.8 – 12.2	11.5
March	15.8	13.8	12.2 – 14.5	11.5 – 13.2
April	15.8 – 19.0	13.8 – 17.0	12.2 – 14.5	11.5 – 13.2
May	16.5 – 20.0	14.5 – 18.0	13.5 – 14.5	12.0 – 13.2
June	17.8 – 22.5	15.8 – 20.5	13.5 – 15.5	13.0 – 14.0
July	17.8 – 22.8	15.8 – 20.5	13.5 – 14.5	13.0 – 14.0
August	17.8 – 22.6	15.8 – 20.9	13.5 – 19.0	13.0 – 14.0
September	17.8 – 22.6	15.8 – 20.9	13.5 – 19.0	13.0 – 14.0
October	17.8 – 25.0	15.8 – 23.0	14.8 – 19.0	14.0 – 16.0
November	19.0 – 26.0	17.0 – 24.0	14.8 – 22.8	14.0 – 21.2
December	21.0 – 29.0	19.0 – 26.0	15.8 – 25.8	16.0 – 26.0

NOTE: Most refined products sales are made on a contract basis. Hence, these published prices represent only a very small fraction of the market and, in some cases, may represent the price being offered for the last gallon.

Appendix F

ARAB OIL PRODUCTION

(Thousands of Barrels Daily)

	September 1973	Percent Reductions Vs Sept. Nov./Dec. 1973	Percent Reductions Vs Sept. January 1974
Saudi Arabia	8,291	–25%	–15%
Kuwait	3,237	–25% (2)	–15% (2)
Iraq	2,116	No cutback	
Abu Dhabi	1,398	–25%	–15%
Neutral Zone	528	–25%	–15%
Qatar	609	–25%	–15%
Oman	302	–25%	–15%
Dubai	[illegible]	–25%	–15%
Bahrain	68	–25%	–15%
Libya	2,286	–25%	–15%
Algeria	1,050 (1)	–25%	–15%
Egypt	195 (1)	(3)	
Syria	150 (1)	(3)	
	20,503		

(1) Estimate
(2) Base for reduction is 3,000,000 barrels daily
(3) Unknown because of war damage
Source: Petroleum Intelligence Weekly

Appendix G

DECLINE IN U.S. PETROLEUM IMPORTS

(Thousands of Barrels Daily)

	Crude Oil	Refined Products	Total
October, 1973 (1)	3,739	2,786	6,525
November, 1973 (2)	3,266	3,015	6,281
Week Ending, (2)			
December 7, 1973	3,427	2,780	6,207
December 14, 1973	3,005	2,938	5,943
December 21, 1973	2,561	2,989	5,550
December 28, 1973	2,679	2,767	5,446
January 4, 1974	2,591	3,045	5,636
January 11, 1974	2,347	2,612	4,959
January 18, 1974	2,171	2,811	4,982

(1) Source: USBM
(2) Source: API

Appendix H

TOTAL DOMESTIC CONSUMPTION OF REFINED PRODUCTS

(Thousands of Barrels Daily)

	1973	1972
January	18,667	16,735
February	18,941	17,861
March	17,193	16,870
April	15,935	15,529
May	16,603	14,801
June	16,471	15,615
July	16,387	14,821
August	17,438	15,936
September	16,620	15,489
October	17,080	16,445
November	17,735	17,610
December	17,662	18,738
Year	17,215	16,367

Source: USBM—1972, 10 Mos. 1973; API—2 Mos. 1973

Appendix I

GASOLINE CONSUMPTION

(Thousands of Barrels Daily)

	1973	1972
January	6,157	5,589
February	6,481	5,755
March	6,555	6,467
April	6,584	6,332
May	6,958	6,490
June	7,009	6,872
July	7,062	6,722
August	7,311	6,986
September	6,625	6,498
October	6,728	6,404
November	6,582	6,516
December	6,168	6,414
Year	6,671	6,422

Source: USBM—1972, 10 Mos 1973, API—2 Mos 1973

Appendix J

MIDDLE DISTILLATE CONSUMPTION

(Thousands of Barrels Daily)

	1973	1972
January	5,650	5,125
February	5,718	5,674
March	4,508	4,773
April	3,824	3,939
May	3,897	3,393
June	3,537	3,473
July	3,522	2,857
August	3,750	3,181
September	3,909	3,438
October	4,161	4,168
November	4,522	4,718
December	4,898	5,628
Year	4,318	4,217

Source: USBM—1972, 10 Mos 1973, API 2 Mos 1973

Appendix K

RESIDUAL FUEL CONSUMPTION

(Thousands of Barrels Daily)

	1973	1972
January	3,262	2,815
February	3,305	3,171
March	3,071	2,682
April	2,472	2,444
May	2,518	2,111
June	2,602	2,196
July	2,430	2,107
August	2,714	2,257
September	2,667	2,239
October	2,532	2,362
November	2,827	2,843
December	2,979	3,151
Year	2,775	2,529

Source. USBM -1972, 10 Mos 1973; API--2 Mos 1973

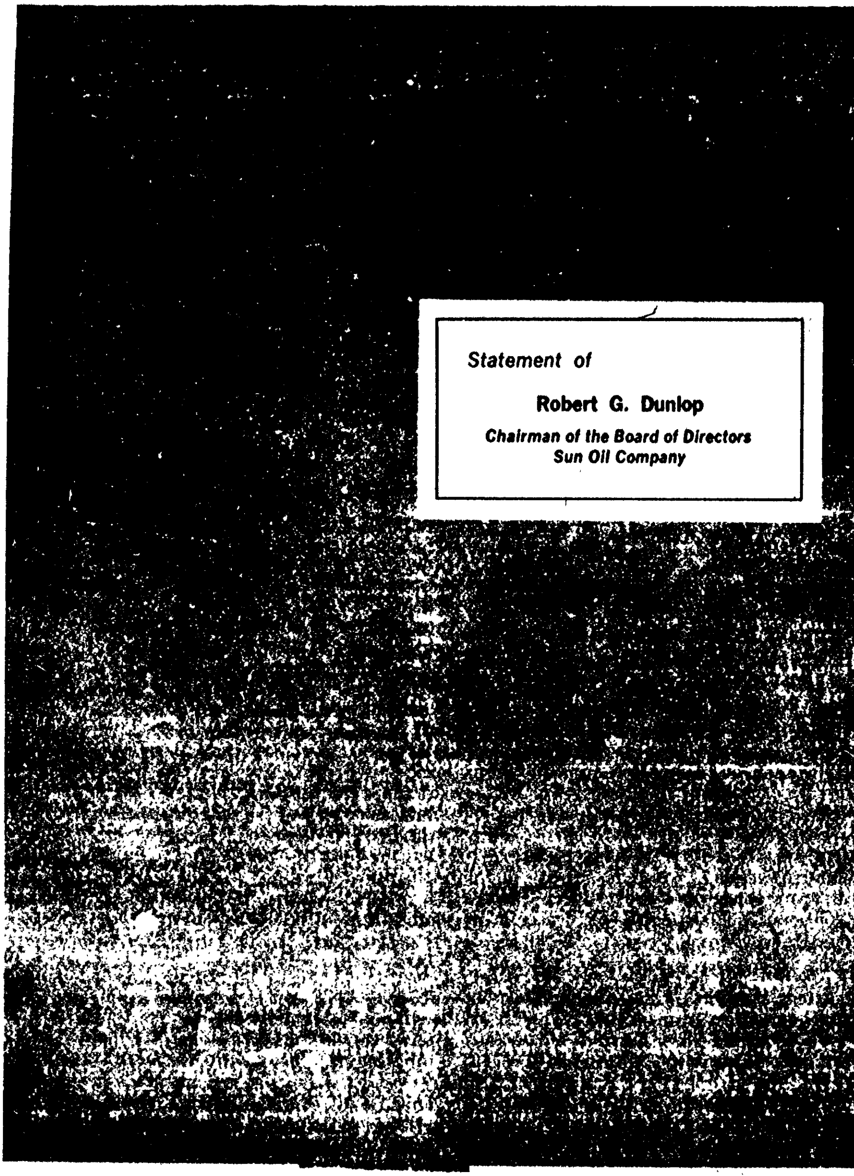
Appendix L

U.S. INVENTORIES

(Millions of Barrels)

	Week Ending 1/18/74	Week Ending 1/19/73
Motor Gasoline	208	218
Jet Fuel	28	25
Distillates	188	143
Residual	49	53
Crude Oil	231	236

Source: API


Statement of
Robert G. Dunlop
Chairman of the Board of Directors
Sun Oil Company

NATIONAL SECURITY, CAPITAL REQUIREMENTS AND ENERGY POLICY

SUMMARY

1. The United States has entered a new era in energy supply. The outlook for continuing restrictions on Middle East oil production, and higher prices for what is available, require an immediate and massive acceleration of domestic energy development.
2. The 1973 crude production cutbacks by Arab exporting countries and embargo of petroleum shipments to the United States and the Netherlands are only the most recent of a long series of post-World War II interruptions in international petroleum movements. However, now there is no spare U.S. productive capacity to offset the substantial import shortfall.
3. The prospect of sharp increases in the world's oil import bill, including the U.S.'s share, poses grave questions for international monetary affairs. Most significant is the balance of payments impact, with the attendant shift of economic power to the oil exporting countries.
4. The United States can no longer accept the risks inherent in depending upon foreign sources for energy that is needed for economic, military, and diplomatic security. We must aim toward reaching as quickly as possible that degree of self-sufficiency that will enable our country to avoid damage to our economy and defense and diplomatic posture in the event foreign oil is denied to us. It is clear that we are now far short of where we should be.
5. The major challenge we face is the challenge of providing the investment dollars essential to carrying out the necessary exploration and development, construction of facilities, opening of mines —all the projects that will be necessary to return the country to a safe level of energy self-sufficiency. Unprecedented amounts of capital, hundreds of billions of dollars, will be required over the next 10 to 15 years.
6. Improved earnings are the key to securing the capital the petroleum industry will require. It is essential that the industry be permitted to earn profits that will enable it to compete effectively with other industries for the capital it needs. Competitive profits will have to take into account the particularly adverse effect of inflation on an industry characterized by costly, long-lived facilities and the fact that the replacement cost of new supplies will be substantially higher than the historical cost of existing reserves being consumed currently
7. Restrictions on the ability of the petroleum industry to earn adequate profits over the past decade or more are at the heart of the grave energy problem we now face.
8. In the short-term, the degree of self-sufficiency we seek is not attainable. It is important that the country continue to have access to foreign production and that we diversify our foreign sources. This makes essential the continuing participation of U.S. companies in the development of foreign petroleum.
9. The overriding need is for the development of a coordinated set of national energy policies. We must recognize that all of the energy issues—economic incentives, environmental concerns, conservation measures, tax considerations—are closely interrelated and cannot be dealt with on a piecemeal basis.
10. Essential measures to provide an *economic climate* supportive of energy development include removal of restraints on price in an orderly manner, and tax policies that support and encourage investment.
11. Required *actions by government* include acceleration in the leasing of Federal energy lands; assurance of a proper balance among environmental and energy goals; and a higher level of financial support for energy research and experimentation.
12. If the essential economic climate exists and the necessary government actions are taken, the *industry will respond* by doing its part in developing the energy supplies we all seek.

I am Robert G. Dunlop, Chairman of Sun Oil Company, St. Davids, Pa., and I am appearing today on behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association and the Western Oil and Gas Association.

My statement relates primarily to the areas of domestic energy security, petroleum capital requirements and national energy policy.

NECESSITY FOR MASSIVE ACCELERATION OF DOMESTIC ENERGY DEVELOPMENT

The United States has entered a new era in energy supply. The outlook for continuing restrictions on the Middle East oil production, and higher prices for what is available, requires an immediate and massive acceleration of domestic energy development. To make this possible, our Nation must adopt coordinated national policies that will enable the energy industries to generate and to attract from investors the tremendous amounts of capital that are essential to strengthening U.S. self-sufficiency in fuel supply.

The events detailed by Mr. Swearingen demonstrate conclusively the risks inherent in relying heavily upon foreign sources of oil. These recent developments are only the latest in a series of major supply interruptions. In fact, testimony before the House Committee on Ways and Means in March, 1973, detailed 11 interruptions in international petroleum movements from the end of World War II until late 1971. It is worth taking a moment today to bring that listing up to date.

The first interruption occurred at the start of the 1948 Arab-Israeli war when Iraq shut down a pipeline to the Mediterranean. During the 1956-57 Arab-Israeli conflict, the Suez Canal was closed, but subsequently reopened. At the start of the 1967 Arab-Israeli war, crude production was temporarily halted by Arab producers, the Trans Arabian pipeline was shut down and the Suez Canal was blocked—and remains closed today. Most recently, the October, 1973, Arab-Israeli conflict resulted in crude production cutbacks by Arab exporting countries and embargo of petroleum shipments to the United States and the Netherlands.

Up to and including the 1967 Arab-Israeli war, the United States had sufficient spare petroleum production and distribution capacity not only to cover its own shortfall but also to export crude oil and products to other nations denied normal supplies.

In a 1967 speech, I pointed out that as a result of the 1967 Middle East fighting, and an unrelated civil war in Nigeria, more than 10 million barrels per day of oil suddenly wasn't available. In the face of this crisis, during the four months of June, July, August and September 1967, the United States exported 17 million barrels of crude oil to the United Kingdom and 6½ million barrels to other free world countries. At the same time, we overcame a deficiency of 27 million barrels in our own imports from the Middle East.

However, I went on to say this:

"Without significant improvements in the industry's economic circumstances, it can be expected to produce at rates that increasingly press upon the total capacity as time goes by, with the result that future crises will likely find it incapable of meeting emergency needs at home or abroad. Unless there is a change in the economic climate in which our industry operates, and soon, we face the stark fact that the last crisis we met with distinction was the last crisis we will be capable of meeting with distinction."

Today, our Nation is once again confronted with a massive interruption in imported oil supplies, but there is no spare productive capacity to offset the import shortfall. And that shortfall is substantial.

Prior to the war and the subsequent embargoes, it had been estimated that the U.S. would require total imports of 7.4 million barrels daily in 1974, or 40 percent of required oil supply.

The actual situation today is that the direct embargo of Arab oil exports and the related cut-off of refined product imports is denying the United States imports of some 2.5 million barrels daily.

Apparently as a result of diplomatic efforts to resolve the Arab-Israeli conflict, the Arab nations have not put into effect all previously threatened production cutbacks and it seems possible that they may institute partial restoration of pre-embargo crude production rates. However, even if the embargo is ended, it is my company's view that there is no substantial likelihood that Middle East production will be restored to levels that would result in a return to the days of "cheap foreign oil."

BALANCE OF PAYMENTS IMPACT AND ATTENDANT SHIFT OF ECONOMIC POWER

The prospect of sharp increases in the world's oil import bill poses grave questions for international monetary affairs.

Most significant is the balance of payments impact. William I. Spencer, President of the First National City Bank of New York, pointed out to the House Ways and Means Committee last March that the U.S. oil import bill could rise from the $8 billion level to $20 billion by 1980. And he went on to say that this would "necessitate a drastic reappraisal of our entire international payments prospect, as well as of our energy production outlook."

Events since that time have greatly magnified the problem. The First National City Bank suggested last month that industrialized countries as a group will have to pay *an additional $50 billion* for imported oil in 1974. On the assumption that the oil price increases will stick, but that oil shipments will return to more normal levels, the Bank says the U.S. will pay an additional $10 billion, or 14 percent of its total merchandise import bill in 1974, with Japan and Western European nations feeling a much sharper impact.

A second major consideration is the anticipated explosive growth in income for member nations of the Organization of Petroleum Exporting Countries. A year ago, it was estimated that as much as $45 billion could be flowing into some half-dozen of those oil exporting countries by 1985. Events of the past few months assure now that the figure will be sharply higher.

Whatever the precise level, some OPEC nations will be accumulating reserves of such dimension that they cannot be absorbed internally, and must be invested abroad. A recent report by the Organization for Economic Cooperation and Development (OECD) had this comment about the situation:

"... the oil producing countries are only likely to spend a fraction of their increased revenues on imports. What they do not spend they will likely invest in one way or another in the money and capital markets of the OECD countries. In the longer run, this may raise problems in finding investment outlets which are satisfactory to both parties (and on which the availability of oil supplies may partly depend) ... there will be important questions about what form this investment takes, as it may increase the volatility of international capital flows, and also where it occurs ..."

The point bears reemphasis. As Mr. Spencer said in March, 1973:

"... U.S. investments of such magnitude by the oil-exporting countries could raise problems depending upon the nature of the investments. Would they be debt or equity, portfolio or direct, in what industries, and with how much control? ..."

LEVEL OF SELF-SUFFICIENCY NEEDED FOR ECONOMIC, MILITARY AND DIPLOMATIC SECURITY

Against this background of supply restrictions, rising foreign oil prices, and balance of payment problems with the attendant shift of economic power to the oil exporting countries, it is apparent that the United States can no longer accept the risks inherent in depending upon foreign sources for energy that is needed for economic, military and diplomatic security. Just as clear is the simple fact that the only means of avoiding such dependence is large-scale development of America's rich energy resources.

The target of this expanded effort need not be absolute: 100 percent self-sufficiency.

I cannot now state a precise percentage figure as a self-sufficiency target, for this involves both the future mix of our energy supplies and variables of supply, demand and price that in the immediate situation are difficult to predict. I can say that we must aim toward reaching as quickly as possible that degree of self-sufficiency that will enable our country to avoid damage to our economy and our defense and diplomatic posture in the event foreign oil is denied to us. Thus, we can afford to import only that portion of our supply which could be offset by interim, short-term conservation measures in emergency periods. However, we must have in place the proven technology and ability to rapidly bring on stream our full energy requirements.

Whatever the proper target figure or figures are, whether 85 percent, 90 percent or some other number, it is clear that we are now far short of where we should be. In 1973, over one-third of our petroleum needs were met by imports, and the present trend is toward ever-increasing, more dangerous dependence on foreign supplies. This is unacceptable.

INVESTMENT REQUIRED TO REACH SAFE LEVEL OF ENERGY SELF-SUFFICIENCY

What must be done to achieve a secure level of self-sufficiency?

In March, 1973, testimony before the House Ways and Means Committee, Bob R. Dorsey, Gulf Oil Chairman, detailed what must be done in terms of exploring for and developing new oil and gas reserves, constructing shale oil plants, coal liquefaction and coal gasification facilities, geothermal and nuclear power facilities, and opening new coal mines.

He went on to point out that these are not alternative actions, but that *all* of these forms of energy must be developed to meet rising U.S. needs. And this points up the major challenge that we face today—the challenge of providing the investment dollars that are essential to carrying out exploration and development, building these facilities and opening these mines. The size and scope of this investment job are staggering.

Current projections of energy capital requirements vary in accordance with the technical assumptions on which they are based. But all reach the common conclusion that petroleum and the other energy industries will require vast amounts of capital. The following representative projections indicate the magnitude of requirements.

In a comprehensive study completed in 1972, the National Petroleum Council (which assumed that foreign oil would be freely available and would serve as the swing fuel to take up the slack as shortages developed) suggested that the total capital requirements of the domestic energy industries would amount to more than $500 billion over the 1971 to 1985 period (expressed in 1970 dollars). (See NPC Table 20 attached.)* This is equivalent to some $34 billion annually—substantially more if inflation is taken into account. Helping to put this figure into perspective is the fact that the entire Apollo space program cost in the range of $25 billion. So the domestic energy industries must invest funds equivalent to one and one-half Apollo programs for each year of the 15-year period.

Within this total picture, the Council further suggested that the petroleum industry alone would require more than $250 billion over the period for investment in conventional and synthetic fuels development. This works out to an average annual investment of some $17 billion, without allowing for inflation, which is more than double the annual average for the previous decade.

More than half of this petroleum industry total—some $140 to $170 billion—would be invested directly in searching for and developing new reserves of oil and natural gas.

On a broader basis, the Chase Manhattan Bank has estimated that worldwide petroleum industry financial

* See p. 60, infra.

requirements will amount to a staggering $1,350 billion over the period 1970 to 1985.

Some $450 billion of this total will be capital investment required for exploration and development of conventional oil and gas supplies. Another $360 billion would be capital invested in refineries, tankers, pipeline and other facilities. The remainder is allocated to other financial needs—debt service, enlarged working capital and dividends.

CENTRAL ROLE OF IMPROVED EARNINGS

In contrast to these capital needs, the capital availability picture is a quite different one. At the same time that investment requirements have been rising sharply, the ability of the industry to attract the needed funds has, prior to 1973, been severely hampered by below-average profitability. There has been a widening gap between capital needs and earnings.

The Chase Bank has placed these trends in perspective in these words:

"Normally, net income should be the most important source of the funds needed for these (capital) purposes. But as a result of their continuing weak performance, earnings provided no more than 32 percent of the money available in 1972. They provided 35 percent the year before, and several years ago they were the source of nearly 50 percent."

Unable to generate sufficient income to keep pace with rising capital needs, the industry had to turn increasingly to borrowing. Long-term debt has been rising steadily, and at the close of 1972 totaled $21 billion for the thirty oil companies surveyed by the Chase Bank. This was equivalent to more than 30 percent of invested capital, or double the 15 percent ratio of 10 years earlier. The sobering fact about this is that in a high-risk activity like petroleum development, there is a point at which debt levels impact on investor confidence. And there is increasing evidence that this point is being reached in the petroleum industry.

Mr. Spencer commented on this in his testimony last March. Noting that many companies were borrowing heavily, he went on to say:

". . . bond buyers and equity underwriters begin to look askance at a company that makes too many trips to the public fountain. Their disapproval is most marked for companies engaged in hydrocarbon exploration or unproven methods of generating electric power—or other activities where the outlays are especially large and the risks especially high."

In brief, improved earnings are the key to securing the vast amounts of capital that the petroleum industry will require in the future. While Mr. True will comment in some detail on the current earnings situation, I do want to mention briefly two points that are particularly pertinent to the matter of petroleum industry profits and the capital needs projections I have described.

One problem is that the statement of profits in current dollars gives no recognition to the impact of inflation over the past two decades. Briefly, current charges for depreciation, based on historical costs, will in no way cover the cost of replacing physical facilities built in earlier years. To duplicate a refinery that cost $100 million 20 years ago could cost close to $200 million today. While this inflation problem is one that affects all industry, it is particularly troublesome for capital-intensive industries like petroleum which are characterized by costly, long-lived facilities.

Another consideration is that current profits should be appraised in the light of steadily increasing costs for developing new supplies of petroleum. It is a fact that the lowest-cost oil and gas have already been developed. As these supplies are produced and consumed, they must be replaced. The replacement cost for new supplies will be far higher than the historical cost of existing reserves being consumed currently. Exploratory efforts must be increasingly concentrated in offshore and other areas where access is difficult, where wells must go deeper, and where operating costs are higher. The cost of a single 100,000 barrel per day synthetic crude project could run as high as $1 billion. Reported industry profits are based on historical costs and do not take into account these much higher replacement costs. Current prices must be adequate to cover replacement costs.

It is essential that the petroleum industry be permitted to earn profits that will enable it to compete effectively with other industries for the capital that it requires. That required capital is enormous, but given the profits it can and will be provided by the industry and the capital markets. As Mr. Spencer stated, from the banker's viewpoint, ". . . we tend to be optimistic . . . in terms of the ability of free societies to raise capital for economically viable operations."

I suggest to you that objective analysis of the record of the past decade shows clearly that the petroleum industry had not been earning such a competitive return. And that fact is at the heart of the grave energy problem we now face.

FOREIGN INVESTMENTS

Before leaving the capital needs issue, I want to make one additional point relating to foreign investments by U.S. petroleum companies. In the short-term, we must realistically face the fact that the degree of self-sufficiency we seek is not immediately attainable. We are now playing catch-up, and energy development takes time. Since we must continue to rely heavily on imported oil for the immediate future, it is important that we continue to have access to foreign production. And we need to diversify foreign sources as rising world demand intensifies pressures on available supply. This makes essential the continuing participation of U.S. companies in the development of foreign petroleum.

My own company's experience supports this position. Sun is basically a domestic company, with its investment base largely concentrated in North America. Even so, it has been necessary for us in the past decade to move increasingly into foreign petroleum exploration. We have been forced to do this in an effort to acquire additional crude oil supplies for our refineries, since domestic exploration opportunities were limited. If the tax laws were changed, as some have urged, to make it uneconomic for Sun to continue its foreign exploration efforts, or to make it impossible for us to compete with the oil companies of other countries, the effect would be less crude for our refineries and less product for U.S. consumers.

ELEMENTS OF A NATIONAL ENERGY POLICY

Against this background, I will conclude my testimony with a discussion of policy considerations and of recommended actions that are essential to rebuilding the energy self-sufficiency of the United States.

First, however, I want to urge as strongly as possible that all of us work together to bring to an end the continuing search for scapegoats on which the energy crisis can be blamed. It is my personal view that in one sense all of us, individuals and institutions alike, share responsibility for the problem. We were all slow to perceive the rapidity with which energy surfeit was changing to energy scarcity.

In any case, the current problem is a real one. Rhetoric and recrimination serve only to divert attention from the major issues, and to impede our efforts to deal with the problem. It is time now for all of us to get on with the job we have to do.

NEED FOR COORDINATED POLICIES

In broad perspective, the overriding need is for the development of a coordinated set of national energy policies. We simply cannot afford to continue dealing with energy issues on a piecemeal basis, for in attempting to solve one problem in isolation we create others. What we need to recognize is that all of the issues—economic incentives, environmental concerns, tax considerations—are closely interrelated, and, therefore, can be dealt with effectively only on the basis of coordinated policies.

Our specific recommendations fall into three broad areas: (1) measures to provide an *economic climate* supportive of energy development; (2) specific *actions by government* that are essential to developing domestic resources; and (3) *petroleum industry responses* that will get the job done.

SUPPORTIVE ECONOMIC CLIMATE

In the first area, there are two major recommendations: (1) to remove restraints on price in an orderly manner, and (2) to maintain tax policies that support and encourage investment.

In a private enterprise economy, when shortages develop, the role of price is to stimulate new supply. When prices are controlled, however, shortages persist and worsen, and market relationships become badly distorted. This is precisely what is happening today in respect to petroleum fuels. The fact that 20 years of natural gas price control, supposedly in the interest of consumers, has created a situation where many consumers cannot obtain gas at any price clearly demonstrates the problem. Low gas prices have also impacted severely on other fuels, driving coal out of many markets and holding oil prices at depressed levels, thereby weakening the overall U.S. energy situation.

It is essential that petroleum price controls be phased out in an orderly manner, that there be a clear commitment to do this upon which the industry and investors can rely, and that natural gas prices be deregulated and decontrolled. Failure to take these actions will cripple the national effort to accelerate the development of domestic energy supplies.

Similarly, tax policy must support and encourage investment in the energy industries. Specifically, this means (1) that profits vital to energy development not be taxed away; (2) that tax policies which have proven to be effective incentives be continued; and (3) that taxation of foreign income continue to recognize the need for U.S. companies to be able to compete effectively with foreign companies in the development of overseas resources. I will not elaborate on these recommendations since Mr. Henry will cover the tax area in detail.

AFFIRMATIVE ACTIONS BY GOVERNMENT

In the area of required affirmative actions by government, I have three recommendations for your consideration.

First, it is vital that leasing of Federal energy lands be accelerated. A major share of the domestic petroleum yet to be developed is believed to be on the outer continental shelf, while virtually all of the high-potential oil shale areas are also under Federal ownership. Good progress was made in stepping-up the leasing of offshore areas during 1973, and the new prototype oil shale leasing program this year is a major step forward. But both the frequency of lease sales and the acreage offered need to be further increased.

Second, we urge the Federal government to take the lead in assuring that a proper balance is maintained among environmental and energy goals. Environmental concerns have already impacted seriously on energy supply through slowing the Alaska pipeline, restricting offshore development and impeding the siting of refineries and nuclear power plants. They are also blocking the broader utilization of our vast coal reserves, which are the key to immediate, large-scale expansion of domestic fuel supply. The balance we seek to correct this situation is not one that sacrifices environmental goals, but one that carefully weighs costs against benefits and permits energy development to proceed with proper environmental safeguards.

Third, we recommend that government provide a substantially higher level of financial support for research and experimentation in developing new energy sources, including loan guarantees for initial commercial projects. It will be difficult to obtain entirely from private investors the very large amounts of capital needed for research and development on synthetic fuels from coal and shale and for longer-range nuclear and solar energy capabilities. Government support could help bring these technologies to the point from which private companies could move into major commercial-scale production.

PETROLEUM INDUSTRY RESPONSE

The final area of required action is that of petroleum industry response to the new economic climate that would result from the above recommendations. Here I think that two responses are particularly significant.

One is in the area of capital investment, where the industry must assure that the available funds are in fact invested in energy development and in the processing, transportation and other facilities that are essential to increased U.S. self-sufficiency. It is my observation, buttressed by recent announcements of capital spending plans for 1974, that the industry is fully committed to such investment. This commitment was strongly reflected in the survey of petroleum companies conducted by Senator Bartlett last Fall. In answer to his question as to how increased cash flow resulting from removal of price controls would be utilized, the great majority of the 115 companies responding said "virtually all or 100 percent" would be used to increase domestic energy capability. Speaking for my company, Sun's proposed capital spending for 1974, some $650 million or more, will be almost double 1973 outlays.

Also, I think the industry must broaden the horizons of its thinking about synthetic fuels development. A truly massive research and development effort will be required to build these fuels into significant contributors to U.S. energy supply. And while government financial support is essential, the petroleum industry must shoulder the major share of the costs.

The commitment of the industry to do precisely this is demonstrated by its response to the recent oil shale lease sale. Two companies represented on this panel today—Gulf and Indiana Standard—invested over $200 million in the winning bid for the acreage offered —and this is only the *beginning* investment in what will surely prove to be a very costly project.

In closing, I repeat that the United States has entered a new era in energy supply.

. . . We can no longer depend upon foreign sources for energy necessary to our military and economic security.

. . . We must accelerate the development of our domestic resources to achieve a degree of self-sufficiency that will enable our country to avoid damage to its economy, its defense posture, and its diplomatic independence in the event foreign oil is denied to us.

. . . To achieve this, we must adopt coordinated national policies and provide the kind of economic climate that will permit the energy industries to generate and attract from investors the capital necessary to get the job done.

Statement of

H. A. True, Jr.

Partner
True Drilling Co.

INDUSTRY PERFORMANCE DOMESTIC

SUMMARY

A. Prices Have Turned Up

(1) The average wellhead price of crude oil was essentially unchanged from 1948 ($2.60 per barrel) through 1968 ($2.94 per barrel). Increases in 1969-70 were offset by the Tax Reform Act of 1969. While an eight percent increase was realized in 1971, no significant increases occurred until 1973. The long-needed price breakthrough of 1973 has brought "new" oil prices to about $10 per barrel and "old" oil prices to about $5 per barrel, an average of about $6.50 per barrel.

(2) The average wellhead price of natural gas increased from 1948 (6.5 cents per Mcf) to the early 1960's (about 15.5 cents per Mcf), but was then held almost constant through the 1960's. A long-needed price breakthrough began in 1971 bringing new contract prices to 34 cents in 1972 and to more than 50 cents in 1973.

B. Profitability Has Recovered

(1) A 50 percent increase in earnings in 1973 brought U.S. oil companies' return on invested capital from a 10-year low of 10.8 percent in 1972 to about 15 percent in 1973, in comparison with about 14 percent for other manufacturing.

(2) Domestic earnings were up far less than 50 percent—12 percent for a group of companies which have reported to date. Foreign earnings for these companies were up 75 percent. Two important reasons for the foreign increase were a recovery from depressed performance in earlier years and devaluation of the dollar.

(3) The 1973 recovery to the 15 percent return range is encouraging. That is the range of returns—following a 23 percent year in 1948—experienced during the postwar expansion of the domestic petroleum industry which ended in 1956. After 1956, returns plunged to the 10 percent range; and exploratory activity fell off.

C. Expansion Has Begun

(1) After a two-year lapse, the Federal government has resumed leasing offshore in the Lower 48 states; 900 thousand acres were leased in 1972, 1.5 million in 1973—well above the 700-thousand acre average of the 1960's. The industry spent a total of over $5 billion for offshore leases in 1972 and 1973. Approval of the Alaska pipeline should also encourage more activity there.

(2) The long-term decline in wildcat drilling has apparently been arrested. The number of rigs in operation has increased. Gas discoveries have increased sharply. Oil discoveries continued to decline in 1973, but oil prices did not move up until 1973; gas prices had started up two years earlier.

(3) Expenditures for exploration and development in the United States increased to more than $6 billion in 1972. Total capital expenditures by a sample of large companies were up 45 percent in 1973, and they plan a further 57 percent increase in 1974.

(4) A U.S. synthetics industry is beginning to become commercial. Numerous research projects are under way for improving techniques for gasifying coal and extracting oil from shale. Coal gasification facilities have been announced but not approved by the Federal Power Commission. One shale plant on private land has been announced; and Federal leasing has begun, with an initial winning bid of $200 million.

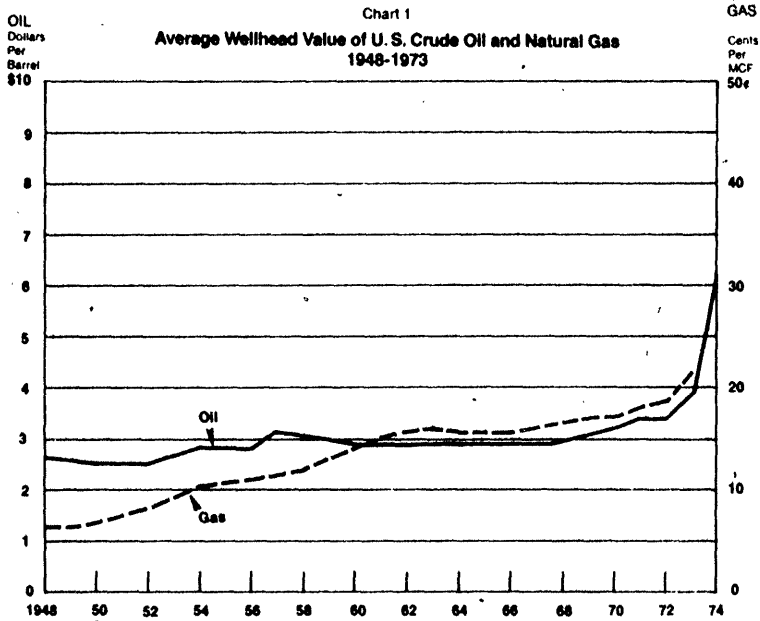
D. Conclusion

The economic stage is set for successful expansion of the domestic oil and gas industry. However, current threats of price rollbacks and increased taxes could easily destroy the favorable new economic environment.

Mr. Chairman and Members of the Senate Committee on Finance, I am H. A. True, Jr., a partner in True Drilling Company of Casper, Wyoming. I am an independent operator. Additionally, I am chairman of the National Petroleum Council, but my appearance today has no relationship to my Council affiliation. My presentation today reviews the 1973 price, profit, and investment experience of the United States oil industry in comparison with the industry's postwar history. It shows that rising prices have led to a recovery in profitability to the levels of the early 1950's, when the domestic industry was last expanding vigorously. As would be expected with improving profitability, we can now see—if not the beginning of another vigorous expansion—at least the end of the 15-year decline in domestic exploration and development that began after 1956.

Chart 1

Average Wellhead Value of U.S. Crude Oil and Natural Gas 1948-1973



Source: 1948-1972 from U.S. Bureau of Mines, January 1974 from U.S. Treasury submission to Committee on Ways and Means, February 4, 1974
(See Supporting Tables V)

A. Prices Have Turned Up

Domestic oil and gas prices have improved significantly.

(1) Crude Oil

After removal of World War II price controls, the average wellhead value of crude oil in the United States more than doubled by 1948, reaching $2.60 per barrel. Then, except for minor fluctuations, it was essentially unchanged for two decades (see Chart 1). The 1968 price of $2.94 per barrel was only 13 percent above 1948.

Price increases aggregating 24 cents per barrel in 1969-70 were effectively neutralized by the reduction in percentage depletion imposed by the Tax Reform Act of 1969. The first increase actually realized since the early 1950's came late in 1971—and it was only about eight percent. Despite industry warnings of impending sharp increases in insecure imports*, the Government claimed that the 1971 price increase was unjustified in the short run and quite possibly in the long run. With price controls, the average price of crude was held at $3.39 until the Spring of 1973.

For the first time in a quarter of a century, U.S. crude oil prices were permitted to advance in 1973. By May, the price was up by 25 cents. Another 35 cents per barrel was approved in August. "New" oil was decontrolled in September and initially rose about a dollar per barrel. When OPEC raised prices sharply in October, U.S. "new" oil rose another $3 per barrel. Stripper well production was decontrolled in December. Controlled oil was raised to about $5 per barrel in

* See, for example, hearings before the Committee on Ways and Means on Tariff and Trade Proposals, June 3, 1970, Part 8 of 16 parts, pps. 2214, 2281, and 2285.

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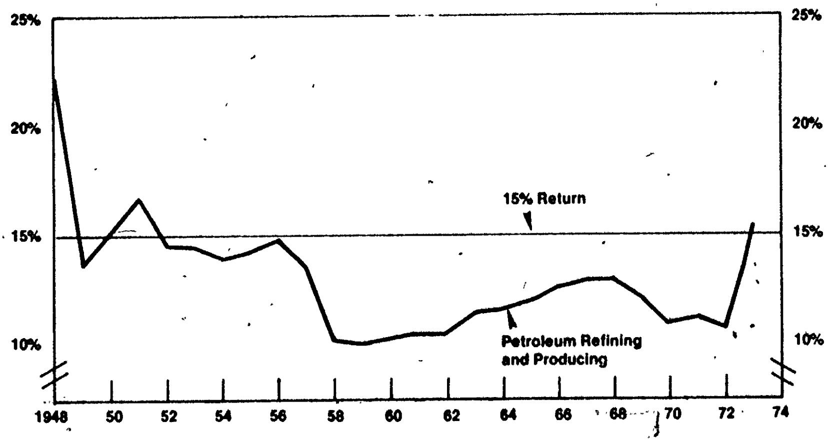
Chart 2

Return on Shareholder's Equity–Petroleum Companies
1948-1973



Source: First National City Bank 1973 preliminary.
(See Supporting Tables V)

December, and decontrolled oil is now selling at more than $10 following the second sharp OPEC price increase at Christmas. Today, the average price of all U.S. crude oil is probably about $6.50. The gains in price in the past year are comparable to the experience of 1946 to 1948 which preceded the postwar expansion of the industry. Hopefully, the recent price increases will open the door to a new period of expansion.

(2) Natural Gas

The average wellhead value of U.S. gas rose from 6.5 cents per Mcf in 1948 to about 15.5 cents in the early 1960's but was then held almost constant for the remainder of the decade (see Chart 1). The average value began to move up in 1971, reaching 21.3 cents per Mcf in 1973. However, the average value of all gas does not adequately reflect recent developments in the market because it is heavily weighted by past sales under long-term contracts. Average prices under new interstate contracts increased from 22 cents per Mcf in 1970 to 27 cents in 1971 to 34 cents in 1972.

1966	17.6¢
1967	18.6
1968	19.5
1969	19.7
1970	22.0
1971	27.4
1972	34.3

Source: Testimony of Dr. J. Rhoades Foster, submitted in the Matter of Stingray Pipeline Company, CP73-27, et. al., August, 1973.

Recent sales have been reported above 50 cents. Thus, U.S. natural gas prices were permitted to improve beginning in 1971—two years ahead of crude oil prices.

B. Profitability Has Recovered

A year ago we reported to Congress that the 1972 probability of U.S. oil companies was at a 10-year low. Their 1972 rate of return on net assets was only 10.8 percent, which came close to the 10.0-10.5 percent experience of the industry's depressed years from 1958-1972 (see Chart 2)*. I am gratified that 1973 was a better year for U.S. oil companies. Preliminary data indicate that their rate of return recovered to just over 15 percent in 1973, a level not experienced since the period 1948-1956.

The industry's 50 percent increase in earnings in 1973 has been the subject of extensive criticism in the press and in Washington. My only real concern about this long-overdue recovery in petroleum industry profitability is that *domestic* earnings apparently did not increase nearly so much as is desirable. Complete data are not yet available, but preliminary earnings statements by some of the largest U.S. international oil companies show domestic earnings up .11 percent, while foreign earnings were up 93 percent—with a worldwide increase of 51 percent. As we have seen, the domestic industry is under strict price controls for products and "old" crude oil, with recent activity in Congress and the Administration aimed at re-controlling and rolling back "new" crude oil prices. There is also an overall profit margin limitation. Thus, the domestic industry (with close government controls) is not yet out of the woods on profits; but some upturn in domestic profits has occurred.

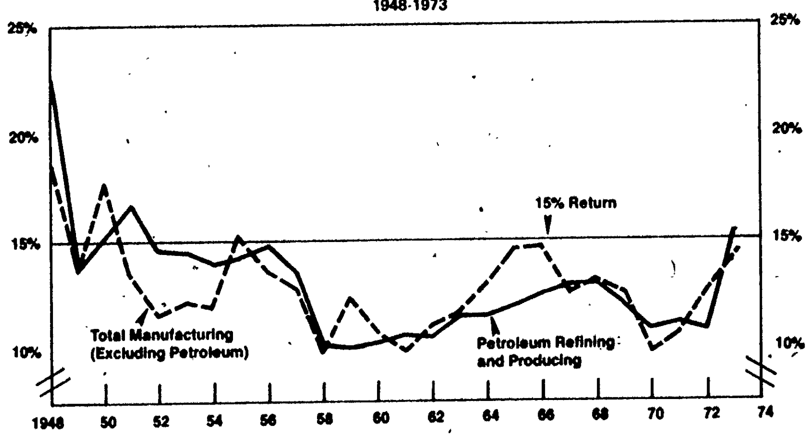
A principal explanation of the large 1973 increase in foreign earnings was a rise from very low refining and marketing earnings to something approaching reasonable levels. A study by the First National City Bank last Summer showed that refining and marketing profitability in Western Europe had been below 5 percent for about a decade. Thus, a sharp increase in profits was also long-overdue there.

Another important reason for the 1973 increase in foreign earnings was dollar devaluation. American companies keep their books in dollars; and each yen or mark or franc earned during much of 1973 was equivalent to substantially more dollars than in 1972. The 1972-73 increase in foreign earnings apart from dollar devaluation was about 67 percent, not 93 percent—38 percent worldwide instead of 51 percent. We must remember that much of the 1973 dollar devaluation has been wiped out by recent deterioration in foreign currency values. The foreign exchange markets have apparently predicted that the rise in world oil prices will ultimately hurt the U.S. economy less than Europe or

* These data are from the First National City Bank, which measures rate of return by dividing net income by shareholder's equity at the beginning of the year. In a period of expansion (as in 1972-74), this overstates the rate of return somewhat.

Chart 3

Return on Shareholder's Equity
Petroleum Companies and Other Manufacturing
1948-1973



Source: First National City Bank 1973 preliminary.
(See Supporting Tables V)

Japan because we import less of our oil requirements. Consequently, a yen or mark or franc earned today is equivalent to fewer dollars than on the average in 1973. This means that the part of the 1972-73 increase in foreign earnings which was attributable to dollar devaluation could be reversed.

The profit experience of 1973 was also encouraging for other U.S. businesses. Using preliminary data, the First National City Bank estimates that manufacturing profits (apart from oil refining) were up about 25 percent. As a result, the return on net assets rose to just over 14 percent (see Chart 3). This increase for other manufacturing continued an improvement begun in 1972, when their rate of return reached 12.5 percent —1.7 percentage points above petroleum. The two-year gains in profits from 1971 to 1973 were about 50 percent for both oil and other manufacturing. Those increases are computed without any consideration of inflation. General price levels rose by 8.5 percent from 1971 to 1973 (as measured by the price index used for deflating Gross National Product).

Just how important is a 15+ percent rate of return for U.S. oil companies? I believe we cannot overestimate the significance of getting the domestic integrated return up through that threshold level. The return should, of course, be higher for the very risky producing stage of the business. The domestic oil industry's expansion after World War II began in earnest in 1948, when the rate of return was 22.7 percent (see Chart 4). During the years through 1956, rates of return ranged from 13.6 percent in the recession year of 1949 to 16.7 percent, with an average of 14.6 percent. And the number of wildcat wells drilled rose from 3,500 in 1947 to 8,700 in 1956 (see Chart 4). It was, I am convinced, no coincidence that those years were a time of expansion. After 1956, the rate of return fell off; and the number of wildcat wells drilled declined to a low of 4,500 in 1971. Hopefully, that decline has been arrested as prices began to rise in 1971 and profits in 1973.

C. Expansion Has Begun

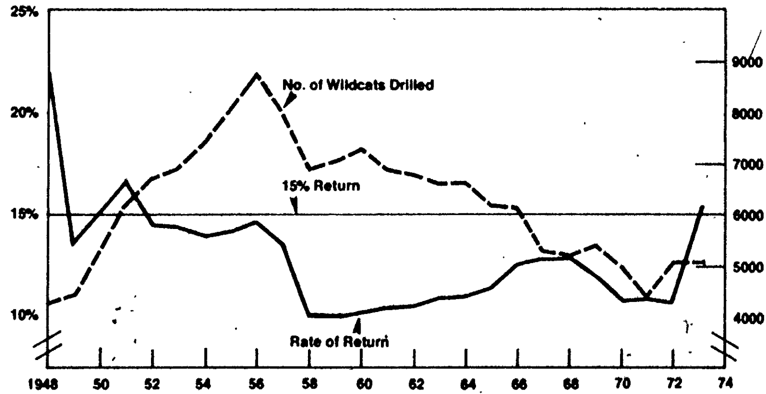
Following these price and profit increases, we have begun to see real signs of expansion of the domestic energy industries.

(1) Acreage Leased

Offshore leasing in the Lower 48 states averaged about 700 thousand acres per year during the 1960's (see Chart 5). Leasing in Alaska averaged about 350 thousand acres per year in the same period. However, offshore acreage leased in the Lower 48 states dropped off sharply in 1971 to only 135 thousand acres. Less than 50 thousand acres per year were leased in Alaska during 1970 and 1971. In large part, these declines reflected well-intentioned but excessive environmental

Chart 4

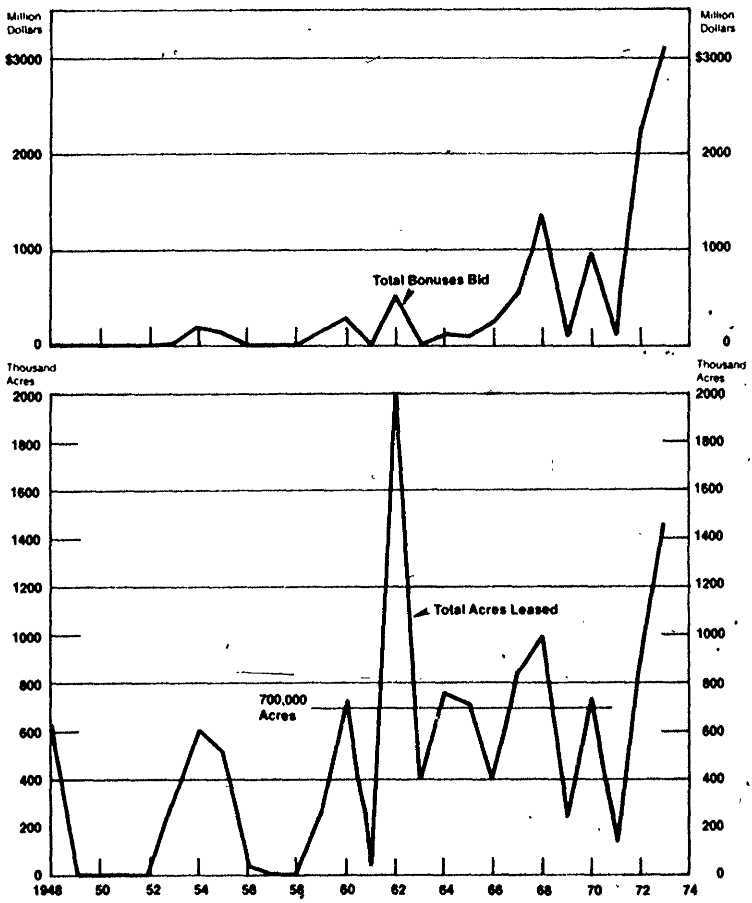
Return on Petroleum Shareholder's Equity and Wildcats 1948-1973



Source: Rate of return from Chart 2. Wildcats drilled from American Association of Petroleum Geologists and API.
(See Supporting Tables V)

Chart 5

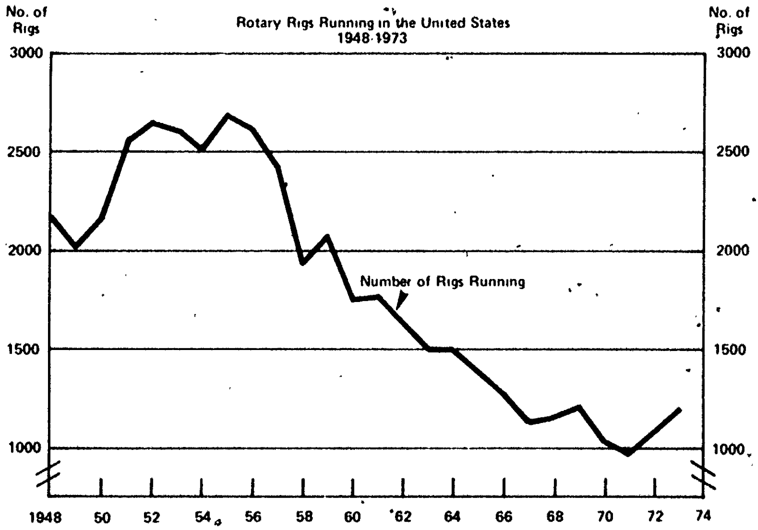
Offshore Lease Sales in the Lower 48 States 1948-1973



Source: Records of U. S. Bureau of Land Management, Louisiana, and Texas.
(See Supporting Tables V)

Chart 6

Rotary Rigs Running in the United States
1948-1973



Source: Hughes Tool Company
(See Supporting Tables V)

concern about the safety of offshore drilling and Arctic pipeline construction. At the very time when domestic oil and gas shortages were developing, our most promising frontier areas were not available for leasing.

However, Federal offshore lease sales in the Lower 48 states were resumed late in 1972 after a two-year lapse; 900 thousand acres were leased then, and 1.5 million acres were leased in 1973, culminating in opening of a new area in the northeast Gulf of Mexico. About 200 thousand acres per year were leased in Alaska during 1972 and 1973; and the pipeline has been approved by the Congress.

I believe that the industry's willingness to work toward eliminating the energy crisis is clearly indicated by the sums of money paid for the 1972-73 offshore lease purchases: over $2 billion in 1972 and $3 billion in 1973, for a total of over $5 billion (see Chart 5), or better than $2000 per acre. The largest single past year had been $1.3 billion in 1968.

This increase in offshore leasing is a good beginning, and we are most encouraged that the Administration has indicated that it will more than triple offerings beginning next year. It is essential that these offerings include the promising Atlantic offshore geological provinces—with, of course, proper environmental safeguards. Since the Atlantic Coast relied most heavily on imports in the era of cheap foreign oil, it needs increased domestic production more than any other area.

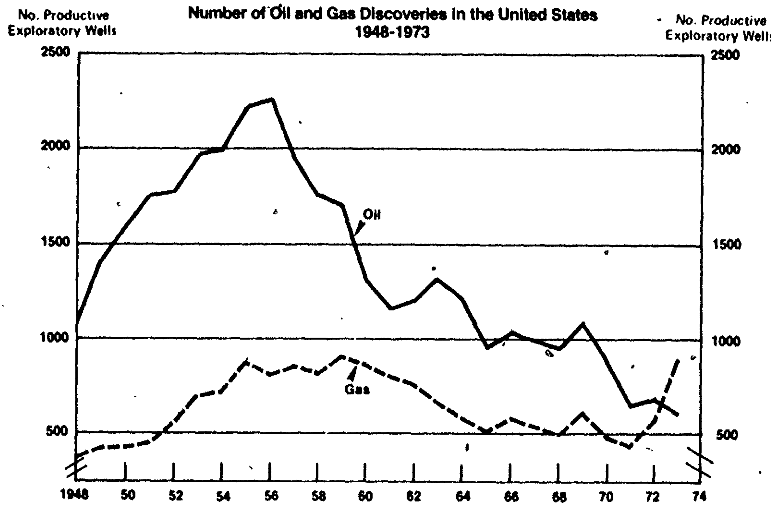
(2) Drilling and Discoveries

We have seen that the decline in wildcat drilling has apparently been arrested. Were it not for a serious (and hopefully only temporary) shortage of drill pipe, casing, wellhead equipment, and personnel, the number of exploratory wells completed might have turned upward. The equipment shortages are attributable to price controls, and years of depressed activity discouraged skilled personnel from entering or remaining in the industry.

Despite the shortages, the number of drilling rigs in operation (as opposed to the number of wells finished) did increase in 1973 (see Chart 6), especially toward

Chart 7

Number of Oil and Gas Discoveries in the United States 1948-1973



Source: American Association of Petroleum Geologists and API. Includes new fields and new pools in old fields.
(See Supporting Tables V)

the end of the year. The average number of rigs running in 1973 was up 10 percent from 1972; and the fourth quarter of 1973 was up 15 percent from the same period in 1972.

Another very promising trend has commenced. Following the gas price increases discussed earlier, the number of gas discoveries has increased dramatically (see Chart 7). In contrast, the number of oil discoveries still seems to be declining. Hopefully, that trend will also react to the improved oil prices of 1973—once the equipment and personnel shortages are alleviated.

I am encouraged that much of this new activity is onshore in the Lower 48 states, where independents have traditionally operated. This area has been intensively explored in the past but never before with $10 oil and $1 gas prices in mind for newly discovered oil and gas. We are now paying prices higher than those for imported crude oil and liquefied natural gas.

A word of caution: the number of discoveries is not what really matters in the end. It is the amount of oil and gas found which is important. It is still far too early for thorough geological evaluation of the size of the new gas discoveries, but I believe that the industry is on the way back.

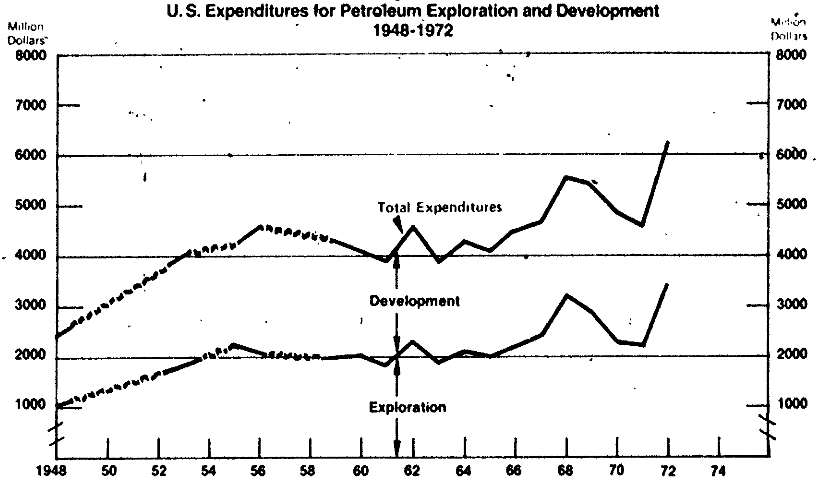
(3) Expenditures

After a long period of stagnation, and even of decline, expenditures for exploration and development increased substantially in the United States in 1972 (see Chart 8). Total expenditures for exploration and development were over $6 billion in 1972; and 94 percent of this was provided by American companies, which spent over twice as much on exploration and development at home as abroad. With accelerated leasing under way, further increases in exploration and development expenditures are certain unless the economic outlook for the industry should darken because of price rollbacks or tax increases.

Data for the exploration-production stage of the industry for the year 1973 will not be available for some time. However, total capital expenditures of a sample

Chart 8

U. S. Expenditures for Petroleum Exploration and Development 1948-1972



Source: Joint Association Survey
(See Supporting Tables V)

of large companies were up 45 percent in 1973; and these companies plan larger increases for 1974—up 57 percent over 1973. Clearly, the industry *is* moving ahead.

(4) Synthetics

In addition to revitalization of exploration for conventional oil and gas, the United States must also look to non-conventional sources of oil and gas if we are to achieve energy independence. The Bureau of Mines has had a shale oil demonstration plant in Colorado for many years. And the Lurgi process for producing low-heat content gas from coal has been used for decades on a small scale in some towns in Europe—and also in the United States until the advent of natural gas pipelines. However, we now need large plants which can make a real contribution to closing the massive national energy gap of the 1970's. The basic processes have been known for many years. But what has been missing is an economic environment that would make the existing basic processes—or new improved processes—competitive with conventional oil and gas.

Now that conventional oil and gas prices have broken out of the stagnant era of $3 oil and 15 cents gas, that economic environment is attainable. Indeed, I can report that the vital United States synthetics industry is no longer simply in the talking and research stage. It is emerging into the world of commerce.

Two coal gasification plants have been announced for the Four Corners area. They will cost about $400 million each; and they will produce gas at a predicted cost of about $1.25 per Mcf, which is higher than recent sales of domestic natural gas but which is certainly competitive with imported liquefied natural gas. These plants will use the Lurgi process with upgrading to produce gas with a high-heat content similar to that of natural gas. These two plants were scheduled to begin operating in 1976. However, the Federal Power Commission has not acted on the applications. Industry is willing but government is waiting.

Another use of the Lurgi process on a much smaller scale—an $18 million facility—is being planned in Illinois. This would use the old Lurgi process to process to produce low-heat content gas to burn under a boiler for generating power. Anticipated cost of this gas is 80-90 cents per Mcf. This project could be the forerunner of a simple (but *not* cheap) means of using this Nation's vast reserves of high-sulfur coal without venting sulfur oxides to the atmosphere.

A number of other commercial coal gasification projects using the modified Lurgi process have been announced. And numerous research projects are under way on better processes. Coal gasification is ready to emerge, but the Federal Power Commission has not yet cleared the way.

A three-company consortium has just announced plans to construct a moderate-sized commercial oil shale plant in Colorado. This plant is expected to be completed in about three years. Another company has announced plans for operation by 1979. These plants will be built on privately owned shale lands, which are limited in area.

After decades of discussion, the United States government—which owns most of the promising shale lands—has scheduled six shale oil lease sales. The first sale was held on January 8, 1974, with a winning bid of $210 million for a 5000-acre tract in Colorado. As with coal gasification, there are numerous other projects under way for developing new shale processes.

D. Conclusion

The economic stage is set for successful expansion of the conventional and non-conventional domestic oil and gas industries. Crude oil and gas prices have broken out of their postwar stagnation. Profitability is increasing to attractive levels. First generation synthetics plans are announced. We should be optimistic over the prospects for achieving ultimate energy independence.

Yet the U.S. petroleum industry is being accused of profiteering and is being subjected to threats of price rollbacks and higher taxes—especially taxation of so-called "excess" profits. Nothing could be better calculated to destroy the new economic environment. Nothing could be more contrary to the national interest.

Statement of

W. L. Henry

Executive Vice President
Gulf Oil Corporation

DOMESTIC AND FOREIGN TAX POLICY

SUMMARY

1. *TAX INCENTIVES:* The API supports present tax incentives—particularly percentage depletion and the expensing of intangible drilling costs—for both foreign and domestic operations.
2. *IMPORTANCE OF INTERNATIONAL OIL OPERATIONS:* The U.S. must import petroleum supplies for at least the next 10 years. Foreign operations of the U.S. oil industry will provide greater control of foreign oil, thus assisting the procurement of essential supplies. If privately-owned U.S. companies were unable to compete in the international oil industry, this country would inevitably become largely dependent on companies owned by foreign governments. A continued American presence in the international oil industry contributes to the economic, strategic, and diplomatic security of this country. It also has a substantial positive effect on the U.S. balance of payments.
3. *FOREIGN TAX CREDIT:* The foreign tax credit is essential to the competitive survival of American business abroad. All other industrialized countries avoid double taxation of foreign source income. If taxed on the same income in both the foreign country and at home, U.S. companies will be unable to compete abroad. Further, disincentives to foreign investments will not increase domestic activity. Domestic activity does not compete with foreign. Each is dependent on its own anticipated economic return.
4. *FACTS ABOUT THE FOREIGN TAX CREDIT:*
   - (a) It is not an incentive. It merely avoids double taxation.
   - (b) It does not apply just to oil companies. It is allowed to every American taxpayer, whether corporation or individual.
   - (c) It does not reduce taxes on U.S. source income. It applies only to foreign income. Foreign tax rates nearly always exceed the U.S. tax rate. Thus, foreign tax increases are very real costs to the industry and do not reduce U.S. income taxes.
   - (d) Foreign taxes are not royalties. The host governments require royalties and impose income taxes just like the U.S.
5. *ADMINISTRATION PROPOSAL:* The Administration proposal would arbitrarily limit creditable foreign taxes on producing income. There is no basis for treating foreign income taxes as anything other than income taxes. The impact of the proposal would likely fall most heavily on those oil companies which operate worldwide integrated businesses and compute the foreign tax credit on the overall method. It would place them at a competitive disadvantage with their principal foreign-owned international competitors.
6. *"EXCESS PROFITS" IN PERSPECTIVE:* API members condemn profiteering. However, an increase in profits does not necessarily mean that profits are excessive. Petroleum company earnings have risen from a level that was much too low. As the industry's costs increase, the absolute level of profits must rise correspondingly. Removing capital from the industry through an "excess profits" tax will not help to solve the energy problem. It will needlessly prolong the energy shortage.
7. *EXCESS PROFITS TAX PROPOSALS:* If the oil industry is singled out for an excess profits tax, a provision that gives credit for reinvestment is of critical importance. At least three proposals have been made:
   - (a) S. 2806 includes a tax based on current taxable income to the extent such income exceeds a profit allowance and the funds reinvested in energy projects. This proposal has the merit of a reinvestment feature, permitting profits to increase with additional investment. However, the 20 percent rate of return allowed in this bill may be inadequate because it relates to the smaller tax basis rather than the usual book basis used for computing rates of return.
   - (b) The McGovern-Aspin proposals would base the tax either on historic profit levels (perpetuating low profits from the chosen base period) or on a profit allowance substantially less than 6 percent of investment on a tax basis. Such a profit allowance would be grossly inadequate. The reinvestment provision is also inadequate.
   - (c) The Administration proposal would impose a graduated tax on the difference between the selling price of crude oil and the ceiling price as of December 1, 1973. The tax rate would be reduced over a three-year period. This tax should be imposed, if at all, only on prices well in excess of the long-run supply price, i.e., the price that will ultimately balance supply and demand. A reinvestment provision would be essential if this proposal is to stimulate new supplies.

Gentlemen, I welcome the opportunity to testify before you today. My topic is the United States taxation of the petroleum industry.

DOMESTIC TAX POLICY

Before offering our analysis and comments on the specific tax proposals, I would like to present our views on the justification for continuing the percentage depletion allowance and the option to expense intangible drilling costs.

From the very earliest days of our Federal income tax structure, tax incentives to encourage the development of our country's petroleum resources have been wisely provided. The need for such incentives is as great as, or greater than, any time in the past if the United States is ever to return to a level of near self-sufficiency in its oil and gas supply.

Percentage depletion and the intangible option are essential elements of such incentives. They have attracted into the high-risk search for petroleum a greater amount of capital than would otherwise have been available. As a result, our available domestic supply of petroleum has been greater than it would have been because the industry has spent the funds—and much more—generated by depletion in search for new petroleum deposits. The industry's expenditures in its exploration and drilling effort in recent years have been at a level twice the amount of the statutory depletion allowance.

Budgeted capital expenditure figures released by several petroleum companies for 1974 indicate that their level of exploration and development effort will increase by more than 50 percent. These increases are part of the response of our industry to the need projected by the National Petroleum Council for exploration and development expenditures at an average level of at least $12 billion annually during the 1970's.

Non-financial factors will also have to be present as part of a successful national energy program to achieve such expenditure levels, but in the face of our current critical energy shortages, it would not make economic sense now to remove established tax incentives which have worked effectively and fairly to attract and retain risk capital in this industry's vital effort to develop additional producing capacity. The reduction by the Revenue Act of 1969 in the rate of the percentage depletion allowance and subjecting it to the 10 percent preference tax added over $500 million annually to the petroleum industry's tax burden. There is no doubt that these changes had a negative effect on efforts to become less dependent on foreign oil and to become self-sufficient in energy. For example, in 1970 following the additional taxes resulting from the 1969 Act, there was a decline of more than 20 percent in exploratory wells and new fields discovered representing an acceleration of the long term decline in exploratory activity.[1]

[1] Richard J. Gonzalez, "Declining Trends in Exploration for Oil and Gas," Statement before Senate Interior and Insular Affairs Committee, August 9, 1972, pages 12–13.

There is another aspect of this issue on which I would like to present our views. Prices of crude oil and petroleum products are subject to control by the Cost of Living Council. Whether price controls continue on domestic petroleum or the prices are allowed to move to the price of imported oil, there is little or no possibility—politically or economically—that for the foreseeable future domestic prices could respond in the manner or the magnitude required to pass on additional tax costs.

The Administration has announced an ultimate objective of establishing a free market which would permit all U.S. crude oil prices to reach world parity. Thus, the domestic price would be set by prices of imported oil regardless of the level of U.S. taxation. Under these conditions, there would be no way to shift any U.S. petroleum tax increases on to consumers. It is a basic principle of international trade that a government cannot, in the absence of import barriers, increase taxes on domestic producers without reducing their profits and discouraging them from making domestic investments. With or without percentage depletion, the U.S. producer could receive no more than the import price. If depletion and the option to expense intangibles were eliminated, the adverse effect on the industry's energy efforts should be apparent. These provisions, therefore, remain essential parts of a national energy policy. Their incentive effects are as important today as ever before.

In the context of today's shortages of developed energy and increasing petroleum prices, the grave danger for the fiscal and energy policy makers in the Congress is that they will look at only the short-run tax or economic consequences of proposed action without regard for the long-run consequences or the evaluation of all the economic considerations. The imposition of additional taxes on petroleum operations now would entail long-term public costs exceeding benefits and would not be in the national interest of expanding our domestic energy resources. If the tax laws cannot be changed to help solve energy problems, then surely they should not be altered in any way that will contribute to greater shortages.

United States Taxation of Foreign-Source Income

U.S. taxation of foreign-source income of American petroleum companies is a subject of numerous misconceptions and the object of many false or misleading statements. In the discussion below, I will outline the importance of overseas oil operations by U.S. oil companies and the history and operation of the foreign tax credit. I will then try to eliminate some of the misconceptions concerning the foreign tax credit and comment on the Administration's proposal to amend the credit.

The National Interest in U.S. Oil Operations Abroad

U.S. taxation of foreign-source income of American petroleum companies must be evaluated in the light of the importance of their activities to the national interest of the United States. A continued American presence in the international oil industry contributes to the economic, strategic, and diplomatic security of this country. It also has a substantial positive effect on the U.S. balance of payments.

As has been indicated in earlier testimony, the United States will continue to require petroleum imports for several years to come. Even with a maximum effort, achieving self-sufficiency will likely take at least 10 years because of the long lead times required to develop new supplies of petroleum and alternative energy sources.

In addition to domestic economic requirements, foreign-source oil is of significant strategic importance, since—in the words of the Department of Defense—"The U.S. alone cannot realistically plan to fuel any Free World type of emergency. . . ."[1] In a deficit oil position itself, the United States is not in a position to help meet the needs of its allies during an interruption of international supplies.

Diversification of foreign sources of supply would also diminish the restraints which might be imposed on American international diplomacy if the country were heavily dependent on one or two foreign oil sources. The security of the Free World supplies requires ready access to diverse and growing sources of foreign oil.

In the case of the United States, the best way to minimize the problems of future access to foreign-source petroleum is to encourage U.S.-owned companies to continue to operate abroad. American companies will apply their managerial and technological expertise to diligent development of the discovered-but-undeveloped reserves in the Middle East, as well as to exploration for new reserves in that area. Moreover, they will apply that same expertise in attempting to diversify sources of foreign supply. If privately-owned U.S. companies were unable to continue to compete effectively in the international oil industry, this country would inevitably become largely dependent for its essential foreign supplies on companies owned in whole or in large part by foreign governments.

It is a commonplace in world affairs that not to be represented in international councils is a severe handicap in obtaining appropriate recognition of a nation's interests. If U.S.-owned companies own or control part of international oil supplies, it is much more likely that an allocation of supply equitable to the United States, as well as to others, will be obtained in the event of a world oil shortage. With the U.S. and foreign-owned private companies continuing in their key position as producer-distributors of international oil supplies, the legitimate interests of the United States and its allies would be considered in any such shortage. In the absence of an American presence in the international oil industry, there would be substantially less U.S. control of foreign petroleum supplies.

In addition to the national security significance of U.S.-owned foreign oil supplies, the participation of U.S. companies in the world oil industry has decided positive implications for the U.S. balance of payments. American ownership of foreign crude producing facilities provides some balance of payments offset to the increasing costs of U.S. oil imports, since the profit component of those supplies accrues to U.S. interests. Profits attributable to American ownership of petroleum producing, transport, refining, and marketing facilities serving foreign markets also have a positive effect on the balance of payments.

In addition to direct earnings, U.S. foreign petroleum investments result in receipts of fees and royalties and in substantial U.S. exports of capital equipment and other merchandise for use in U.S.-owned facilities abroad. The annual income received from foreign petroleum investments by U.S. companies also results in additional U.S. tax revenues when this income is taxed upon distribution to individual U.S. shareholders.

U.S. TAX POLICY AND U.S. OIL OPERATIONS ABROAD

If American petroleum operations abroad are to remain viable, U.S. taxation of foreign-source petroleum income must not be amended to leave U.S.-owned companies at a competitive disadvantage relative to foreign-owned petroleum companies. Companies owned by producing country governments have an obvious advantage in access to supplies while companies owned by the governments or private citizens of the principal consuming countries of Europe and Japan generally receive special tax and non-tax incentives for foreign oil exploration ventures. The combined incentives for foreign oil ventures provided by other major countries are generally at least as valuable as the tax treatment provided by the United States—and in some cases are more valuable. (See Exhibit 1 next page.)

While the details of these foreign government combined tax/incentive/financing packages vary from country to country, it is clear that most foreign competitors of U.S. oil companies have strong incentives from their governments and in many cases unique advantages, e.g., direct or indirect government financing in whole or part by France, Italy, Japan, the United Kingdom, and West Germany. U.S. tax policy should not impose competitive constraints on American companies by adversely changing U.S. tax treatment of foreign petroleum operations.

Avoidance of Double Taxation—The primary tax requirement for continued competitiveness of U.S. oil operations abroad is that the United States continue its

[1] Submission to the 1969 Task Force on Oil Import Control.

EXHIBIT I

Summary Statement of Tax Treatment and Other Incentives for Foreign Petroleum Operations by Companies Domiciled In:

(1) *France* *Does not tax.*
Other Incentives:
None for private companies. (Government finances wholly-owned government company and owns substantial interest in large private company.)

(2) *Japan* *Taxes on overall basis with credit.*
Other Incentives:
Exploration loans of up to 50% not repayable in the event of failure, government guarantees of bank loans for exploration and development: percentage depletion at 15% with reinvestment requirement; expensing of dry holes.

(3) *Netherlands* *Does not tax.*
Other Incentives:
Allows deduction of foreign losses from domestic income.

(4) *United Kingdom* *Taxes on per country basis with credit.*
Other Incentives:
Expensing of all pre-discovery costs; expensing of plant and machinery expenditures; rapid depreciation of other post-discovery expenditures. Allows a form of averaging of foreign losses and profits similar to U. S. overall method. Allows deduction of a net foreign loss. (Government owns substantial interest in large private company.)

(5) *West Germany* *Taxes on the per country basis with credit.*
Other Incentives:
Outside the Common Market, exploration loans up to 75%, not repayable in the event of failure—50% of a loan may not be repayable in the event of discovery; expensing of all exploration costs; rapid depreciation of tangibles and intangibles. Allows deduction of a net foreign loss.

(6) *United States* *Taxes on the per country or the overall basis with credit*
Other Incentives:
Percentage depletion; expensing of dry holes and intangibles on producing wells (but no deduction of pre-discovery costs other than dry holes, until properties are abandoned). Allows deduction of a net foreign loss.

Note: This exhibit is drawn from a more detailed analysis in Appendix A. Also see that appendix for notes and explanations.

traditional policy of avoiding double taxation of foreign-source income. Since all other major consuming countries avoid double taxation, U.S. abandonment of this policy would render American companies noncompetitive.

The United States avoids double taxation by allowing a credit for foreign income taxes paid. If the United States were to treat foreign income taxes as a deduction from income rather than as a tax credit, U.S.-owned companies would be double taxed—once by the foreign country and once by their home country. For example, with a 50 percent tax rate at home and 50 percent abroad, their combined tax rate on foreign income would be 75 percent (50 percent foreign plus 25 percent U.S.). Foreign-owned competitors would pay only 50 percent. Thus, the American-owned companies would be fatally disadvantaged relative to their foreign competitors who have to pay no home country taxes on their foreign operations.

As former Assistant Secretary of the Treasury Stanley S. Surrey has said, "American investment would not proceed at all without the foreign tax credit because . . . two taxes would be imposed and the overall burden of two taxes would be so great that investment would practically cease."[3] We emphasize that only American investment would cease. Oil companies owned by others—especially by foreign governments—would be only too glad to step in to fill the ownership gap left by the tax-induced departure of their U.S. competition.

Equal Treatment of Foreign and Domestic Income—A second traditional goal of U.S. taxation of foreign-source income has been equality of treatment of like investments at home and abroad. Substantial petroleum imports are going to be required to supplement domestic sources for a number of years to come. Accelerated domestic exploration and development is essential, but continued foreign exploration and development is also necessary to meet U.S. energy requirements. For this reason, U.S. petroleum tax policy should continue to encourage foreign oil operations. For example, percentage depletion, expensing of intangible development costs, and accelerated depreciation should not be denied to foreign operations. Making foreign operations by U.S. companies more difficult would not, itself, mean that the companies would in-

[3] Hearings before the Committee on Foreign Relations, United States Senate, 90th Congress, 1st Session on Tax Convention with Brazil, Executive Journal, 1967, pp. 19-20. Professor Surrey reaffirmed his view that the foreign tax credit should be retained in his appearance before the Committee on Ways and Means, February 5, 1973.

crease domestic exploration. Domestic exploration rises when—and only when—domestic economic incentives improve. That improvement cannot be achieved by raising taxes on foreign exploration.

In short, the national interest need for increasing the security of overseas oil supplies requires that the U.S. government use the utmost care to avoid foreign tax policies which would disadvantage foreign operations of U.S.-owned petroleum companies. Certain suggested foreign tax changes now pending before the Congress would do this.

FOREIGN TAX CREDIT

General—Two methods are used in determining the allowable foreign tax credit. The per country method treats the income and taxes from each foreign country separately in determining the amount of the allowable foreign tax credit. The overall method treats all foreign profits and all foreign income taxes as a whole. Taxpayers may choose that method which appears more suitable on a long-term basis considering their particular business circumstances, but they may not change methods from year to year.

In both cases, the foreign investor always pays the higher of the U.S. or foreign tax rates. Under the United States credit system, if the foreign income tax rate is less than the U.S. rate, the U.S. government collects the difference from the taxpayer. However, if the foreign income tax rate is higher than the U.S. rate, the taxpayer bears the difference; no additional tax is paid to the U.S. The amount of the allowable credit is limited to the amount of U.S. tax which would otherwise be due on the foreign-source income. Accordingly, the allowance of the foreign tax credit cannot reduce a company's income tax on U.S. source income. Of course, a net foreign loss is deductible in accord with the treatment of losses by other countries which tax foreign source income earned by their nationals (See Exhibit I and Appendix A).

The Overall Method—The overall method is particularly important to firms which operate worldwide integrated businesses in competition with foreign-owned worldwide integrated businesses. For example, in a manufacturing industry, components may be produced in a number of countries, assembled within a single country, and the final product sold on the world market.

The vertical integration of the international oil industry, which traces back to the early years of this century, is also a good example of interrelated foreign business operations. Investments in foreign oil-producing activities are often in countries far removed from the major consuming areas. The additional investments in refineries, pipelines, tankers, and other distribution facilities which are required to bring this production to market often occur in a number of other countries, all of which may have internal taxing concepts and income tax rates which differ substantially from each other and from those of the United States. The overall method has been criticized for permitting averaging of incomes and taxes in different countries where a U.S.-owned firm may "fortuitously" do business. There is nothing fortuitous about the inter-country integrated operations of the established international companies. Sales in Europe and production in the Middle East are part and parcel of the same operation. In assessing the effect of taxes on the economic feasibility of such integrated ventures, it is the overall tax burden on the competing international firms which matters.

As is shown in Exhibit I above, in order to avoid double taxation of foreign source income earned by their nationals, some governments use an averaging concept or an overall foreign tax credit system which obtains results similar to the United States overall method. Other countries impose no domestic income tax on foreign source income. Multinational companies domiciled in those countries which impose no tax on foreign operations automatically bear a foreign income tax burden which is the average of all foreign income taxes paid—again a result similar to the U.S. overall method.

Since the principal foreign-owned worldwide competitors of U.S. integrated international oil companies are domiciled in countries falling in one of these categories (France, Italy, Netherlands, U.K.), the U.S. overall method providing for averaging of all foreign taxes enables the more completely integrated U.S. company to compute its foreign-source income tax obligations in a manner closely similar to that available to its primary foreign competitors. For example, if a U.S. company and a foreign competitor domiciled in, say, France derive half of their income from a country with a 60 percent tax rate and half of their income from a country with a 40 percent tax rate, the foreign-owned company's overall foreign income tax burden would be 50 percent (60 + 40 ÷ 2 = 50). On the U.S. overall basis, the U.S. company would also pay the foreign average of 50 percent, which is higher than 48 percent U.S. rate. On the other hand, if the U.S. company were on the per country basis, the U.S. would collect an eight percent tax on income earned in the second country, whose rate is 8 percentage points lower than the U.S. rate. Thus, the U.S. company would pay 54 percent overall on the per country basis (60 + 40 + 8 ÷ 2 = 54).

Use of the overall method, therefore, places a U.S. oil company which is more completely integrated from crude production through refining and marketing in a better position to achieve competitive tax equality with its principal foreign-owned integrated international competitors in world markets. Accordingly, the option to compute the foreign tax credit on the overall basis corresponds to the competitive requirements of integrated foreign operations of U.S. firms. The more complete the degree of integration, the more economically appropriate is the application of the overall method.

It has been suggested that the overall method of computing the foreign tax credit encourages the export of U.S. manufacturing jobs to low tax rate countries in order to permit the taxpayer to take advantage of the excess credit being generated in a high tax rate country. This argument overlooks the other and paramount aspects of a business decision to go overseas, particularly such compelling factors as proximity to market or supplies and host government requirement that local markets be served by the products of local plants. As the U.S. Tariff Commission has recently said, ". . . while tax considerations always are relevant, they seldom are dominant in the multinational company's decision to invest abroad." [4] For example, production of crude petroleum must occur where the natural resources are geographically located. Similarly, the location of pipeline operations is determined by the source of the oil or gas and the site of the market being served. Governments often require that refined products be manufactured within the country. And service stations can only be located at the market. In determining the site of business facilities, compelling factors such as these generally far outweigh any advantage which might accrue from use of the overall method. The overall method is not used as a device to export U.S. operations and jobs to foreign countries; rather, it enables integrated U.S. companies to meet the competition of foreign-owned integrated companies.

The Per Country Method—The per country method for computing the foreign tax credit is vitally important to many companies in high-risk industries when they are entering new foreign areas. On the per country method, operations in each foreign country are given the same U.S. tax treatment for purposes of computing the foreign tax credit as would prevail for comparable operations in the United States. Thus, U.S. tax treatment is neutral in its effect on investment decisions for an operation in the U.S., in foreign country A or in foreign country B. The decision on whether to conduct operations in the U.S., in foreign country A, or in foreign country B, rests on basic economic considerations, not on U.S. tax considerations.

The foreign competitive position of less completely integrated U.S. firms requires the per country method, especially if a considerable part of their foreign endeavors is composed of risky ventures such as petroleum exploration in new foreign areas. The ability to deduct foreign losses with a resultant decrease in U.S. tax is necessary for their competitive survival in the race for new oil sources against foreign-owned companies receiving the combined tax/incentive/financing assistance outlined in Exhibit 1 and Appendix A. Recall that West Germany and the United Kingdom permit full loss deduction on a country-by-country basis. And we have seen that other countries such as France, Italy, and Japan provide direct or indirect financial assistance to foreign oil operations conducted by their citizens. Japan, for example, grants exploration loans up to 50 percent, not repayable in the event of failure.

The per country method is needed for purposes of foreign loss deductions because such deductions are usually not available on the overall method. Foreign loss deductions for U.S. tax purposes are available on the U.S. per country method when there is a net loss in an individual country, but a loss deduction would only be available on the overall method in the event of a net loss in all foreign countries combined.[5] However, a U.S.-owned company on the per country method could fully deduct any loss in a new country from its other taxable income.

If restricted to the overall method, new entrants may be restrained in their efforts to find and develop foreign petroleum reserves in new areas. In petroleum exploration and production, the chance of loss is high; and foreign tax rates are generally at least as high as U.S. rates. After one successful foreign venture under these conditions, the costs of any further foreign exploration and development would increase because the U.S. tax deductions would be effectively lost as a result of the operation of the overall limitation. This would have the effect of nearly doubling the capital required. That capital burden may be beyond the capability of many smaller petroleum companies, thus eliminating them from the search for foreign oil and gas. It is important that these companies be encouraged to seek new oil reserves in diversified locations abroad, as well as domestically, in order to increase the security of petroleum supplies for the United States and its allies.

The Method Which Gives the Higher Tax—The United States once required taxpayers to use the method which gave the higher tax; but Congress determined that this approach was undesirable and abandoned it in 1954.

Forced application of either method of computing the foreign tax credit to any given taxpayer is likely to produce a bias against some form of activity. For those presently using the overall method, forced application

[4] U.S Tariff Commission, Implications of Multinational Firms for World Trade and Investment and for U.S. Trade and Labor (Washington: 1973) p. 12.

[5] For example, if a U.S. company on the overall method has its foreign-source income equally divided between two countries having tax rates of 54 percent and 42 percent, its overall foreign tax rate is 48 percent (54 + 42 ÷ 2 = 48). Hence, there is no U.S. tax on the foreign-source income. If the U.S. company pursues a risky venture in a third country and incurs a loss, its total foreign tax could not be reduced because the third country loss would not be deductible in other foreign countries. The third country loss could also not reduce the U.S. tax, since there was no U.S. tax on foreign-source income with a 48 percent average foreign rate. If the average foreign rate had been, say 40 percent before entry into the third country, and eight percent U.S. tax would have applied (48 − 40 = 8). And the third country loss would reduce that tax on the overall basis. However, foreign tax rates in the major countries are generally sufficiently close to U.S. rates that any such U.S. tax is unlikely to be large. The third country loss would lead to a full reduction in U.S. tax on U.S.-source income (i.e., 48 percent of the loss) only if the company had a combined loss in the first two foreign countries—no doubt a rare situation. Thus, a U.S. company on the overall method can realize little or no reduction in U.S. tax from a foreign loss in a new country.

of the per country method would produce onerous competitive results in worldwide integrated production and distribution networks and discourage development in existing producing countries. In the case of taxpayers presently using the per country method, expansion into new areas of exploration would likely be limited by a forced change to the overall method. Neither of these results would be in the national interest. The overall method encourages exploration and development operations of the more completely integrated firms in existing producing countries where success in obtaining needed incremental oil supplies is more likely. The per country method encourages companies concentrating on exploration and production to engage in risky attempts to achieve diversification of sources of supply, which is essential to increase the security of imported supplies. Both activities are required in the national interest.

One of the objectives of sound international tax policy is to promote tax neutrality between foreign and domestic investment decisions in order that tax policy will not, itself, distort the economic decision on where to locate a facility. The U.S. policy of having its foreign investors pay the higher of the U.S. or foreign tax approaches international tax neutrality when applied under the existing option to choose either method. The foreign tax rate may be higher than the U.S. rate, but only because the foreign country chooses to levy higher rates. U.S. action to force the taxpayer to use the less favorable method is almost certain to produce bias against foreign investment because it will almost always lead to a higher tax rate on a foreign investment than on a similar investment at home.

MISCONCEPTIONS OF THE FOREIGN TAX CREDIT

The many misconceptions of the operation and effect of the foreign tax credit have led to false or misleading charges directed to the petroleum industry.

Charge: It is an incentive for the oil industry. Answer: No—The foreign tax credit has been mislabeled as an incentive for the oil industry. In fact, it is not an incentive nor does it apply only to the oil industry.

The foreign tax credit is necessary to prevent double taxation of the same income—once by the foreign government and again by the U.S. Without it American companies could not compete with other companies since all other industrialized nations avoid double taxation.

The foreign tax credit is allowed to every American taxpayer, whether it be a corporation or an individual, who earns income abroad and is required to pay an income tax to the nation in which the income is earned. The fact that the oil companies account for 45 percent of all foreign tax credits simply reflects that (1) their foreign investments are higher than any other business, and (2) they are operating in countries that impose very high income taxes.

Charge: Oil companies do not resist foreign tax increases. Answer: False—Critics have alleged that the industry does not resist tax increases imposed by foreign producing governments asserting that the increases are credited against and reduce U.S. income tax dollar for dollar. There is no truth to this charge.

A U.S. oil company receives a credit for foreign taxes paid, but only up to the amount of the U.S. tax that would otherwise be due. To the extent the foreign tax exceeds the U.S. tax, the excess cannot be used as a credit against U.S. taxes. The following example illustrates the unused credit:

EXHIBIT II

United States Tax Calculation

1	Sales at market price		$8.00
2	Less the following:		
	Royalty at 12½%	$1.00	
	Production Costs	.50	
	Depletion 22% of $7.00	1.54	
			$3.04
3	U.S. Taxable Income		$4.96
4	U.S. Tax at 48%		$2.38
5	Less Foreign Taxes Paid at 55%		$3.57
6	U.S. Tax Due		0
7	Unused Foreign Tax Credits		$1.19

Note: The unused foreign tax credits cannot reduce the U.S. tax on U.S. income. The foreign tax rules apply uniformly to all U.S. corporations operating abroad.

Any increase in the foreign tax simply increases the unused tax credit. For example, if the foreign tax rate in Exhibit II were increased to 60 percent, the unused credit would increase by 33 cents per barrel. But it would have absolutely no effect on U.S. tax payments.

Additional foreign taxes are a very real cost to the industry. In some instances, companies have been able to recoup the additional taxes from their customers. In others, the companies have absorbed the cost.

Thus, statements that the companies have not resisted increases in foreign tax because the United States "picks up the tab" are completely false.

Charge: Oil companies are allowed to treat foreign royalties as taxes. Answer: False—Charges are made that all of the payments to the producing country governments are royalties, not taxes. That is not true. The basis for this misconception is probably due to the fact that a foreign government deals with the oil industry in two capacities: (1) as the owner of natural resources in place; and (2) as a sovereign taxing power. The foreign government collects a royalty as the owner of the natural resources; and it levies an income tax on the profits in its capacity as the taxing sovereign. Each payment is separate, and each is made for different reasons. In recognition of this distinction, a U.S. tax deduction is allowed for the royalty; and a U.S. tax credit is allowed for the income tax to the extent that the U.S. would tax the same income. Thus, a tax credit is not allowed for oil royalties paid to foreign governments.

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This system of payments parallels payments to the U.S. government on its own oil lands. It collects a royalty as the landowner and levies an income tax on the profits as the taxing sovereign. There is no reason to treat payments to foreign governments differently—particularly because the Internal Revenue Service reviews the validity of the foreign tax as an income tax.

If the foreign taxes were treated as royalties, it would be about the same as allowing a deduction rather than a credit. As shown above, American-owned companies would be fatally disadvantaged relative to their foreign competitors who pay no home country tax on foreign operations.

Charge: Foreign disincentives will increase domestic activity. Answer: False—It has been asserted that discouraging or eliminating foreign oil and gas operations of American companies would increase domestic activity. That is false. Reducing the foreign operations would do nothing toward making domestic exploration and development more attractive. It would do nothing to increase energy supplies and would likely reduce the total supply available to the U.S.

This charge assumes that attractive opportunities in the United States have been foresaken in favor of foreign exploration. It is true that until 1972 domestic exploration had been decreasing. But, the decline in domestic exploration was attributable to (1) policies that have withheld Federal acreage from exploration; (2) environmental restraints that have discouraged the search for new reserves; and (3) U.S. price restrictions. Raising taxes on foreign exploration and development will not assist domestic exploration and development. Domestic exploration and development will be undertaken on the basis of the adequacy of its own anticipated economic return to investors rather than in competition with foreign exploration and development. In the light of the critical shortage of fuels on a worldwide basis, both domestic and foreign exploration are urgently needed.

ADMINISTRATION PROPOSAL FOR REDUCING THE FOREIGN TAX CREDIT ON PRODUCING OPERATIONS

In its energy message the Administration announced that the Treasury Department had been asked to prepare proposals which would cause part of the income taxes paid to foreign countries on producing operations to be designated as creditable in computing the foreign tax credit and the balance to be allowed solely as a deduction in computing taxable income. The impact of this proposal will fall principally on those oil companies which operate worldwide integrated businesses and compute the foreign tax credit on the basis of the overall limitation. To assist in our discussion of this proposal it will be helpful to consider a hypothetical but nonetheless representative description of the activities of such a company. This company carries on its foreign operations (1) through some U.S. corporations which are included in its consolidated tax return, (2) through some U.S. corporations in which its ownership interest is not large enough for inclusion in the consolidated tax return and (3) through foreign corporations which are not includible in the consolidated tax return. These foreign operations include exploration, production, transportation, refining and marketing of crude petroleum and its product.

Exploration Operations—Most of this hypothetical corporation's exploration and producing operations are carried on through U.S. corporations includible in the consolidated tax return but in some cases foreign corporations are utilized. When carried on through a U.S. corporation the deductible expenses during the period prior to production reduce consolidated taxable income and correspondingly reduce the consolidated foreign tax credit. When they are carried on through foreign corporations such pre-production expenses are not taken into account in the computation of U.S. income tax liability.

Producing Operations—This hypothetical company conducts producing operations in many foreign countries. Most of these countries impose income taxes at rates higher than the U.S. rate, but some impose income taxes at rates lower than the U.S. rate or provide tax incentives which result in a lower effective income tax rate. Most of these operations are carried on through wholly-owned U.S. companies in which case the income from the producing operations is included in the consolidated tax return and the foreign income taxes it pays are directly taken into account in computing the consolidated foreign tax credit.

In some instances the foreign operations are carried on through U.S. corporations in which the ownership interest is less than 80 percent, in which case the producing company files its own U.S. income tax return and computes its own foreign tax credit. In such a case 15 percent of the dividends received by the U.S. corporate shareholder are included in that shareholder's taxable income as foreign source income, but none of the foreign income taxes paid by the producing company may be taken into account in computing the shareholder's consolidated foreign tax credit.

In some instances the producing operations are carried on through foreign corporations. In these cases the U.S. corporate shareholder includes dividends from that foreign corporation in its consolidated tax return and takes into account in the computation of its consolidated foreign tax credit the foreign income taxes paid by the foreign corporation that are attributable to such dividend income.

Transportation Operations—Most international transportation of crude oil and its products is through the use of large oceangoing tankers. In some instances the tankers are owned by foreign corporations incorporated under the laws of the consuming countries but in most instances they are owned by foreign corporations incorporated in countries which impose little or no income tax on income from shipping operations. Dividends from such foreign corporations are included in consolidated taxable income and foreign income taxes attributable to those dividends are included in calculating the consolidated foreign tax credit.

Refining and Marketing Operations—Most of our hypothetical corporation's refining and marketing operations are carried on through foreign corporations incorporated in the countries in which the refining and marketing operations are conducted. Sometimes the effective foreign income tax rates are higher than the U.S. rate; in other cases they are lower. In either case the U.S. shareholder includes dividends from the foreign corporation in computing its consolidated taxable income and takes into account in computing its consolidated foreign tax credit the foreign income taxes paid by the foreign corporation which are attributable to such dividends. In addition there usually are foreign income taxes imposed on such dividends which are also taken into account in computing the consolidated foreign tax credit.

Calculation of U.S. Income Tax—The foregoing description demonstrates that the sources of income from the foreign operations of our hypothetical company are quite varied. Some are taxed at rates higher than the U.S. rate, some are taxed at rates lower than the U.S. rate and some are subject to no foreign income tax. Yet they all represent segments of an integrated foreign operation. Under the overall limitation to the foreign tax credit the various foreign income taxes applicable to the integrated operation are aggregated and are compared with the U.S. tax (before foreign tax credit) on the consolidated taxable income from such foreign operations. In that aggregation a portion of the foreign income taxes attributable to income eligible for the percentage depletion deduction is not taken into account. Because the rates of income tax on producing operations are generally higher than the U.S. rate, the aggregate foreign income taxes exceed the consolidated U.S. tax attributable to foreign source income and thus through application of the foreign tax credit no U.S. income tax is payable on income from foreign operations. The overall limitation to the foreign tax credit prevents utilization of foreign income taxes in excess of the U.S. income tax on foreign source income from reducing the U.S. income tax on U.S. source income. What is thus achieved is a result closely comparable to that achieved under the income tax laws of most other major foreign countries, namely, either complete exemption of foreign income from home country taxation or the avoidance of international double taxation by not imposing home country taxes when foreign country income taxes are imposed at a higher rate. This system has made it possible for U.S. oil companies who are more completely integrated from crude production through refining and marketing to be in a better position to achieve competitive tax equality with their principal foreign-owned integrated international competitors in world markets.

Impact of Administration Proposal—What the Administration's proposal would do to our hypothetical U.S. company is to disallow as a creditable foreign income tax that portion of the income taxes paid to a foreign producing country which is greater than the U.S. tax rate on the producing income from that country, treating the excess as a deduction in computing that producing income. An algebraic formula is required to determine the interdependent amounts of the portion of the foreign income tax that is deductible and the portion that is creditable but the result of that algebraic computation is to allow the foreign income tax to offset the U.S. tax on producing income from that foreign country but not to allow it to reduce U.S. income tax on foreign income from any other source. As a result the U.S. company using the overall limitation would be required to pay income taxes on its other foreign operations which were not taxed at rates as high as the U.S. rate, despite the fact that its total foreign income tax burden is greater than the U.S. income tax rate.

The primary objection to this proposal is that it would place the more completely integrated U.S. companies who utilize the overall limitation to the foreign tax credit at a competitive disadvantage with their principal foreign-owned integrated international competitors. Income from shipping operations would be particularly hard hit. Such companies would be far less likely to invest in tankers and the loss in U.S. control of oceangoing tanker tonnage would be harmful to the national interest.

Foreign Tax Policy—Summary—The U.S. should not increase its taxes on foreign operations at a time of severe worldwide energy crisis. In addition to promoting increased domestic production, United States tax policy should promote discovery of diversified crude oil supplies overseas by U.S.-controlled companies, as well as accelerate development and new exploration in existing producing countries. But increased U.S. taxation of foreign-source income would do exactly the opposite. At the most inopportune of times, it would seriously, if not fatally, disadvantage the operations of American petroleum companies abroad. This would be an irretrievable move, for once the American companies relinquish their position abroad, they will be immediately and permanently replaced by European and Japanese companies.

EXCESS PROFITS TAXES

There is widespread pressure in Washington to levy an "excess" profits tax on the oil industry in order to make certain that no one exploits the energy crisis to make profits far above the level needed to attract the capital required to reachieve a reasonable degree of energy self-sufficiency in the United States. Let me make clear that while the member firms of the American Petroleum Institute wholeheartedly support profits, they wholeheartedly oppose profiteering. But, when do profits become "excessive"?

WHAT PROFITS ARE EXCESSIVE?

Perhaps the best way to answer this question is to specify what profits are not excessive. Clearly, profits are not "excessive" merely because they are increasing as time passes. We have seen that industry earnings were up about 50 percent in 1973, but a 50 percent increase over an unsatisfactorily low level does not necessarily mean an unsatisfactorily high level. Consider the case of a firm which was incurring losses in the base period established for an excessive profit tax. Blanket prohibition of increases in profits could condemn it to unsatisfactory performance for the life of the tax. Indeed, "excess" profits taxes can almost always be expected to discriminate against some companies depending upon their performance in the base period. What matters is the rate of return on investment, not the rate of increase of profits as time passes.

Nor are profits "excessive" merely because they may reflect prices higher than required to attract capital in past years. In periods of persistent inflation—such as we have experienced since 1965—rising "profits" as determined by conventional accounting practice may not be rising in real terms at all. From the point of view of the corporate shareholder, profits per share must rise at least with inflation; otherwise his income will lose buying power.

Entirely apart from inflation, some industries are characterized by what economists call "increasing costs". In the minerals producing industries, for example, the geological prospects which appear to be the best are tapped first. Therefore, as the industry expands, it must tap progressively more costly prospects. The lower investment and operating costs of fields discovered and developed years ago are irrelevant to what it will cost to bring on new supplies. New supplies will cost much more in terms of the real resources of men, materials, and invested capital required to bring them into production. Hence, expansion requires increasing prices and profits in order to maintain acceptable rates of return on the new, higher-cost investments. If capital requirements per barrel of oil producing capacity, say, double because it becomes necessary to move to more remote and hostile locations, the company must earn twice as many dollars merely to maintain its rate of return. And it may well need *more* than twice as many dollars because the results of investment in "frontier" areas are often much more uncertain than in proved areas. The petroleum industry is now facing precisely this problem as it moves to exploration in the Arctic and deepwater offshore areas, as well as to the exploitation of new energy sources requiring unproved and costly technology. Such increased uncertainty requires increased rates of return in order to attract capital.

Unquestionably then, both the absolute level of dollar profits and the rate of return for an increasing cost industry operating in an era of persistent inflation must rise as time passes. And the more uncertain the outcome of investments, the more rapidly profits must rise.

High profits attributable to occasional discovery of highly productive properties in an uncertain minerals industry must also not be considered excessive. The rate of return on a billion barrel oil field is likely to be high. But it is not excessive because the remote possibility of the big prize is undoubtedly a major motivating factor in attracting capital to the search for oil and gas, where the chance of break-even success has been only about one in 60 in recent years. (That figure is for break-even success on the productive venture without consideration of the costs of unrelated dry holes.) The investor's knowledge that he will receive the full fruits of a major find does much to offset the negative influence of the dry hole. This is especially true because the Congress has recognized that the discovery value of a find—as approximated by percentage depletion—should be recoverable without taxation. Absence of the opportunity to realize the profits from a big find would make it far more difficult to attract capital to the petroleum industry.

It is sometimes argued that while consumers must reasonably expect to pay a price which compensates investors for the higher cost of expanded new production in an increasing cost industry (including return on investment), there is no reason why they should pay that price for old production which originally cost less than present replacement cost. Such a price for old oil would, it is said, lead to excess profits.

But why should consumers *not* expect to pay the replacement cost of the old oil or gas they use? When a barrel of lower cost old oil is used, it can only be replaced with higher cost new oil. The consumer actually has no grounds to contend that a price which covers the cost of replacing old production leads to excessive profits. With any lower price for its old oil, the firm will not generate sufficient profits to stay in business at past levels of operation—much less to expand. Internal generation of funds is particularly important in high-risk endeavors, such as petroleum exploration, where outside capital is less readily available.

Foreign profits are also not an appropriate subject for control by a United States excess profits tax. Profits from foreign ventures by American firms increase U.S. Gross National Product and improve the balance of payments. It would be wholly counterproductive to discourage U.S. foreign investment by taxing profits of those ventures at high rates above the foreign rate. That would make new ventures of American companies non-competitive with those of foreign-owned firms. And it would expose existing American-owned facilities to retaliatory taxation by the foreign governments. If an excess profits tax is to be paid by the foreign ventures of Americans, why should the foreign government permit the tax to flow to the United States government?

We have outlined a number of categories of profits which are not excessive. What, if any, profits *are* excessive? A common concept of excess profits would be any increase occurring as the result of extraordinary price increases during a period of emergency shortage. But we have seen that this concept is clearly inadequate, because profits may have been sub-normal before the crisis, costs may have risen, etc. A far more acceptable concept would hold such profits to be excessive only if price had risen beyond the level required to equate supply and demand in the long run.

However, even profits attributable to prices well above the supply-demand equating level have long been recognized to have a useful economic function. Such profits (which economists call "quasi rents") give investors extra encouragement to increase capacity in an industry where demand temporarily exceeds supply. After sufficient supply is available, price would fall back to the equilibrium level; and these extra profits would disappear. They, in effect, self-destruct after their economic purpose has been served.

REQUIREMENTS FOR AN EXCESS PROFITS TAX

We believe that levying an excess profits tax on the petroleum industry would be contrary to the national interest, since it would almost inevitably discourage investment. And increased investment is absolutely essential if we are to reachieve a reasonable degree of energy self-sufficiency. Is there any reasonable chance that investors will take such a tax in stride without any reduction in their plans to devote funds to the uncertain search for oil and gas and to the risky development of new energy sources? We think not, because Congressional action to increase taxes on the industry is virtually certain to discourage investment, no matter how carefully an "excess" profits tax may be designed to avoiding taxing those profits which are necessary, not excessive. The psychological effect on investors of knowing that success will be penalized can only be negative. We, therefore, oppose an "excess" profits tax.

If, however, we are to have one, what form should it take to be minimally damaging to the critical national interest in sharply increased output of domestic energy? Essential requirements of any excess profits tax are that it:

1. Treat all competing firms equally.
2. Define as "excess" or "windfall" profits only funds attributable to prices clearly higher than the level of price which will equate supply and demand in the long run—after allowing for inflation and rising real costs.
3. Permit minerals explorers to retain the profits from large discoveries.
4. Enable the industry to retain sufficient profits for the replacement of used-up facilities and to show an adequate rate of return on new facilities.
5. Affect only domestic profits.

What it really means is that "excess" profits taxes must never be imposed unless prices rise very sharply in supply emergencies to levels well beyond the long-run supply-demand balancing level. Moreover, the tax should expire when the emergency expires. And it should apply to any industry experiencing emergency shortages, not just to oil.

One must concede that the economically sound concept that profits are excessive only if attributable to prices well beyond the supply-demand balancing price may be administratively difficult to implement in an "excess" or "windfall" profits tax because a reasonably accurate estimate of the long-run equilibrium price is required. One promising device for dealing with the difficulty of estimating that price correctly would be to require reinvestment (within a reasonable time) of any profits attributable to prices higher than the estimated correct level. This would assure consumers that if they did, in fact, pay more than the long-run supply-demand balancing price, the funds would either be reinvested—thereby expanding capacity and putting downward pressure on prices and profits—or be taxed away. Amounts reinvested in replacing existing supplies and adding new ones are not windfalls.

We would like to evaluate three "excess" or "windfall" profit tax proposals now before the Congress in the light of these criteria.

GRAVEL PROPOSAL—TAX ON UNINVESTED PROFITS FROM ENERGY SOURCES

Under this proposal profits from energy sources in excess of profit allowance would be taxed at 40 percent unless reinvested in energy projects.

There are many substantial conceptual and technical problems with the bill. On the other hand, it includes three of the essential requirements of an excess profits tax:

1. It is not measured by historical profits; thus permitting some needed profit increase and minimizing discrimination among taxpayers.
2. It appears that the profit allowance is based on investment in all energy related activities, thus providing a better measure of profits. (As discussed below, the 20 percent rate of return is somewhat deceptive since it is based on tax basis rather than the conventional book basis.)
3. A deduction for reinvestment is permitted.

But let me discuss some of the problem areas.

Profits—The starting point for computing the tax would be "profits from energy sources" which means taxable income (with certain modifications) from all phases of the energy business. Production, transportation, transmission, importation and sale of consumable energy or of fuel for conversion into consumable energy are specifically included. While it is not entirely clear, it appears that in the case of the petroleum industry, all production, transportation, and marketing are specifically included. Presumably refining is also included. These points should be clarified. The inclusion of all phases of the energy cycle is proper since it is the only feasible method of measuring true profits.

In the case of oil, gas, and other minerals, the bill specifies that "taxable income from energy sources" has the same meaning as the term "taxable income from the property" for purposes of Section 613. This apparently is an attempt to simplify the calculation. However, in doing so, it has created a question on the allowance of depletion in computing taxable income subject to the excess profits tax since "taxable income from the property" is prior to either cost or percentage depletion. This should be clarified by adding the phrase "less allowable depletion" immediately after "taxable income from the property" in Section 4961(a)(2).

In determining taxable income from energy sources, certain modifications to taxable income would be required by the bill.

1. U.S. income taxes attributable to energy profits are deducted. As will be discussed below, there are problems regarding foreign income. Deduction of U.S. taxes is proper in arriving at the amount subject to this tax.
2. Accelerated depreciation is disallowed to the extent it exceeds straight-line depreciation. This is an unnecessary complication since only timing is involved. More importantly, it detracts from the investment incentive for new plants. Further, to the extent accelerated depreciation reduces the current income tax, the advantages of accelerated depreciation are already reduced since the deduction for income taxes will be smaller.

   If this modification is required, then the investment base on which the profit allowance is computed should be adjusted to reflect the difference in tax basis due to accelerated depreciation. This point is discussed further below.
3. No deduction or capital loss is allowed with respect to outlays treated as a "qualified investment". (As discussed in detail below, "qualified investments" are those investments in energy projects that may reduce profits subject to tax.) As a result, if a depreciable item costing $100,000 is treated as a qualified investment, no depreciation will be allowed on that asset in computing taxable income from energy sources. Operating in this fashion, the reinvestment incentive is greatly diminished since only the timing of the tax may be involved.

   In addition, this approach will present many difficult compliance problems in identifying deductions attributable to specific assets.

   In some regards this is similar to the investment credit as originally enacted. It required reduction of the depreciable basis by the amount of the credit. Therefore, in part, it provided some timing incentive. The investment credit was subsequently amended to create a greater incentive by eliminating the basis adjustment. As so amended, it also avoided the compliance problems similar to the ones anticipated under the current proposal.

   If the proposal is not changed, clarification is needed in Section 4961 (b)(1)(B). As written, it seems to disallow deductions for expenditures that are only attributable to qualified investments, i.e., expenditures that do not represent the cost of qualified investment but merely were attributable to the same property would be disallowed. For instance, the provision could be interpreted literally to disallow the cost of drilling a well on a lease if the cost of the lease were a qualified investment.

   The only reasonable interpretation is that this provision is meant to apply to expenditures that were treated as qualified expenditures under the "binding contract" rule of Section 4960 (c)(1)(B). If that is the intention, the citation in Section 4961 (b)(1)(B) should be specific.

In addition to the modifications contained in the bill, the income subject to the proposed tax should not include dividends from energy companies that are themselves subject to the tax, or there may be double taxation.

Foreign profits are included in the bill in the same manner as domestic profits. That is fundamentally wrong as discussed above. Further, to the extent refining and marketing profits on foreign crude are realized in the United States, those profits will be subject to this excess profits tax since downstream operations are included.

Profit Allowance—The bill provides that profits as determined above shall be reduced by the "profit allowance" which is 20 percent of the average net investment in energy properties.

The profit allowance based on investment is a key essential to any excess profits tax measured by net income since it will permit some profit increase for expansion. It also minimizes discrimination among competing companies. Of course, the difficult problem is in establishing the rate of return to be allowed.

At first impression, many will be inclined to believe the 20 percent rate proposed in the bill to be excessive when compared to historical rates of return. However, it must be recognized that the proposed rate of return is on a very different base. It uses the tax basis of investments in properties rather than the book basis which is traditionally used in financial reporting. Probably without exception, the book basis of any taxpayer in the oil and gas business will be substantially higher than the tax basis. The difference is primarily attributable to three items: intangible drilling costs, percentage depletion, and accelerated depreciation. For tax purposes, IDC may be currently expensed. Thus, the tax basis is zero. For financial reporting, IDC is generally amortized rather than expensed. Similarly, for tax purposes, the greater of cost or percentage depletion is deducted from leasehold investment. Only cost depletion is deducted for financial purposes. Accelerated depreciation will also reduce the basis in assets below the book basis since, for financial purposes, no accelerated depreciation is used.

Because of these reductions of the base for computing the profit allowance, the rate of return on a tax basis must be substantially higher than 20 percent if the objective is to provide a 20 percent return on book basis.

Since drilling expense is one of the essential expenditures to increasing oil and gas supplies, there is substantial merit in expanding the definition of investment to include IDC. Excluding IDC from the investment base would be fundamentally wrong. The fact that IDC has been deducted for income tax purposes does not mean that there is no cost to the operator on which a return must be included. If the base is not expanded, no rate of return or profit allowance will be permitted on IDC. This will severely distort the calculation of producing profits.

Earlier it was mentioned that taxable income from energy sources should not be adjusted for the difference in accelerated and straight-line depreciation. If that adjustment is required, then the investment on which the profit allowance is computed should be adjusted upward to reflect the difference. Certainly it is inconsistent to deny the deduction for accelerated depreciation and, at the same time, reduce investment by the accelerated depreciation in determining the basis for computing the profit allowance.

The base should be expanded to permit a profit allowance on leased property. Leasing property is an effective method of spreading a limited amount of capital. However, if no return is allowed on leased property, taxpayers may be influenced by the operation of the excess profits tax to purchase rather than lease. Furthermore, property is used in the production of profits from energy sources whether it is leased or owned. For these reasons, leased properties should be included in investment. A reasonable approach is to capitalize rental property at eight times annual rentals. (This method has long been satisfactorily used in state income taxation to allocate income to the individual states.)

Section 4962, Net Investment in Energy Sources, refers to the "equity interest of the taxpayer". It provides further that such equity interest shall be determined by "taking into account indebtedness". The meaning of these phrases is not clear. Presumably, the "tax basis" of property is the investment on which the profit allowance is computed. The tax basis includes indebtedness on property. We are concerned that the term "equity" coupled with the phrase referring to indebtedness could be interpreted to require that debt be subtracted from the asset basis. We doubt that that is the intent, but clarification is needed.

Whatever rate of return is ultimately established, it should not be less than the historical rate earned during periods when investments and reserves were being increased. It is unlikely that even that rate will be sufficient since costs and risks have increased so greatly as a consequence of moving to the deeper offshore and remote areas such as the North Slope.

Reinvestment—After deducting the profit allowance from profits, the remainder may be further reduced by investments in qualified energy projects.

A qualified energy project is one within the U.S. that expands or improves existing energy sources or furthers the exploration for, research on, or development of new energy sources. Further, the Federal Energy Administration must determine the projects that qualify. This may be done generally rather than by approval of individual projects.

This definition seems adequate with one exception. It is not clear that processing and refining facilities are included. Additional refining capacity is needed within the U.S. Also, processing facilities for oil shale or coal gasification will be required at great capital costs. Such activities should be included under the reinvestment provisions of this bill.

The bill provides that profits from energy sources in excess of the profit allowance must be reinvested or contracted for by the end of the taxable year following the year such profit is earned. Amounts which the taxpayer contracts to expend must actually be expended within two years to qualify. Because of the long leadtime involved in many projects—especially offshore production and oil shale or coal gasification plants—it is doubtful that the time period provided in the bill is adequate. At least one more year should be permitted under each provision. The taxpayer would thus have until the end of the second taxable year and could include expenditures to be made within three years under a binding contract. The maximum time period would still be just five years.

A carryover of excess qualified investments should be permitted. That would avoid hardship cases where large investments are made in one year but, more importantly, it would eliminate a potential deterrent to current spending. In other words, if no carryover were permitted, a taxpayer could be influenced to defer spending in excess of "usable" qualified investments. The carryover will eliminate such considerations.

It was earlier stated that foreign operations should be excluded from the bill. If they are not, reinvestment of foreign profits should also be permitted outside the United States.

Consolidated Returns—The bill does not specify who the taxpayer is in the case of an affiliated group of companies filing a consolidated Federal income tax return. It should be made clear that the consolidated group is the taxpayer for purposes of this tax. Otherwise, profits from some functions, such as oil and gas production that may be in a separate company, could not be reinvested in activities of other affiliated companies such as a separate coal or shale oil company. Also, since taxable income, the starting point for computing the tax under this bill is proposed on a consolidated basis, all other calculations under the tax should be consistent.

Termination—The bill does not contain a termination clause. An excess profits tax should be imposed, if at all, only during emergency periods. It should never become a permanent part of the tax structure. The bill should provide a termination date or a reasonable provision for phasing it out.

Summary—Gravel Proposal—If the oil industry is to be singled out for an excess profits tax measured by net income, Senate bill 2806 provides a reasonable framework. It is based on an allowable rate of return rather than historical profits, thus permitting absolute profits to increase and minimizing competitive discrimination because of prior performance. Further, it provides for reinvestment of excess profits.

However, if the bill were to be enacted, it should be amended as follows:

1. "Profits from energy sources" should be clarified to specify the downstream operations that are included.
2. Depletion should be deducted in determining profits.
3. Accelerated depreciation in excess of straight-line should not be added to taxable income. If it is, the investment base should be adjusted accordingly.
4. Deductions attributable to qualified investments should not be disallowed.
5. Dividends should be excluded from "taxable income from energy sources".
6. Foreign profits should not be included.
7. IDC costs should be added to the investment on which the profit allowance is computed.
8. Rental property should be capitalized at eight times the annual rental payment and included in investment.
9. Refining and processing facilities should be qualified investments.
10. More time should be permitted in which to reinvest profits.
11. A carryover of excess qualified investment should be permitted.
12. If foreign operations are included, reinvestment should be allowed outside the United States.
13. Consolidated returns should be permitted.
14. A termination provision should be added.

McGOVERN-ASPIN EXCESS PROFITS TAX PROPOSALS

The McGovern-Aspin proposals would impose an excess profits tax beginning January 1, 1973, on corporations engaged in the production, manufacture, or sale of any form of energy. The tax would be 85 percent of the excess of taxable income over a surcharge exemption which is the greater of (1) the average taxable income for the base period of 1969 through 1972, or (2) six percent of invested capital. Excluded from income subject to the 85 percent surcharge is an amount equal to any increase in investment in energy properties or activities above the average investment during the base period.

The principal problem in these proposals is the use of prior profits as the measure of excess profits. That approach is unsound primarily because it discriminates among taxpayers and largely restricts additional profits potential. The reduction of profits subject to tax because of increased net investment partially cures the problem in that it encourages some reinvestment. The bill provides an alternative profit allowance, ostensibly a six percent return on investment—far too low to be very meaningful.

Taxable Income: The "taxable income" upon which this tax is based is the same as for calculating regular Federal income tax. As discussed in commenting on the Gravel proposal, taxable income should be adjusted as follows:

1. Foreign operations should be excluded.
2. Income taxes should be deducted in arriving at "excess profits".
3. Consolidated tax return should be specified.
4. Dividends should be excluded.

Base Period Income: The first surcharge exemption in computing the excess profits tax is average taxable income for the years 1969 through 1972. Since it is based on prior periods, it would affect taxpayers differently as a result of differences in taxable income in the base period. In other words, a taxpayer with low taxable income during the base period would likely be affected more adversely than a taxpayer with high taxable income during the same period. The differences in taxable income may be the result of many things such as large lease abandonments in the base period. For example, a taxpayer may have averaged $50 million taxable income during the base period before deducting an average $25 million abandonment loss. If the taxpayer had the same $50 million taxable income subject to this proposal and no abandonment loss, $25 million would be treated as excess profit even though actual profits before extraordinary losses are the same. because of differences of this type, any proposal that relies on historical operations will discriminate against similarly situated taxpayers.

Adverse changes in the tax laws can also "create" profits under this proposal. In 1969, taxable income was computed with a 27½ percent depletion deduction. Reducing the rate to 22 percent increased taxable income. However, this proposal operates to treat the loss of depletion as excess profits. That result cannot be justified under any reasonable theory.

Using prior profits also tends to perpetuate base period performance which may have yielded profits that were already too low, and prevents expansion since no significant increase in profits can be realized.

Investment Allowance: The bills would permit a reduction of taxable income by six percent of net investment (presumably for tax purposes) in lieu of average taxable income in the base period. For example, a taxpayer with losses during the base period could deduct six percent of its tax investment from taxable income before computing excess profits; i.e., anything over six percent of investment would be considered excess profit. Since there is no provision for deducting income taxes in determining the base, the "profit allowance" is really much less than six percent.

The alternative of deducting an investment allowance is certainly better than allowing credit for only prior taxable income. However, the rate proposed is obviously far too low.

As discussed under S. 2806, calculating the rate of return on tax investment is very misleading since tax basis in the minerals industry is almost certain to be much less than book basis because of the different treatment of IDC, depletion and accelerated depreciation. Thus, a six percent rate of return on a reduced tax basis equates to a smaller return on the book basis, the conventional method for financial reporting.

Apart from the smaller base, the allowance is determined before taxes, thus, again overstating the return on investment. For example, if taxable income were \$120,000, income tax were \$58,000 (implying \$62,000 net income after tax), and invested capital were \$1,000,000, the excess profits tax would be computed as follows (assuming that the investment allowance is greater than average base period income and no reinvestment):

Taxable Income	\$120,000
Less: Investment Allowance (6% × \$1,000,000)	60,000
Amount Subject to EPT	\$ 60,000
Tax @ 85%	\$ 51,000

Thus, \$60,000 of the \$62,000 net income after income tax is treated as "excess profits". Therefore, the actual profit allowance under the proposals is only \$2,000 or 0.2 percent. After both taxes the profit would be \$11,000 or a return on a tax basis of 1.1 percent.

The actual effective rate of the investment allowance will vary depending upon the relationship before-tax of income and investment, but it will always be substantially less than 6 percent. It is also possible for the combined taxes to exceed taxable income, i.e., the excess profits tax creates an after-tax loss. Any proposal that can create a combination tax rate in excess of 100 percent is obviously defective.

At the profit levels permitted under these bills, it would be impossible to generate or attract capital for the industry. To provide some realistic opportunity to expand energy sources, the alternative profit allowance should be expanded along the lines of the Gravel bill with the modifications suggested to it. Essentially, that would include in the investment base IDC and capitalized leased property and allow a rate of return no less than rates earned during periods when capital spending and reserves were being increased.

Reinvestment: After deducting average base period taxable income (or the alternative investment allowance) from taxable income, a further deduction would be allowed to the extent average net investment increased over average base period investment. Certainly a reinvestment alternative is an essential part of any excess profits tax that will promote more energy. Thus, the basic concept of the reinvestment provision within these proposals is sound. However, the manner in which this reinvestment provision operates greatly reduces its incentive value.

Since only the increase in average net investment over the base period is "creditable" against the excess profits, the taxpayer must spend at least the amount by which investment is reduced through depreciation or capital asset dispositions before any amount would qualify for the special reinvestment deduction. To illustrate, if average net investment for the base period were \$100 million and the annual depreciation rate were 10 percent, the average net investment at the end of the first year would be \$95 million (the average of \$100 million at the beginning of the year and \$90 million at the end of the year). To maintain the same average investment, the taxpayer would have to spend \$10 million (because of the averaging). However, the \$10 million would not be treated as a reinvestment since there was no increase in average net investment. Similarly, if the taxpayer abandoned a worthless mineral property with a cost of \$30 million, and paid that same amount for another lease, none of the expenditure would reduce the excess profits tax.

Since the reinvestment is keyed to prior investments, the incentive value of reinvestment is greatly reduced —especially when coupled with a surcharge exemption that allows an after-tax return on investment of substantially less than six percent. To be effective, the reinvestment provision should allow a special deduction for all such expenditures. This should be done along the lines of the reinvestment provisions we have suggested for the Gravel bill.

Summary—McGovern-Aspin Proposals: These proposals are basically defective since historical profits are used in computing the tax. An alternative profit allowance based on an allowable rate of return is permitted but the rate (substantially less than six percent) is far too low. A reinvestment provision is included but its incentive value is greatly reduced since only amounts in excess of capital recovery (depreciation, etc.) qualify.

The bills could be improved by the following amendments:

1. Taxable income should be modified to exclude foreign operations and income taxes should be deducted.
2. Base period taxable income should be adjusted for extraordinary items.
3. The rate of return for the profit allowance must be substantially increased.
4. The investment base should be expanded to include IDC and capitalized rentals.
5. Reinvestment should include all expenditures for energy related projects.

ADMINISTRATION PROPOSAL: EMERGENCY WINDFALL PROFITS TAX

The Administration has proposed a "windfall" profits tax which would be, in essence, a graduated tax based on the difference between the crude oil base price on December 1, 1973, and the actual or imputed sales price. There is no provision for plowback although the proposal suggested that Congress might consider (1) allocating the receipts to an Energy Development Bank for financing energy projects and (2) a refund of the tax to operators who reinvest their profits into energy producing projects. The President, in the January 19 Energy Message, stated that the reinvestment provision should be included.

Excess Profits Base: Unlike either of the previously discussed proposals, the excess profits under the Administration plan would be based on the price of crude. The tax would be levied on crude oil produced in the United States, at rates which would increase as the price of the crude increases. The base price would be gradually modified so that after three years the tax would not apply to amounts below the expected average "long-run supply price", i.e., the price would balance supply and demand in the long run. However, for an additional period of two years beyond the initial three-year period, the tax would continue to apply to prices in excess of the long-term supply price, at tax rates ranging up to 85 percent.

One problem with this approach is that the initial base price must be established without any clear rationale for selecting any specific price, i.e., there does not appear to be any particular reason for selecting the December 1 price. Thus, establishing a base price is rather arbitrary.

The preferable approach would be to subject only prices in excess of the long-run supply price to the tax. Treasury estimated that to be about $7.00 per barrel. As discussed earlier, prices less than the long-term supply price cannot produce excessive profits.

The Administration proposal gives some recognition to the $7.00 long-run supply price by adjusting the base price upward over a three-year period. However, over the three-year period, several billion dollars would be diverted from the industry. Total tax payments would depend upon the amount of crude produced, including the amount of new supply brought on stream, the market price of crude not subject to price controls, and the ceiling prices permitted to be charged on crude subject to price controls.

If the tax is to apply to prices less than the long-run supply price, there could be a substantial deterrent to maximizing production. For example, to induce additional recoveries, price controls were recently removed from stripper well production so that it is now treated as "new" oil. Under the higher prices the economic life of marginal production may be substantially extended, thus increasing total recoveries. However, the current proposal would impose an immediate tax of about 89 cents a barrel if sales are at $7.00, the estimated long-run supply price, or $3.43 per barrel on oil selling at $10.00. Thus, the tax would be a substantial additional cost of production which would negate the effect of the price increase for stripper wells and reduce the life of marginal production. Any such effect could be greatly minimized by applying the tax only to prices in excess of the long-run supply price.

The proposed tax has been widely criticized as an excise tax which would have no effect because it would be passed on to consumers. In fact, the 85 percent rate would make it virtually impossible to pass on the tax, since a price increase many times the tax would be required.

Reinvestment: If the recognition of the long-run price is deferred three years, much of the adverse effect of the proposal may be avoided by permitting reinvestment of the excess profits. The reinvestment provisions should be along the lines discussed in the Gravel proposal above. One of the most important provisions is the definition of qualifying expenditures. In our view, qualifying expenditures should not be limited to expenditures for additional oil and natural gas discovery and production and research and development of alternate energy sources. The energy supply job does not end with the production of raw crude and gas, nor is it limited simply to research and development of alternate sources. Qualifying expenditures should cover all energy sources and should include expenditures from the R&D stage, through exploration, production, refining or manufacturing, and transportation.

An adequate time period must be permitted to make the expenditures. For example, a rule could be adopted that the expenditures would qualify if actually made within two years following the close of the tax year or if a firm contractual obligation therefore is made within that two-year period.

Termination: The Administration proposes that Congress review the tax during its stated five-year term to assure that it is not continued beyond the point where it can perform any worthwhile function and to avoid the risk that the tax could become embedded in the market mechanism and result in a permanent and unnecessary increase in energy costs. This we wholeheartedly endorse.

Summary—Administration Proposal: If only applicable to prices in excess of the long-range supply price and if a reinvestment provision is included, the Administration proposal may be preferable to other suggestions for taxing so-called windfall or excess profits.

CONCLUSION

In conclusion, we have shown a continuing need for current tax provisions. Percentage depletion and the intangible drilling cost deduction still appear the best tax incentives available to assist in the development of new energy supplies. The foreign tax credit must also be retained if American companies are to compete in the exploration and development of foreign sources of petroleum. And if U.S.-controlled companies are not involved, it will be extremely difficult and costly to obtain needed imports.

On the domestic side, I am convinced that the oil industry does not have excess profits and should not be singled out for an excess profits tax. If, however, an excess profit tax is to be enacted, it should permit some growth and expansion of profits if we are to have a reasonable opportunity of increasing energy supplies. Thus, a reinvestment provision and a profit allowance based on a return on investment are essential.

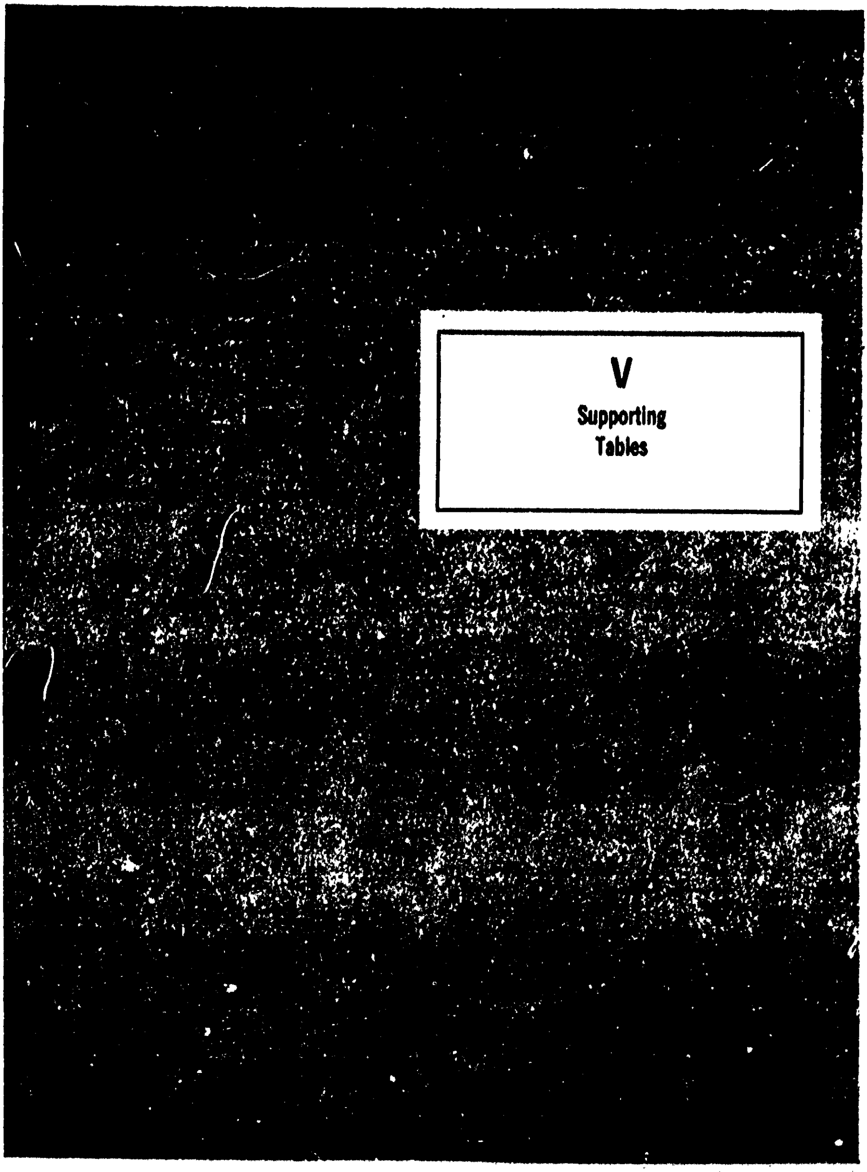
APPENDIX A

Taxation of Income of Foreign Branches; Dividends & Interests from Foreign Subsidiaries Under The Tax Systems of Certain Major Countries in the Free World

Country	Basis of Taxation	*Foreign Branches* Taxability of Income	*Foreign Branches* Treatment of Foreign Income Taxes	*Income from Foreign Subsidiaries* Dividends	*Income from Foreign Subsidiaries* Interest
Australia	Incorporaration	Taxed at normal rate, exempt if subject to taxation by host country (2)	—	Exempt, if taxed by host country or the foreign tax credit may be elected	Exempt, if taxed by host country
Austria	Incorporation	Taxed at normal rates, exempt if subject to tax by host country (1)	Credit under per country limitation	Taxed at normal rates, with direct taxes as a credit	Taxed at normal rates
Belgium	Residence	Taxed at reduced rate, exempt if subject to tax of host country (2)	—	Taxed at reduced rate	Taxed at a reduced rate if taxed by country of source
Canada	Residence	Taxed at normal rates (2)	Credit under per country limitation with five-year carry-over provision	Exempt up to 1976	Taxed at normal rates
Denmark	Residence	Taxed at 50% of normal rate (2)	Credit under per country limitation	Taxed at normal rates, excess foreign income taxes refunded	Taxed at normal rates
Finland	Incorporation	Taxed at reduced rate, exempt under most treaties (2)	Deduction only	Taxed at normal rates	Taxed at normal rates
France	Incorporation	Exempt from taxation (1)	—	Taxed at 5% of normal rate and foreign tax credit for direct taxes	Taxed at normal rate, credit for withholding taxes
Germany	Incorporation	Taxed at a reduced rate, exempt under most treaties (2)	Credit under per country limitation	Exempt or the foreign tax credit may be elected under the deemed paid system	Taxed at normal rate
Greece	Incorporation	Taxed at normal rates (1)	Credit	Taxed at normal rates	Taxed at normal rate
Indonesia	Incorporation	Exempt (1)	—	Exempt	Exempt
Italy	Incorporation	Taxed at normal rates (2)	Credit allowed if there is reciprocity	Taxed at normal rates and foreign tax credit for direct taxes if there is reciprocity; otherwise direct taxes deductible	Taxed at normal rates

Japan	Incorporation	Taxed at reduced rate (2)	Credit under overall limitation, except for income not taxed by host country	Taxed at reduced rate	Taxed at a reduced rate
Netherlands	Residence	Income exempt if taxed by host country, losses allowed against domestic income, with a carryover provision	—	Exempt, if subject to tax by country of source	Taxed at normal rate
Norway	Residence	Taxed over 50% of normal rate, exempt under most treaties (2)	Deduction	Taxed at normal rate with credit for taxes withheld at source	Taxed at normal rate with credit for taxes withheld at source
Spain	Incorporation	Taxed at normal rate, exempt under most treaties if taxed by host country (2)	Credit under per country limitation	Taxed at 67% of normal rate	Taxed at a reduced rate
Sweden	Incorporation	Taxed at normal rate, exempt under most treaties if taxed by host country (1)	Credit under per country limitation	Exempt	Taxed at normal rate
U.K.	Residence	Taxed at normal rate (2)	Credit under per country limitation, with no carryover or carryback for excess creditable foreign taxes	Taxed at normal rate with foreign tax credit under deemed paid system	Taxed at normal rate
United States	Incorporation	Taxed at normal rate (2)	Credit, under either the overall or per country limitation	Taxed at normal rate with foreign tax credit under deemed paid system	Taxed at normal rate

Notes: (1) No tax benefit from net foreign branch losses.
(2) Similar tax treatment for foreign branch losses.


V
Supporting
Tables

Supporting Tables for Charts Accompanying Statement by H. A. True, Jr.

Chart 1

AVERAGE WELLHEAD VALUE OF U.S. CRUDE OIL AND NATURAL GAS 1948-1973

	Oil —$/Bbl.—	Gas —¢/Mcf—
1948	$2.60	6.5¢
1949	2.54	6.3
1950	2.51	6.5
1951	2.53	1.3
1952	2.53	7.8
1953	2.68	9.2
1954	2.78	10.1
1955	2.77	10.4
1956	2.79	10.8
1957	3.09	11.3
1958	3.01	11.9
1959	2.90	12.9
1960	2.88	14.0
1961	2.89	15.1
1962	2.90	15.5
1963	2.89	15.8
1964	2.88	15.4
1965	2.86	15.6
1966	2.88	15.7
1967	2.92	16.0
1968	2.94	16.4
1969	3.09	16.7
1970	3.18	17.1
1971	3.39	18.2
1972	3.39	18.6
1973	3.89P	21.3P
1974	6.50J	

P—Preliminary
J—January
Source: 1948-1972 from U S. Bureau of Mines. January 1974 from U S. Treasury submission to Committee on Ways and Means, February 4, 1974

Charts 2, 3, 4

RETURN OF SHAREHOLDERS EQUITY

	Petroleum Refining and Producing	Total Manufacturing (Excluding Petroleum)	No. of Wildcats Drilled
1948	22.7%	18.5%	4296
1949	13.6	13.7	4449
1950	15.1	17.7	5290
1951	16.7	13.7	6189
1952	14.5	11.6	6698
1953	14.4	12.1	6925
1954	13.9	11.8	7380
1955	14.2	15.2	8105
1956	14.7	13.6	8742
1957	13.6	12.7	8014
1958	10.2	9.8	6950
1959	10.0	12.3	7031
1960	10.2	10.7	7320
1961	10.4	9.8	6909
1962	10.5	11.0	6794
1963	11.4	11.5	6570
1964	11.6	13.0	6632
1965	11.9	14.5	6182
1966	12.6	14.6	6158
1967	12.9	12.4	5271
1968	12.9	13.2	5205
1969	12.1	12.6	5421
1970	10.9	9.8	5069
1971	11.2	10.7	4462
1972	10.8	12.5	5086
1973	15.5P	14.5P	4989

P—Preliminary
Source: First National City Bank 1973 preliminary. Wildcats drilled from American Association of Petroleum Geologists and API

Chart 5

OFFSHORE LEASE SALES IN THE LOWER 48 STATES
1948-1973

	Total Bonuses Bid —$Millions—	Total Acres Leased —Thous. Acres—
1948	$11	629
1949	—	—
1950	—	—
1951	—	—
1952	—	—
1953	32	342
1954	195	601
1955	161	517
1956	15	35
1957	X	5
1958	X	3
1959	137	257
1960	286	732
1961	12	46
1962	497	2013
1963	16	392
1964	112	746
1965	97	707
1966	236	414
1967	521	845
1968	1351	987
1969	116	248
1970	951	723
1971	101	136
1972	2256	905
1973	3108	1457

X—Less than $500 thousand

Source. Records of U S Bureau of Land Management, Louisiana and Texas.

Chart 6

ROTARY RIGS RUNNING IN THE UNITED STATES
1948-1973

	Number of Rigs Running
1948	2169
1949	2017
1950	2154
1951	2543
1952	2641
1953	2613
1954	2508
1955	2686
1956	2620
1957	2429
1958	1923
1959	2074
1960	1750
1961	1760
1962	1636
1963	1501
1964	1502
1965	1387
1966	1273
1967	1134
1968	1150
1969	1194
1970	1028
1971	976
1972	1087
1973	1194

Source: Hughes Tool Company

Chart 7

NUMBER OF OIL AND GAS DISCOVERIES IN THE UNITED STATES 1948–1973

	Oil	Gas
1948	1098	365
1949	1406	424
1950	1583	431
1951	1763	454
1952	1776	559
1953	1981	699
1954	1985	726
1955	2236	874
1956	2267	822
1957	1945	865
1958	1745	822
1959	1702	912
1960	1321	868
1961	1157	813
1962	1211	771
1963	1314	664
1964	1219	577
1965	946	515
1966	1030	578
1967	986	532
1968	954	486
1969	1084	616
1970	790	481
1971	651	437
1972	684	601
1973	611	890

Source: American Association of Petroleum Geologists and API. Includes new fields and new pools in old fields.

Chart 8

U.S. EXPENDITURES FOR PETROLEUM EXPLORATION AND DEVELOPMENT 1948–1972

Year	Exploration	Development	Total Expenditures
	—Million Dollars—		
1948	$1032	$1420	$2452
1949	N.A.	N.A.	N.A.
1950	N.A.	N.A.	N.A.
1951	N.A.	N.A.	N.A.
1952	N.A.	N.A.	N.A.
1953	1784	2245	4029
1954	N.A.	N.A.	N.A.
1955	2189	2449	4246
1956	2117	2436	4553
1957	N.A.	N.A.	N.A.
1958	N.A.	N.A.	N.A.
1959	2012	2313	4325
1960	2045	2082	4127
1961	1851	2070	3921
1962	2324	2266	4590
1963	1845	2039	3884
1964	2109	2193	4302
1965	1971	2133	4104
1966	2165	2322	4487
1967	2396	2316	4712
1968	3218	2333	5551
1969	2896	2559	5455
1970	2287	2631	4918
1971	2187	2469	4656
1972	3433	2836	6269

Notes: N. A. Not Available.

Source: Joint Association Survey.

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Supporting Table

Accompanying Statement by

Robert G. Dunlop

U. S. ENERGY OUTLOOK (SUMMARY)
NATIONAL PETROLEUM COUNCIL,
DECEMBER, 1972

TABLE 20

SUMMARY OF CUMULATIVE CAPITAL REQUIREMENTS
U.S. ENERGY INDUSTRIES 1971-1985

(Billions of 1970 Dollars)

	Initial Appraisal	*Supply Cases* *I*	*II*	*III*	*IV*
Oil and Gas					
Exploration & Production	92.4	171.8	144.8	135.1	88.0
Oil Pipelines	3.5	7.5	7.5	7.5	7.5
Gas Transportation	21.0	56.6	46.9	39.8	29.5
Refining	20.0	19.0	24.0	30.0	38.0
Tankers, Terminals	14.5	2.0	9.0	16.0	23.0
Subtotal	151.4	256.9	232.2	228.4	186.0
Synthetics					
From Petroleum Liquids	—	5.0	5.0	5.0	5.0
From Coal (Plants Only)	1.5	12.0	4.6	4.6	1.7
From Shale (Mines & Plants)	0.5	4.0	2.2	2.2	0.5
Subtotal	2.0	21.0	11.8	11.8	7.2
Coal †					
Production	9.3	14.3	10.4	10.4	9.4
Transportation	6.0	6.0	6.0	6.0	6.0
Subtotal	15.3	20.3	16.4	16.4	15.4
Nuclear					
Production, Processing, Enriching	5.0	13.1	11.0	8.5	6.7
Total All Fuels	173.7	311.3	271.4	265.1	215.3
Electric Generation, Transmission ‡	200.0	235.0	235.0	235.0	235.0
Water Requirements	N.A.	1.1	0.8	0.8	0.7
Total Energy Industries	373.7	547.4	507.2	500.9	451.0

* Based on maximum U.S. requirement, some of which may be spent outside the United States.

† Cases I-IV include capital requirements for coal for synthetic fuels. The Initial Appraisal includes only capital requirements for coal for conventional markets.

‡ Condition 1; capital requirements under all six conditions postulated by the Electricity Task Group are as follows.

Condition	Cumulative Investment (1971-1985) Billion 1970 Dollars 1	2	3	4	5	6
Power Plant Construction	181	183	186	169	196	163
Transmission (estimated at 30% of Condition 1 Cumulative Power Plant Investment)	54	54	54	54	54	54
Total	235	237	240	223	250	217

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Cash Flow from Higher Domestic Crude Prices in Comparison with Capital Requirements for Self-Sufficiency

The National Petroleum Council has estimated that the industry should spend $19 billion per year during 1971-1985 for oil and gas exploration, development, refining, transportation, and synthetics (plants and mines) in order to achieve 83 percent oil self-sufficiency by the end of the period. This figure is in 1970 constant dollars, but general prices in 1973 were already 14 percent above 1970 (measured by the price index used to deflate Gross National Product). Moreover, expenditures in 1971 and 1972 averaged only $7 billion per year. If we allow for this 1971-1972 under-expenditure and for inflation, the industry's capital requirements for 1973-1985 would be about $23.5 billion annually in 1973 prices. Preliminary data would indicate about $26 billion annually for 1974-1985 in 1974 prices. This will require more than tripling the 1972 expenditures of $8 billion for these items.

Preliminary data indicate the planned 1974 petroleum industry domestic capital expenditures in the above categories will be about $14 billion -- up $6 billion from 1972. Thus, despite a major increase in the level of expenditures, the industry is still under-spending the NPC requirements by some $12 billion annually.

How does the increase in cash flow attributable to higher domestic crude prices compare with actual and needed capital expenditures?

If operating costs remain the same, every dollar of incremental crude price yields about 50 cents of after-tax profits to a corporate producer of existing oil:

	U. S. Tax Computation		Increase in Profit	
Extra Revenue		$1.00		$1.00
Less - Royalty @ 15%	$.15		$.15	
State and local taxes (@ 8% of 85¢)	.07		.07	
Percentage depletion (@ 22% of 85¢)	.19	.41		
Taxable income		$ .59		
Federal income tax @ 48%		.28	.28	.50
Net income				$ .50

This 50-cent figure is for a corporation on a gross production basis considering royalty as an expense. An independent producer in a 70 percent marginal tax bracket would receive about 37 cents on the dollar. Thus, on average, a dollar of incremental crude value means about 47 cents of incremental profits to crude producers. (That assumes an 80/20 split of production between corporations and individuals.) In round numbers, the producer keeps half; and governments and royalty owners get half. The minimum tax is disregarded in the computation.

The above computation overstates producers' cash flow somewhat because, as time passes, operating costs will increase. We have assumed that all of

(OVER)

the increase in price on existing production represents profit (before tax), but some part of it is needed to cover rising operating costs.

Since 1972, the average price of domestic crude has increased by about $3 per barrel (from $3.39 to about $6.50). With 4 billion barrels of production, that would imply an increased cash flow of about $6 billion (= half of $3 x 4 billion barrels). That increase is about the amount required to cover planned 1974 expenditures: $8 billion spent in 1972 plus $6 billion extra cash flow = $14 billion. While $14 billion approximates the expected level of expenditures in 1974, it is far less than the needed expenditures.

Reflecting world prices, uncontrolled new domestic crude oil is selling for something over $10 per barrel -- up about $7 per barrel since 1972. If all domestic oil were selling at $10, the implied increase in cash flow since 1972 would be about $14 billion (= half of $7 x 4 billion barrels). That is much more than the $6 billion increase in planned spending, but it is still not enough to cover needed expenditures: $8 billion spent in 1972, plus $14 billion extra cash flow equals $22 billion, which is well below the $26 billion needed.

Of course, some of the $26 billion could be borrowed; but far and away the majority of the funds must be generated internally. The First National City Bank of New York suggests about 80 percent (80 percent of $26 billion is $21 billion). And some of the added cash flow must go to dividends in a period of inflation if equity values are to be maintained.

It might be argued that a temporary windfall profits tax could be applied until expenditures actually reach the required level without damaging the national effort to re-achieve a reasonable level of self-sufficiency. However, to the extent that the industry is under-spending now, it must over-spend later. Thus, the money will be needed in the future if self sufficiency is to be attained. Taxing away any present surplus will leave a corresponding future deficit.

Conclusion

While these cash flow and expenditure data are necessarily only approximations, it seems clear that the industry should be spending at levels even higher than implied by the increase in cash flow which would result if all domestic crude oil were selling at world prices:

Crude Price		Incremental Needed Expenditures		Incremental Cash Flow		Deficit
--$/bbl.---		(--------Billions of 1974 Dollars--------)				
$10.00		$18.0	-	$14.0	=	$4.0

The above computations are in 1974 dollars and make no allowance for future inflation.

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THE FOREIGN TAX CREDIT AND THE U.S. OIL INDUSTRY

May 1974

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Introduction

The five month political embargo on Arab oil shipments to the U.S. and the sharp and unexpected increases in world oil prices unilaterally imposed in 1973 by OPEC have brought home to most Americans the risks and costs of depending on foreign sources for a significant share of domestic oil requirements. This situation is quite new. Until 1972 our dependence on foreign oil was such that the kind of embargo that existed from October 1973 to March 1974 would have had relatively little effect on our supplies. In fact, throughout the embargo period we received more foreign oil than during the comparable period of 1972. Likewise, world oil prices prior to 1973 had always been below U.S. prices so that in the past imports had the effect of lowering our average oil cost.

It is not surprising that under the shock effect of these radical changes, legislators and policy makers are asking for a return to the pre-1973 period and, in fact, are looking for self-sufficiency in energy by about 1980. Whether this is a realistically achievable goal has been questioned by many experts in government and industry. The National Petroleum Council in its major study, The Outlook for Energy, released in December 1972, projected that by 1980 our dependency on foreign oil would range from 30% to 66% with 48% as the most likely number. Even if we assume the National Petroleum Council's most optimistic domestic supply projection (which the Report termed "difficult to attain") and the smallest demand projection, we will still have to bring in a minimum of about 6 million barrels daily of foreign oil by 1980. Thus, it is reasonable to assume that regardless of what energy policy we pursue, foreign oil will play a significant part in supplying our demand for the next ten years at least. It is therefore essential that we do not embark on policies which will reduce our access to foreign oil during this period without having an offsetting effect on domestic supplies.

The various current proposals to alter or abolish the Foreign Tax Credit on income from U.S. oil operations abroad must be examined from this point of view. The acknowledged principal purpose of these proposals is not to raise additional tax revenue but to create a tax disincentive to U.S. investment in foreign oil production on the assumption that this would lead to increased investment in domestic oil production. If the assumption is correct, a reduction of the Foreign Tax Credit may be justified. If it is not, the effect of the removal is likely to be counter-productive.

Thus, before we go into the technical aspects of how the Foreign Tax Credit works and what the consequences of the various proposals to reduce or eliminate it would be, we must determine why U.S. oil companies ventured abroad, what would have been the consequences if past government policy had prevented them from doing so and what the role of foreign oil will be in supplying our future energy needs.

Tax Policies and Oil Investment - U.S. vs. Foreign

American oil companies have been investing substantially in foreign countries before the turn of the century, well before the adoption of the modern income tax law in the United States in 1913. Their historic reasons for doing so are well covered in other studies. Here we are concerned with the question of what role, if any, taxes have played in the continuation of such investments, particularly since the end of World War II.

The fact is that from the tax point of view it was better throughout this period to produce oil in the U.S. than in almost any major foreign producing country. Prior to 1970, when the Tax Reform Act of 1969 became operative, the average federal income tax payment of integrated U.S. oil companies amounted to not quite 20% of their total U.S. book earnings* and less on their earnings from domestic crude oil production alone.

The principal reason for this relatively low rate were two special tax provisions applying to oil and gas production: the depletion allowance and the expensing of intangible drilling costs. The rationale for these two provisions on which a vast literature exists lies outside the scope of this report. But with the exception of Canada, no major foreign oil producing country has granted oil companies such preferential tax treatment.

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*Petroleum Industry Research Foundation, Inc., The Tax Burden on the Domestic Oil and Gas Industry, 1972.

As a result, since the introduction of the so-called 50/50 principle in foreign oil taxation (which consisted of a 50% income tax rate minus a tax credit for royalties and other payments made to the state), in 1948 in Venezuela and two years later in the Middle East, U.S. oil companies operating in the major foreign producing countries have consistently paid a higher tax rate there than at home. Over the years the differential has grown dramatically. Until about 1960 the income tax rate on oil operations in the Middle East and Venezuela was approximately 36% or nearly twice as high as the effective tax rate in the U.S. In the early 1960's increasing competition forced the oil companies abroad to introduce discounts off their posted prices. However, OPEC did not allow these discounts to be used for the purpose of calculating taxable income. As a result, the effective tax rate on real income was further increased. Then in the second half of the 1960's OPEC required that royalties be treated as a deduction instead of a tax credit. This together with the discounts raised the effective tax rate to 54-56% of real earnings.

In 1971 statutory income tax rates were raised to 55% in the Middle East and African producing countries and to 60% in Venezuela. In addition, a series of sharp increases in posted prices were imposed by the producing country governments culminating in the current postings which range from $11.44 to $15.77 per barrel, about four times the level of a year ago. As a result, the current effective tax rate in the Middle East is about 67% of the real earnings on a company's own (equity) crude oil production (see page 29), assuming a market price of $9.70 f.o.b. Persian Gulf.

By comparison, the total U.S. tax burden on crude oil production, including state income and production taxes, is probably less than half of this rate. In other words, U.S. oil companies have gone abroad despite the fact that U.S. tax treatment of their earnings has been consistently more favorable than that of major foreign producing countries. Over the years, this difference has steadily increased as the foreign countries raised their tax bases and rates while the U.S. limited such general tax incentives as the Investment Credit and Accelerated Depreciation largely or wholly to domestic investments.

The Reasons for U.S. Foreign Oil Investments

The principal reason why, despite this disparity, American companies have apparently increased their investments in foreign exploration and production much more than those at home in the last 12-14 years lies of course in the resource base differential. The opportunity to find very large deposits of very low cost oil abroad at a time when domestic deposits were beginning to show signs of decline and finding costs were rising was sufficient to overcome the foreign tax disadvantage. The results bear out the correctness of this choice. Production costs in the OPEC nations range from

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*Approximately in line with published price quotations in the early part of 1974.

10¢ to 60¢ per barrel while in the U.S. they average in excess of $1.00 per barrel. Even more dramatically, while in 1971 the drilling of a total of 11,858 oil wells in the U.S. did not prevent a production decline of about 100,000 b/d from the previous year, in the Middle East where a production increase of 3 million barrels daily (b/d) was achieved only 160 wells were drilled.

Suppose the U.S. government through prohibitive tax measures or other means had suceeded in preventing or hampering U.S. companies from developing the petroleum resources abroad in the last 15-20 years?

Would such a policy have resulted in higher investment in petroleum production at home? Probably not. There is clear evidence that the decline in U.S. oil production investments did not reflect lack of funds but lack of opportunity to employ the funds profitably. The great bulk of domestic oil investment had occurred on-shore in the Southwestern and West Coast regions. There is now general agreement among geologists that the bulk of the recoverable reserves in these areas have been locatod and that the only way to extract more oil from these reserves is to introduce secondary or tertiary recovery methods. This is a direct function of the existing or expected wellhead price of oil rather than the availability of capital.

Investment Opportunities in the U.S.

The principal areas for major new oil finds in the U.S. will be the offshore regions along our coastlines and the offshore and onshore areas of Northern Alaska. The American petroleum industry has shown every sign that it wants to develop these areas at the most rapid rate and has the capital to do so. The Alaskan North Slope discoveries which, together with the pipeline to the warm water port of Valdez will have cost a total of well over $10 billion by the time commercial production gets under way, were found and developed when domestic crude oil prices were at one-third and landed foreign prices at one-fifth of their present levels.

The only thing that held up the commercial development of the North Slope reserves were court and government actions, never lack of capital. The eagerness of additional companies to join in the Alaskan oil search was clearly demonstrated at the lease auction in September 1969 when $1 billion was payed in bids to the Alaskan state government for the right to search for oil. There is every indication that if the state or federal government were to open more areas with promising geological indications for oil search in Alaska on any profitable basis, the American oil industry would be willing and financially capablo to undertake this search without any change in existing tax or other legislation.

Similarly, every lease sale in federal off-shore lands in the Gulf Coast in the last several years has brought in over a billion dollars in bonuses. In the two latest sales, held early in 1974, the industry paid $1.8 billion and $2.2 billion, respectively, in cash bonuses to acquire leases. In fact, the petroleum industry's position is that more federal off-shore leases should be offered for bidding than the 3% of the total area that has been opened up so far. The industry has also urged the opening up of the East Coast for oil exploration and the removal of some of the restrictions put on oil search and production in the Pacific off-shore areas.

Without going into the specific positions of the industry and the government on the question of off-shore drilling, it is clear that American oil companies are willing to invest considerably more money in search for oil and gas in the major remaining potential oil bearing areas in this country than they have been permitted to do so far. The reason for the decline in domestic production and reserves in the last several years is therefore not lack of funds but lack of opportunity.

If a change in U.S. government policy were to make it more difficult for U.S. oil companies to invest funds abroad, it would not follow that these funds would be invested in U.S. oil production ventures which are currently considered not profitable enough. The basic criterion for any business investment decision is to maximize the return on the investment. If opportunities outside the oil producing sector promise a higher rate of return this is where the funds would go. Thus, one result of discouraging past foreign oil investments would probably have been increasing domestic diversification of oil companies into other lines of business. The same thing can be expected if such a policy were to be adopted now.

Balance of Payments Considerations

It is sometimes argued that if U.S. companies had not been able to develop foreign production they would have had to develop more production at home even if the profitability were less, since integrated oil companies cannot stay in business without adequate crude oil supplies. This assumes that any oil not found by American oil companies abroad would stay unfound. Actually, international competition between U.S. and non U.S. oil companies is very keen. Three of the world's biggest and oldest oil companies -- Royal Dutch Shell, British Petroleum and Compagnie Francaise des Petroles -- are headquartered in Europe. There are also large oil companies in Germany, Italy, Belgium and Japan. Some of these have access to government funds for their foreign exploration ventures. Furthermore, the national oil companies of all the major producing countries have by now acquired enough knowledge and skill to produce and sell their own oil. In the future their role as international oil marketers will in fact be greatly expanded.

Thus, the amount of oil available for sale abroad would not necessarily be less in the absence of American oil companies. U.S. companies could therefore import the same volume of oil as they do now by purchasing it from foreign producers. The only difference would be that the profits abroad from the sale of this oil would accrue entirely to the foreign producers. In turn, this would have a negative effect on our balance of payments.

The importance of foreign oil earnings in our blance of payments is shown in the following table.

Capital Transactions Of The U.S. Foreign Petroleum Industry Affecting The Balance of Payments - 1966-1972
($ million)

	Net Capital Outflows	Interest, Dividends and Branch Earnings*	Ratio Inflows to Outflows
1966	885	1,781	2.01
1967	1,069	1,989	1.86
1968	1,231	2,271	1.84
1969	919	2,638	2.87
1970	1,460	2,608	1.79
1971	1,950	3,442	1.77
1972	1,635	3,950	2.42
	9,149	18,679	2.04

*Net balance of payment inflows

Source: Survey of Current Business, September 1973

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It should be pointed out that most of these earnings are not the result of imports into the U.S. but into other markets - mainly Europe and Japan. In 1972 U.S. oil companies produced a total of about 18 million b/d abroad while oil imports into the U.S. amounted to less than 5 million b/d and not all imports came from U.S. controlled companies. In previous years the share of U.S. controlled foreign oil going into third countries was even larger. Had there been effective interdiction of U.S. investments in foreign oil production, we might have lost up to a cumulative maximum of $10 billion of foreign earnings inflow since 1965 without necessarily reducing our dollar outflow for oil imports by any relatively significant amount.

Investment in Down-Stream Facilities

In the future the role of U.S. oil companies in the main foreign producing areas will clearly decline while that of the national oil companies will rise. U.S. earnings from oil production abroad can therefore be expected to diminish. But the same is not likely to hold for the role of U.S. companies in the importing countries abroad. In fact, as their earnings from upstream profits dwindle, the companies will try to shift their profit center to refining and marketing operations. If U.S. companies were handicapped vis-a-vis their foreign competitors in participating in these operations, the inflow of foreign earnings would of course be diminished. There would be no compensating increase in domestic investment and earnings. An international oil company blocked by U.S. tax policy from building a refinery in Europe to supply the local market will not build one in the United States instead.

Refinery building is a function of market demand and availability of crude oil. The reason for the insufficient U.S. refining capacity is not lack of domestic capital. Rather, a variety of other factors such as our former oil import policy, environmental opposition to refinery location and the existence of excess refining capacity until 1972 came together to create this situation. Some of these factors are no longer prevalent or have been mitigated. As a result, almost every large refining company has announced plans within the last ten months to expand its capacity. If all these plans are carried out it will mean an increase in U.S. refining capacity of about 3 million b/d by 1977/78, enough to raise our self-sufficiency in refined products above the level of recent years. How many of the announced expansions or new constructions will actually take place depends primarily on one factor - secure access to foreign crude oil. Any attempt to hinder U.S. companies from finding more oil overseas could therefore have a negative side effect on U.S. refinery construction in the next few years.

Foreign Oil and U.S. National Security

Self-sufficiency in petroleum in the next ten years is not a realistically achievable goal for the U.S., official statements to the contrary notwithstanding. It would reqnire a reduction of 50% in our historic energy growth rate from 1974 on. This is clearly unrealistic. It would result in an economic recession of major proportions.

We can, however, reduce our dependency on foreign oil considerably over the next ten years from what it would be in the absence of a concerted effort to do so. Thus, by 1980 our domestic petroleum production under the stimulation of higher prices and a more liberal government policy on off-shore leasing might be as high as 14 million b/d, compared to 11 million barrels in 1974. At the same time our oil demand which had been projected to reach 24 million b/d in 1980 by various authoritative studies made prior to the major changes in world oil demand and supply conditions which occurred last year, may be reduced through conservation measures and substitution of coal to an absolute minimum of 20 million b/d. This would imply an annual growth rate of 1.8%, about one-third of our recent historic rate.

Even these spectacular achievements in increasing domestic supplies and decreasing the growth in demand would require imports of at least 6 million b/d in 1980, or 30% of total demand. If we further assume that all increases in oil demand between 1980 and 1984 can be met from domestic sources and that at the same time oil imports can be reduced by another 10% from their 1980 levels, we will still have to bring in 5.4 million b/d of foreign oil ten years from now. Thus, even under these clearly optimistic assumptions we will continue to be substantial importers of oil for the next decade and very probably beyond. The question of access to foreign oil will therefore continue to be of major national significance.

One thing we have learned from the present oil crisis is the need for maximum diversification of supply sources. Without the existence of major producing areas in Canada, South America, West Africa and Southeast Asia the effect of the Arab oil embargo on the U.S. would have been far more serious than it was. Some of these areas were developed only within the last ten years. Nigeria, for instance, produced only 75,000 b/d in 1963 compared to 2.2 million b/d in 1974. Ecuador which had virtually no exports prior to 1973 now sells over 250,000 b/d abroad. In Indonesia production has increased from 450,000 b/d ten years ago to the current level of 1.4 million b/d. Canadian production has nearly doubled in the last ~~five years~~ to its present level of 2.1 million b/d. In all these cases U.S. companies were involved in finding and developing this oil.

All major oil importing countries other than the U.S. are officially encouraging the search for new deposits throughout the world in order to diversify their supply sources. At the same time the national oil companies of existing or potential producing countries are looking for minority partners or subcontractors to help them develop their resources. If American companies were to be prevented from participating in this search the security of supply of our required imports would clearly be weakened.

The Arab oil embargo has demonstrated that during a physical shortage the global allocation of available supplies is in the final analysis in the hands of the international oil companies. To the extent to which these companies are American our government has some means of influencing the allocation. True, during the embargo U.S. companies operating in Arab countries were specifically prohibited from supplying their own country and had no choice but to respect this prohibition. However, by increasing shipments from non-Arab sources and by importing finished products from refineries in countries which continued to have access to Arab crude oil, the shortfall of imports into the U.S. throughout the five months of the embargo was kept below the level that would have prevailed if the embargo had been fully effective and no offsetting shipments from non-embargoed sources had come in. Given the present constellation of world politics it is questionable that such remedial action would have been taken if most of the oil shipped to the U.S. had been controlled by private or government companies of other countries.

Thus, as long as the U.S. remains a major importer of oil it would seem to be in the national interest to encourage U.S. companies to participate in as many foreign oil ventures as possible.

Concept and Calculation of the Foreign Tax

Now let us turn to the role the Foreign Tax Credit plays in U.S. foreign oil operations. One of the most concise as well as authoritative explanations of the principle of this tax provision was given by the then Secretary of the Treasury, George P. Shultz, before the House Ways and Means Committee on February 4, 1974 which is quoted below.

> "The basic concept of a tax credit system is that the country in which the business activity is carried on has the first right to tax the income from it even though the activity is carried on by a foreigner. The foreigner's home country also taxes the income, but only to the extent the home tax does not duplicate the tax of the country where the income is earned. The duplication is eliminated by a foreign tax credit. For example, if a U.S. corporation were taxed at a 30 percent rate in country X on its income from operations in country X, the U.S. would not duplicate country X's 30 percent tax on that income. But since the U.S. corporate income tax rate is at 48 percent, the U.S. would collect -- i.e., "pick-up" the 18 percent which remained over and above the 30 percent collected by country X. Technically the result is achieved by imposing a hypothetical 48 percent U.S. tax on the income earned in country X, with the first 30 percentage points rebated by a credit. However, if the foreign rate were 48 percent or more, there would be nothing left for the U.S. to pick up and thus no tax payable to the U.S. on that foreign income.
>
> Note that the foreign tax credit only affects income earned in some foreign country through activities conducted in that country. Income arising out of operations conducted in the U.S. and the taxes on that income are totally unaffected by the credit."

The Foreign Tax Credit is of course not limited to the oil industry but applies to all U.S. controlled business enterprises abroad. However, the oil industry's foreign tax credit is the largest of any U.S. industry. But the same applies to the foreign earnings of the U.S. oil industry. In the three years 1969-1972 the foreign earnings, and tax credits of all U.S. industries and of the petroleum industry were as follows:

U.S. Corporate Foreign Earnings And Tax Credits
(¢/million)

	Foreign Earnings			Foreign Tax Credit		
	All Corp's	Petrol.	Petrol's Share Of All Corp's	All Corp's	Petrol.	Petrol's Share Of All Corp's
1969	8,128	2,452	% 30.2	3,988	1,779	% 44.6
1970	8,789	2,935	33.4	4,549	1,820	40.0
1971	10,299	3,856	37.4	5,486	2,444	44.5
1972	12,386	4,552	36.7	n.a.	n.a.	n.a.

Source: Dept. of Commerce Survey of Current Business and Internal Revenue Service, Corporate Income Tax Returns

The Two Methods Of Computing The Foreign Tax Credit

The allowable Foreign Tax Credit can be determined in two ways. The "per country" method treats the income and taxes from each foreign country separately in determining the Foreign Tax Credit. The "overall" method treats all foreign net income and all foreign taxes as a whole. Tax payers may elect either method. But if they elect the overall method they are not free to change to the per-country method in subsequent years unless they receive special permission from the Treasury.

The principal attraction of the overall method is that it permits a company operating in several foreign countries to average differential tax rates. Thus, excess foreign tax credits accumulated in countries with tax rates higher than in the U.S. may be used to offset U.S. tax liabilities arising in countries with tax rates below the U.S. level.

The advantage of the per country method is that it permits losses in a foreign country to be deducted from U.S. income taxes on domestic earnings, independent of the accumulation of excess tax credits in other foreign countries. This is based on the principle in our tax law that if the foreign income of U.S. businesses is subject to U.S. taxes, foreign losses must be deductible from U.S. taxes. In the case of foreign income a Foreign Tax Credit is allowed to avoid double taxation. In the case of a foreign loss there is no conceivable counterpart to the Foreign Tax Credit. A taxpayer on the per country basis may therefore deduct the loss directly from his total earnings which include of course his domestic earnings.

The Case of Aramco

An illustration of a limitation on the use of the excess foreign tax credit, regardless of the method used to compute it, is provided by the Arabian American Oil Company (Aramco) - the world's largest crude oil producer. Aramco's own operations are limited almost entirely to Saudi Arabia. But its four U.S. owners -- Exxon, Texaco, Standard of California and Mobil -- operate of course in many foreign countries. However, since none of them controls a large enough share of Aramco to treat it as a subsidiary for U.S. tax purposes, they can not make use of Aramco's accumulated excess foreign tax credit. According to recently released figures by the Senate Foreign Relations Committee, Aramco paid nearly $2 billion in income taxes in Saudi Arabia in 1972 and an estimated $3.9 billion in 1973. On the basis of these figures it can be estimated that the company received U.S. tax credits of approximately $1.4 billion in 1972 which gave it an excess Foreign Tax Credit of about $600 million in that year. In 1973 the excess tax credit was probably somewhat above $1 billion, according to preliminary figures. For the reasons pointed out, no part of the excess tax credit generated by Aramco can be used to reduce the U.S. tax liability of its owners in any other country. It has therefore no value for the four companies.

Some Misconceptions of the Foreign Tax Credit

Much of the controversy over the oil industry's use of the Foreign Tax Credit arises out of misunderstandings over how the credit works and what its limitations are. In the following paragraphs the most common of these misconceptions will be discussed.

(1) The Foreign Tax Credit as an Offset Against U.S. Income Taxes

In the public discussions about the Foreign Tax Credit it is sometimes claimed that U.S. oil companies can offset increases in foreign tax liabilities by a corresponding lowering in tax payments to the U.S. Treasury through the Foreign Tax Credit device. It is important to understand that this credit is available only up to the point where foreign tax rates equal U.S. rates. Since, by and large, foreign tax rates for the oil industry have exceeded U.S. tax rates since the mid-1960's, increases in foreign tax payments since then have had very little effect on tax payments to the U.S. Treasury.

In other words, the U.S. oil industry has paid very little domestic income taxes on its foreign earnings for a number of years and since tax liabilities arising out of domestic earnings can never be reduced by a foreign tax credit, there has simply been nothing to write off against the many increases in foreign tax payments in recent years. As a result, all U.S. oil companies with substantial foreign producing operations have built up increasing amounts of unusable excess Foreign Tax Credits.

The following table illustrates this point. It shows the composite foreign income tax liabilities and U.S. foreign tax credits of 18 major oil corporations which report their earnings and taxes regularly to the public accounting firm Price, Waterhouse and Co. As can be seen, foreign tax liabilities have risen by $2.3 billion during the four-year period but the Foreign Tax Credit has gone up by only $0.4 billion. Similarly, in 1972 the Foreign Tax Credit covered only 37% of total foreign income tax payments, compared to 58% in 1969 - an indication of the growth in excess foreign tax credits, that is tax credits in excess of those required to offset U.S. tax liability. In 1973 the ratio dropped still further.

Since at least part of the increase in the Foreign Tax Credit since 1969 was due to higher earnings in oil importing countries, some of whose tax rates are below the comparable U.S. level, virtually none of the sharp increases in tax liabilities to the oil producing countries during this period were passed on to the U.S. Treasury through higher Foreign Tax Credits.

Foreign Income Tax Payments And Tax
Credits Of 18 Major U.S. Oil Companies
($ million)

	Foreign Tax Credit	Foreign Income Taxes	Ratio Of Column (1) to Column (2)
1969	1,176.5	2,027.0	58.0
1970	1,181.6	2,366.6	49.9
1971	1,676.2	3,808.4	44.0
1972	1,616.2	4,315.0	37.5
Increase 1969-72	37%	113%	

Source: Reports by Price Waterhouse & Co. to the General Committee on Taxation of the American Petroleum Institute with adjustments in 1972 to reflect changes in accounting practices of some companies*

(2) The Question Of Royalty Payments

It is sometimes charged that the income tax paid by oil companies in the major foreign producing countries is only a disguised form of royalty payment and should be treated as such in the computation of the U.S. income tax liability on these earnings. The difference would be quite significant, since a royalty under U.S. tax law is in effect treated as a deduction rather than a tax credit. Thus, under

*The figures shown are those reported in the published financial statements. They exclude two major U.S. foreign oil companies -- Aramco and Caltex -- the income taxes of which were not included in the consolidated reports of their shareholders prior to 1972. For 1972 adjustments were made to reflect the fact that some companies included Aramco's income taxes in their financial statements a hypothetical 50% U.S. tax rate one dollar paid in foreign income tax would reduce U.S. tax liability on that income by one dollar while one dollar paid in royalties would reduce U.S. tax liability by only 50¢.

The dispute over whether the payments to foreign oil producing governments are taxes or royalties arises in part out of the confusion as to the kind of payments made to these countries and in part out of the historic origin of these payments. For the past 20 years at least foreign oil producing companies have paid both an income tax and a royalty to their host governments. The latter ranges from 12.5% to 16.6% of the posted or tax reference price of the crude oil. It currently amounts to about $1.46/bbl in Saudi Arabia and about $1.25 a barrel in Venezuela. The royalty is treated as a regular business deduction for U.S. income tax purposes and thus does not figure in the computation of the Foreign Tax Credit. The foreign producing countries also treat royalty payments as a tax deduction, although prior to 1965 most of these countries treated them as a tax credit in calculating the 50% income tax rate then in effect. Some of the confusion might arise from this previous differential treatment of oil royalty payments in the producing countries.

Another reason for the confusion is that at one time all payments to foreign producing countries were in the form of fixed royalties per barrel. In Venezuela an income tax law applicable to foreign oil companies was passed in 1943 and in Saudi Arabia it was introduced in 1950 as part of the 50/50 principle of sharing profits between the government and the company. Shortly thereafter all remaining major oil producing countries adopted income tax legislation. The system in most of these countries is similar to that in effect in the U.S. for oil operations on federal territories. Oil companies producing on public lands or off-shore areas must pay a royalty to the government, in addition to which they are of course subject to an income tax on their earnings.

The argument has been made that since a major reason for the change over from a pure royalty to a combination income tax and royalty system in Saudi Arabia was to take advantage of the U.S. Foreign Tax Credit, Saudi Arabian and other Middle East income taxes are really converted royalties and as such should not be given Foreign Tax Credit status. The argument ignores several points.

(a) It is only common sense for any country to try to minimize, within the framework of existing laws and conventions, the tax payments to other countries from profits earned within its borders. The long-standing provision in the tax codes of the U.S. and the U.K., the two largest investors in Middle East oil, of a Foreign Tax Credit was a clear invitation to reduce the outflow of tax payments. The fact that under the royalty system the U.S. Treasury received a much larger income from Saudi Arabian and other Middle East oil operations than the treasuries of these countries provided a strong additional incentive to take corrective action.

(b) It is now generally recognized that the income tax is a superior form of governmental revenue collection than a fixed royalty, both because it has greater flexibility and because it makes the government a partner in the profits and losses of the enterprise. The move from a royalty to an income tax system must therefore be regarded as a normal development in fiscal sophistication on the part of the less developed countries which would have come about even in the absence of Foreign Tax Credits in U.S. and other tax legislation.

(c) It would be extremely arbitrary for the U.S. to insist on treating all tax payments to foreign oil producing countries forever as royalties because at one time some of these countries (none where the first oil discovery was made after 1950) collected their oil revenues in the form of royalties.

(3) <u>Posted vs. Market Prices</u>

Another criticism of the U.S. Foreign Tax Credit provision as it applies to foreign oil is that the credit is permitted on the artifically inflated earnings based on posted prices. Posted prices were originally the market prices at which oil companies were willing to sell to third parties. In the early 1960's the setting of these prices was taken over - at first informally and now officially -- by the governments of the producing countries and were set above actual market values. For instance, the current posted price for light Saudi Arabian crude oil is $11.65 per barrel. But the actual market value of this oil is $1.50-$2.00 less. Since company profits for tax purposes are calculated on the basis of posted prices by the producing countries, it is argued that the profits are overstated as are the resulting tax payments to the foreign governments and the ensuing U.S. Foreign Tax Credit.

The problem is that some countries such as Saudi Arabia and Iran require the producing companies to use only posted prices for accounting and operating purposes. If these companies grant discounts off the posted prices to meet market competition they must do so outside the producing countries. In some other countries, such as Venezuela, it is only necessary to pay taxes on the basis of "tax export values". For export purposes the foreign companies in Venezuela are free to use actual market prices. They take therefore a Foreign Tax Credit only on that portion of their foreign tax payments which is based on market prices. The balance is treated as an expense.

Since the U.S. Treasury takes the position that profits or losses for tax purposes should be based on transactions at real market values, it has argued that the Foreign Tax Credit should be based universally on foreign earnings arising out of <u>market</u> prices rather than government-imposed posted prices. The change would not bring about additional tax payments to the U.S. Treasury because all producing-country tax rates are above comparable U.S. tax rates. The only effect would be a reduction in excess Foreign Tax Credits.

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The table on the following page illustrates the workings of the Foreign Tax Credit, based on the estimated recent market price of one type of crude oil at the Persian Gulf. The table shows that the allowable Foreign Tax Credit equals slightly more than half the actual tax paid to the producing country. As pointed out earlier, the resulting excess tax credit may under certain conditions be used to reduce U.S. tax liability on earnings in other foreign countries.

The table also shows the effect of the removal of depletion allowance on foreign earnings which is currently under consideration by Congress. In the case shown, the excess tax credit would be unaffected (see footnote to table) because of a tax provision enacted in 1969 which invalidates that part of an excess foreign tax credit which is generated by the depletion allowance in countries whose tax rate is above that of the U.S. However, loss of the allowance could bring about an increase in U.S. tax liabilities from earnings in countries where the tax rate is below the statutory U.S. rate. The Treasury has estimated that removal of the depletion allowance on foreign oil production earnings would increase U.S. tax liabilities by $40 to $50 million a year.

The removal of both the Foreign Tax Credit and the depletion allowance would in the specific case shown create a U.S. liability of $1.28/bbl in addition to the $5.52/bbl liability to the producing country. This would cut the existing net profit of $2.67 on equity crude oil nearly in half.

Hypothetical U.S. Income Tax Liability
And Foreign Tax Credit On Equity Kuwait
Crude Oil, March, 1974 - (Posted Price $11.55)
($/bbl)

		Present Law		Present Law Without Depletion Allow.		No Foreign Tax Credit No Depletion Allow.
Recent Market Price		9.70		9.70		9.70
Depletion Allow. Computation:						
Rollback to Wellhead	0.08					
Royalty (12.5% of Posted Price)	1.44					
		-1.52				
Gross Depletable Revenue		8.18				
Depletion Allow. (22% of above)		1.80				
U.S. Income Tax Computation:						
Gross Income		9.70		9.70		9.70
Less:						
Royalty	1.44		1.44		1.44	
Operating Cost	0.07		0.07		0.07	
Depletion Allow.	1.80		-		-	
Kuwait Tax	-		-		5.52	
		3.31		1.51		7.03
Taxable Income		6.39		8.19		2.67
U.S. Tax @ 48%		3.07		3.93		1.28
Kuwait Income Tax (see p. 29)		5.52		5.52		5.52
U.S. Foreign Tax Credit		3.07		3.93		-
Excess of Kuwait Tax Over Foreign Tax Credit		2.45*		1.59		-
Total U.S.-Kuwait Tax Cost		5.52		5.52		6.80

*Internal Revenue Code Section 901 (e) would eliminate that part of excess foreign tax credit generated by the depletion allowance, so that the useable excess tax credit in this case would be the same as in the absence of the depletion allowance - $1.59.

Income Tax, Tax-Paid Cost And Effective
Tax Rate On Kuwait Equity Crude Oil
($/bbl)

a) Income Tax Calculation		b) Tax-Paid Cost to Companies
Posted Price	11.55	
Production Cost	-0.07	0.07
Royalty	-1.44	1.44
12.5% of posted price)		
Taxable Income	10.04	
55% Income Tax	5.52	5.52
Tax-Paid Cost to Companies		7.03

c) Effective Income Tax Rate

Market Price		9.70
Cost:		
Production	0.07	
Royalty	1.44	1.51
Pre-Tax Profit		8.19
Income Tax Payment		5.52
Ratio of Tax to Profit		67.4%

(4) The Real Profit Margin on Foreign Oil

The tables on pages 28 and 29 show that crude oil with an fob market value of \$9.70/bbl at the Persian Gulf has a total tax-paid cost to the producing company of \$7.03/bbl, resulting in a profit margin of \$2.67/bbl. This is substantially higher than the historic profit margin on foreign crude oil for most international oil companies. The sharp increase in the margin has created the impression that higher posted prices and tax payments in the foreign producing countries have moved in tandem with higher after-tax profits for the oil companies.

However, the profit margin shown in the two tables applies only to "equity" crude oil, that is crude oil owned by a private company and produced for its own account. Until 1973 virtually all crude oil (except royalty crude) produced in the Middle East and North Africa could be considered equity oil. Since then government companies in the producing countries have progressively taken over varying shares of the oil companies' equity. In Kuwait and Qatar equity crude will account for only 40% of total production. In Saudi Arabia a similar share is being negotiated, probably retroactive to January 1, 1974, while in Libya the companies' share seems to have been set at 49% of total production.

Since all of the established international oil companies need considerably more oil than their equity share entitlement to meet their internal and external market requirements, they must buy the balance back from the producing country government at prices imposed by the latter. While the level of many of these "buy-back" prices has not yet been determined, it will probably be near the current market price.

Thus, under the new system the profit on a company's equity crude must now be viewed in conjunction with the possible loss -- or, at the very least, absence of profit -- on its buy-back crude. Taken together, the overall profit margin per barrel of crude oil is therefore considerably smaller than that on a company's equity crude alone. For instance, a company with 40% equity crude, having to obtain the balance of its crude requirements under buy-back provisions or in the open market, could under our assumption, have an overall per-barrel profit of less than half of that received on its equity crude.

(5) Differential Treatment of State and Foreign Taxes

The question is sometimes asked why foreign income taxes are treated differently from U.S. state income taxes. A state income tax can only be deducted as an expense in computing federal income tax liability while a foreign income tax can either be deducted or be treated as a tax credit for federal income tax purposes.

The question is only superficially meaningful. State income taxes and foreign income taxes are simply not comparable. Since U.S. tax legislation treats all state income taxes alike, the problem of competitive advantage or disadvantage does not enter into consideration in the federal treatment of state taxes. In the treatment of foreign tax liabilities of U.S. firms, however, this consideration is of major importance. If the U.S. practice were to be more severe, that is create a greater total tax burden, than that of other nations, American firms abroad would of course be at a competitive disadvantage.

Treating foreign income taxes as a deduction for U.S. tax purposes would result in partial double taxation - taxation of the same income at the foreign source and at home. According to a calculation of the National Foreign Trade Council, this would increase the total tax burden for U.S. companies as follows in a number of selected countries:

Effective Income Tax Rate* For U.S. Companies

Local Tax Jurisdiction Of Subsidiary	Treating Foreign Taxes As A Deduction	Under Present Law	Percentage Increase
Canada	77.2	56.2	37.3
France	74.6	51.2	45.7
Germany	71.8	45.8	56.8
Italy	76.0	53.9	41.0
Japan	72.9	47.8	52.5
Mexico	73.2	48.5	50.9
Netherlands	73.3	48.6	50.8
United Kingdom	71.4	45.0	58.0

*Economic Implications Of Proposed Changes In The Taxation Of U.S. Investments Abroad, National Foreign Trade Council, Inc. June, 1972 p. 12

The increases would apply only to U.S. companies. Domestic companies in those countries would of course not be affected by it.

Nor would firms of third countries other than the U.S., since most countries either do not tax the foreign earnings of their business enterprises at all or allow a tax credit for such earnings.

Most other home countries of international oil companies treat taxation on foreign-source earnings at least as favorably as the U.S. Any weakening of the Foreign Tax Credit provision in our law would therefore create a disparity between the tax burden of U.S. and foreign oil companies. The U.K., the Netherlands, France, Italy, Germany, Belgium, Sweden and Japan, all home countries for companies with foreign oil operations, either exempt foreign earnings from taxation or grant full tax credits on such earnings.

Most of these countries -- the U.K., Netherlands, Italy, Germany, Belgium and Japan -- also permit the deduction of foreign losses. This indicates that U.S. tax legislation in this regard is in line with international tax practice.

A proposed change in this particular tax provision, requiring the recovery of these losses out of future earnings for U.S. tax purposes, would weaken the international competitive position of U.S. oil companies primarily in the one activity of most interest to the U.S. - the exploration and development of new areas. Most oil company losses abroad are incurred during the search for new oil deposits and the early development years of such deposits and are deductible either currently (with loss carry-over provisions) or are amortized over a period of years. However, any U.S. tax benefits that may be realized in the exploratory stage through deduction of losses are partly or wholly offset by the reduction of creditable foreign taxes during the pay-out period because most foreign producing countries also permit the deduction of such losses from future earnings.

If U.S. oil companies were required to refund the loss deductions to the Treasury out of subsequent earnings they would find it more difficult to bid competitively with non-U.S. companies in the ever faster race for access to the remaining petroleum resources around the world. The national interest would seem to indicate just the opposite stance on the part of the U.S. government. Certainly, no other country is putting these or other restraints on the foreign activities of its oil companies -- not even countries, such as the U.K. and the Netherlands, which have recently found substantial oil and gas reserves in their own home territories.

Senator FANNIN. The hearing will be recessed until 2 o'clock this afternoon.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 2 p.m. the same afternoon.]

AFTERNOON SESSION

Senator FANNIN (presiding). The meeting will come to order.

The first witness this afternoon will be Dr. Dan Throop Smith, professor of economics, Stanford University, and former Deputy Assistant Secretary of the Treasury.

Dr. Smith, again we are privileged to have you with us here this afternoon.

STATEMENT OF DAN THROOP SMITH, PROFESSOR OF FINANCE, EMERITUS, HARVARD UNIVERSITY; SENIOR RESEARCH FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY; AND FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. SMITH. Thank you, Mr. Chairman.

I must correct the record. It is not surprising that the identification is incorrect because I have moved around a great deal. I am professor of finance, emeritus, at Harvard University and now senior research fellow at the Hoover Institution, at Stanford University. I was successively Assistant, Special Assistant and Deputy to the Secretary of Treasury for Tax Policy from the period 1953 to 1959.

Recently I have been a member of the Commission on International Trade and Investment, the President's Task Force on Business Taxation, and chairman of the Tax Advisory Committee of the Council on Environmental Quality. I am also past President of both the National Tax Association and the Tax Institute of America.

I appreciate this opportunity to testify regarding proposed changes in the tax law, especially the taxation of income from foreign direct investment and depreciation allowances. I should like to supplement my comments and refer to certain points that were raised in the testimony this morning, particularly with reference to capital gains and the minimum tax.

Three general points need to be emphasized to place comments on these and other specific features of the tax law in proper perspective.

TAXATION INHERENTLY REPRESSIVE

First, it must never be forgotten that each and every tax is inherently repressive. Taxation, by itself, is discouraging. Individual income taxation discourages individual economic activity and personal investment by reducing net earnings. Business taxation discourages business investment and business activity directly by reducing net income, or indirectly by increasing costs and through higher prices, in reducing sales. Consumption taxation discourages consumption by increasing prices.

Since taxation is inherently repressive, it is misleading to speak of tax incentives or tax preferences. So-called incentives are really no more than attempts by the Congress to minimize the inherent repressive effects of taxation as it is applied to particular activities where the full impact would be particularly repressive or even destructive. One may choose to consider a lesser discouragement as a positive encouragement, one can think of many amusing analogies, but the implication is misleading. One analogy I thought of is if the good child is spanked briefly and the bad child is spanked at length, one might say that the good child is encouraged by being spanked only briefly. I think the analogy does somewhat apply on so-called tax incentives.

The distortion of language has been carried to the point of describing any level of taxation below the highest as a tax expenditure or tax subsidy. The ultimate implication seems to be that all income of all people rightfully belongs to the Government and that whatever the Congress does not tax away represents generosity by the Government to the people. It is sometimes even stated that money left in the hands of taxpayers represents money paid out by the Treasury. This attitude is such a ridiculous reversal of our most fundamental concepts of the relations between citizens and the Government that it may seem unnecessary to warn against it. I do so because casual acceptance of these cleverly contrived phrases can make particularly repressive tax proposals seem desirable and innocuous.

Tax Legislation Should Be Based on Reality

A second general point is the importance of basing tax legislation on the facts of the real world rather than theoretical models, often expressed in mathematical terms. The danger of reliance on overly-refined theory as well-expressed by Wassily Leontiev, Nobel Prize winner in economics, in his 1970 presidential address to the American Economic Association in which he commented that "continued preoccupation with imaginary, hypothetical, rather than observable reality has gradually led to the distortion of the informal valuation scale used in our academic community." Leontiev quoted with approval F. H. Hahn, a recent president of the Econometric Society, who said:

> The achievements of economic theory in the last two decades are impressive and in many ways beautiful. But it cannot be denied that there is something scandalous in the spectacle of so many people refining the analysis of economic states which they give no reason to suppose will ever, or have ever, come about. It is an unsatisfactory and slightly dishonest state of affairs.

As an economist, I agree wholeheartedly with these criticisms. It is tempting and intellectually satisfying to construct an elaborate theory about some aspect of taxation. But the theories are often based on assumptions about how people should react rather than on facts about how they do react. And it is more elegant to contemplate theory in an academic cloister, or refine it with a computer, than it is to seek actual facts.

Senator Fannin. Dr. Smith, I apologize for interrupting, but that is the signal that it is just a short time before the vote is going to be taken, so I will excuse myself, and then Senator Hansen is going to get back just as rapidly as he possibly can.

Mr. Smith. I am very alert to the reason. Thank you, sir.

Senator Fannin. We will stand in recess until we return.

[A brief recess was taken.]

Senator Hansen [presiding]. The hearing will come to order. The witness may resume.

Mr. SMITH. Senator Hansen, in the interests of time and because of the other witnesses who are waiting to appear, with your permission I shall make a few brief extemporaneous comments. My statement is on file, and I will call attention to that.

I note in my prepared statement the very great importance of a deliberate process of legislation, avoiding situations where, as the phrase is, major legislation is written on the floor without adequate recognition of the importance of refined analysis and refined calculations.

I recall the experience of 20 years ago in this committee in preparing the Internal Revenue Code of 1954, where so frequently, even after hearings, it was deemed to be necessary to go back to existing law, as the phrase was. That seems to me to be a particularly important thing at the present time.

I note further the importance of looking at the tax system as a whole rather than individual parts of it, in determining the appropriateness or fairness of the system. I refer to the analogy that in appraising a person's diet, one does not look at each dish to decide whether it contains the appropriate components. One looks at the entire combination of items in a meal or a diet rather than tossing out a particular dish because it does not have enough of this, that, or the other.

Too frequently the criticism of particular tax provisions look at the individual items as though they were the whole system of taxation.

TAXATION OF FOREIGN INCOME

In turning to the foreign tax credit, I note, as others have, that no other countries gives full double taxation of income from foreign investment. I note that it would be, I used the phrase, altogether destructive to impose full double taxation. It is inconceivable that we could do that. There are those who still contend that business investment abroad is against our national interests in that it reduces domestic employment and investment. The evidence is overwhelming, however, that business investment abroad actually increases domestic employment and our own exports. Foreign direct investment sustains rather than impedes our domestic economy.

We have never taxed undistributed income before of foreign subsidiaries except in special cases. To do so would bring in little if any revenue, because foreign tax laws inevitably would be modified to impose their own taxes on whatever amounts we taxed as imputed income.

I refer also to various other proposed technical changes indicating the conditions and restrictions that should be imposed if any of them were to be adopted. My general recommendation is that no change be made in the taxation of foreign income at the present time.

I note that I do not consider the present treatment ideal, however, especially the regulations under section 482 and proposed regulations under 861 need extensive revision. They are extremely complex. They may be of great intellectual satisfaction to a perfectionist, but they are an abomination to a practical man.

Various groups, some of which I have been associated with, have made recommendations for changes there.

DISC

With reference to the DISC, which has been discussed today, I note that the criticisms often ignore the realities of business. Too often the emphasis has been on the importance of price and price alone in determining exports. What is overlooked is the simple fact that most products do not sell themselves. Sales effort is required, and top management attention is necessary to stimulate and direct the sales effort. The DISC provisions can be significant in calling the attention of management to the advantages of exports.

This is particularly important in the United States where the domestic market is the principal market for most companies, in contrast to the situation in many European countries and Japan where exports are a large part of total sales and accordingly receive regularly major attention.

The phrase has been used by others that the DISC provision brought exports into the Board room, the top management paid attention to exports in a way that they had not done otherwise. I repeat, especially for American companies, small-, medium-sized ones, the exports do not come about automatically. It takes attention and direction of management, and DISC is very important in directing the attention of management to the possibilities of exports.

The economists have a phrase, the announcement effects. The announcement effects of DISC have been, I am sure, very significant.

Depreciation Allowances

On the depreciation allowances, the adoption of the asset depreciation range method of calculating depreciation reduced the tax penalties against capital investments by U.S. companies to levels somewhat comparable to those in other major countries. This was referred to by my colleague, Secretary Cohen, earlier this morning, former Secretary Cohen.

Our tax laws have been among the most stringent in the world with respect to depreciation allowances. That is, it has embodied the most forceful disincentives and then taking a long-range view, the process of improvement began in 1954 when declining balance depreciation was adopted in this committee on the recommendation of the Treasury. It was a relief measure compared to the previous requirement for straight line depreciation.

There were subsequent improvements in the adoption of the asset depreciation range, but when that was first adopted, it was almost nullified by a reserve ratio test.

The present treatment has, for the first time, made our law reasonable and competitive with others.

Attacks on Corporate Profits Unreasonable

Now, my final comment has to do with the current attack on corporate profits which seems especially inappropriate and unreasonable. With returns of 8 to 10 percent available on passive investments, corporate profits must rise to secure new funds and to justify the use of whatever funds are available in corporations for business investments with all of their inherent risks. It is, in fact, questionable whether normal uses of retained earnings are justified when profits are under attack and alternative uses are available at existing interest rates. Fortunately, tradition is strong and customary patterns of business behavior persists, but if there is a freeze on profits or a reduction in income directly or indirectly through changes in the tax laws, the alternative uses of corporate funds will come to be considered by management or insisted on by stockholders.

The attacks on corporate profits by some groups represent an adversary point of view which, if it prevails, can have truly catastrophic effects on our economy, and I do not use the word "catastrophic" lightly. An adversary point of view seems to prevail in England where individual income tax rates on investment income have been raised to 98 percent. Such taxation represents, in the words of one English journal, "pure fiscal vindictiveness." The changes under consideration here fall far short of such an extreme, though some of them certainly reflect an adversary point of view, which approaches a punitive if not a vindictive attitude toward our system of enterprise. The proposals now under consideration for hasty change in the tax law require careful analysis and extensive review to avoid unintended repressive and even destructive consequences.

Senator, I prepared a memorandum on the role of profits in business which I would like to have included as a supplement to my statement. It immediately follows my prepared statement.

Senator FANNIN (presiding). Yes, Doctor, that will be included as a part of your statement, and your testimony.

We apologize. We have to rush off.

We do have some questions on that. I do not know what your time is, whether your timing is critical or not.

Mr. SMITH. I have to get a plane back to California this evening. I just came last night. I will be glad to wait if I may.

Senator FANNIN. We can submit the questions to you if they would save you time.

Mr. SMITH. I would be glad to wait if it is another vote.

Senator FANNIN. Yes, it is another vote. We had better run, but we certainly apologize.

We appreicate very much your testimony. I am just sorry that all of the Senators were not here to hear you, and I assure you that this will be placed in the Congressional Record so they will have an opportunity, not only the members of the committe, but all of the Members of Congress, to review your testimony.

Mr. SMITH. Thank you, sir.

Senator FANNIN. We will stand in recess until we return.

[A brief recess was taken.]

Senator FANNIN. The hearings will resume.

Professor Smith, let me again apologize to you for the interruptions.

SLIDING SCALE FOR CAPITAL GAINS TAXATION

Dr. Smith, we briefly discussed this morning a bill I introduced which would provide a sliding or graduated scale to the tax on capital gains.

Could you give the committee the benefit of your views on this subject?

Mr. SMITH. Senator, the sliding scale has been something that has seemed to me to be as important a single improvement as could be made in the tax law. It happens to be a topic that I have given a great deal of thought to and have given considerable attention.

If I may call attention to a publication of the Tax Foundation, December 1972, based on a speech I gave. The first sentence of that speech. "Capital gains of individuals should be taxed on a sliding scale with assets held for longer periods subject to successively lower rates of tax." My concluding sentence—

> The change for a sliding scale with short term gains taxed more heavily and long term gains taxed less heavily than at present would be a major improvement in our tax laws. It is desirable from the standpoint of both fairness and economic consequences.

Senator FANNIN. Dr. Smith, you are reading from a record. Is that a Congressional Record?

Mr. SMITH. I am reading from a record. I put this into the hearings of the Ways and Means Committee the first day of hearings on general tax reform last year. That is published on pages 110 and 113 of volume 1. I do not have a loose reprint with me at the moment.

I stand, as I did previously over several years, in believing that this would be the most significant and useful change that could be made in the taxation of individual incomes other than a general reduction in the top bracket rate to 50 percent.

INFLATION CONFISCATING CAPITAL RECOVERY ALLOWANCES

Senator FANNIN. Well, thank you very much. And today you brought out that current capital recovery allowances do not compensate for the confiscation of capital by inflation. I think this has been brought out. This too was brought out by Dr. Cohen.

Mr. SMITH. I heartily concur on what was said on that. They fall way short of compensating. If I may elaborate just very briefly on the point that Senator Bennett raised as to whether any other country had made allowances for that, I indicated that France had done so. I should like to explain that France did it on the basis of index numbers, rather than a specific replacement cost of specific items of machinery. This was something that was adopted in France a great many years ago. I believe their adjustment went all the way back to a base year of 1913 before the First World War.

With reference to the adjustments for replacement cost, until relatively recently I hoped that our inflation would not be so bad that we would have to make this complication, insert this complication in the law. But I am afraid now that the level of inflation which we have and which seems to be in prospect is such that I would urge this committee to give very serious consideration to an adjustment in depreciation allowances to take account of higher replacement costs. But I believe that would have to be done crudely and roughly on index number bases, rather than identification of specific items of equipment.

EFFECT OF REPLACING FOREIGN TAX CREDIT WITH A DEDUCTION

Senator FANNIN. Thank you very much, Dr. Smith. And incidentally, I will refer to your testimony in the House last year, and also see if I cannot incorporate some of your recommendations in the record at the same time as I put in your statement. On another subject, on the foreign tax credit; it has been estimated that by substituting a deduction for a credit, it would increase the effective tax rate on the overseas income of U.S. corporations operating in other industrialized nations from a present range of 45 to 56 to 71 to 77 percent.

Would this amount to near confiscation?

What is your thought in that regard?

Mr. SMITH. In my opinion that would amount to near confiscation. I have figures in my prepared statement, which I omitted in the interest of time, indicating that if one goes from a 50-percent rate in both countries, in effect you have a 75-percent rate.

Another way of looking at that is that the amount of income left after taxes is only one-half of what is available as net income in either country alone. It would place American business in a completely untenable position. It would, I think, force the liquidation and sale of assets by American companies abroad, often at distress prices. It would remove the potential for future income from foreign business investment, which is particularly important in our present balance-of-payments situation.

COMPANY PROFITS BOLSTERED BY UNDERDEPRECIATION

Senator FANNIN. Dr. Smith, we are trying to show in proper perspective just what has happened as far as the American oil companies. We are not taking a position in favor of them or in opposition, but we feel that they should be treated fairly and equitably.

The first quarter results of their profits show many American companies with recordbreaking accomplishments.

Is it not true, though, that many companies' profits were bolstered by underdepreciation which ignores soaring replacement costs?

I think this is something that you brought out.

But to be a little more specific, do you agree with that statement?

Mr. SMITH. I do.

Senator FANNIN. Well, I certainly thank you, and Senator Byrd will take over as the chairman.

Senator BYRD [presiding]. Thank you, Senator Fannin.

Mr. Smith, do you feel that the depreciation rates should be further increased over what they are now, the accelerated depreciation?

Mr. SMITH. If there were to be any changes, I think they should be in the direction of permitting faster, rather than slower, writeoffs—that is, increasing the depreciation rate, as you say.

Senator BYRD. If there is going to be any change, well then, do I gather from that that you feel that the depreciation rates are about right now and should be left alone?

Mr. SMITH. Well, I have not contemplated a further liberalization because I am so concerned with arguing against a lengthening. But on an international comparison, as others have pointed out this morning, as the record shows, in many places—I believe Mr. Sanden, who is scheduled as a witness later today may also have further evidence on this, and I defer to him—our treatment is relatively stingy among major industrial countries at the present time.

Senator BYRD. Well, thank you very much, Mr. Smith. We really appreciate your being here today.

Mr. SMITH. Thank you, Senator.

[The prepared statement of Mr. Smith and material for the record follow:]

Statement by

Dan Throop Smith

Senate Finance Committee

June 11, 1974

Mr. Chairman and members of the Senate Finance Committee, I appreciate this opportunity to testify regarding proposed changes in the tax law, especially the taxation of income from foreign direct investment and depreciation allowances.

Three general points need to be emphasized to place comments on these and other specific features of the tax law in proper perspective.

First, it must never be forgotten that each and every tax is inherently repressive. Taxation, by itself, is discouraging. Individual income taxation discourages individual economic activity and personal investment by reducing net earnings. Business taxation discourages business investment and business activity directly by reducing net income or indirectly by increasing costs and, through higher prices, reducing sales. Consumption taxation discourages consumption by increasing prices.

Since taxation is inherently repressive it is misleading to speak of "tax incentives" or "tax preferences." So called incentives are really no more than attempts by the Congress to minimize the inherent repressive effects of taxation as it is applied to particular activities where the full impact would be particularly repressive or even destructive. One may choose to consider a lesser discouragement as a positive encouragement -- one can think of many amusing analogies -- but the implication is misleading.

The distortion of language has been carried to the point of describing any level of taxation below the highest as a "tax expenditure" or "tax subsidy." The ultimate implication seems to be that all income of all people rightfully belongs to the government and that whatever the Congress does not tax away represents generosity by the government to the people. It is sometimes even stated that money left in the hands of taxpayers represents money "paid out" by the Treasury. This attitude is such a ridiculous reversal of our most fundamental concepts of the relations between citizens and the government that it may seem unnecessary to warn against it. I do so because casual acceptance of these cleverly contrived phrases can make particularly repressive tax proposals seem desirable and innocuous.

A second general point is the importance of basing tax legislation on the facts of the real world rather than theoretical models, often expressed in mathematical terms. The danger of reliance on overly-refined theory was well-expressed by Wassily Leontiev, Nobel Prize winner in economics, in his 1970 presidential address to the American Economic Association in which he commented that "continued preoccupation with imaginary, hypothetical, rather than observable reality has gradually led to the distortion of the informal valuation scale used in our academic community." Leontiev quoted with approval F. H. Hahn, a recent president of the Economic Society, who said, "the achievements of economic theory in the last two decades are impressive and in many ways beautiful. But it cannot be denied that there is something scandalous in the spectacle of so many people refining the analysis of economic states which they give no reason to suppose will ever, or have ever, come about.... It is an unsatisfactory and slightly dishonest state of affairs."

As an economist, I agree wholeheartedly with these criticisms. It is tempting and intellectually satisfying to construct an elaborate theory about some aspect of taxation. But the theories are often based on assumptions about how people should react rather than on facts about how they do react in real life. And it is more elegant to contemplate theory in an academic cloister, or refine it with a computer, than it is to seek actual facts. The pursuit of factual knowledge is often considered intellectually demeaning.

Fortunately, our process of legislation provides for successive steps in which evidence is collected, through hearings and otherwise, tentative policy decisions are reached, draft legislation is prepared, and additional hearings are held to appraise the consequences of tentative decisions before final action is taken. The successive hearings, monotonous and tedious though they must be to you who have to devote so much time to them, are essential to assure a reasonably solid base for legislation. My counterparts in foreign finance ministries, during the time I was responsible for tax policy in the Treasury, used to speak with envy of our legislative process insofar as it assured sufficient deliberation to avoid major errors because of inadequate review.

Those of you who labored through the development of the present Internal Revenue Code just twenty years ago will recall in how many instances what appeared to be desirable changes even after a first set of hearings turned out to have unintended undesirable results with a need for extensive revisions or, in many cases, a reversion to existing law. The phrase "Back to existing law" became a frequent slogan. Its use indicated wisdom rather than defeat.

A third general point is the importance of seeing the tax structure as a whole, made up of many parts. Though a single segment might not be ideal if it existed alone, it may be a reasonable and necessary part of a complex tax system. A breadth of view is especially necessary in appraising the distribution of the tax burden. Too often, individual elements of the tax system are condemned as not being, by themselves, progressive. But it is as ridiculous to expect each tax to conform to whatever degree of progression is desired for the system as a whole as it would be to criticize each dish in a meal for not containing the exact proportions of proteins, carbohydrates, salt and even iodine needed for a balanced diet. It is the composite of dishes and meals which must be judged to decide whether a diet is healthy. It is the composite of separate taxes which must be judged to decide whether the tax system as a whole will finance a healthy government -- and leave enough private income for a healthy economy and society.

More fundamentally, even the entire tax system should not be viewed alone in an appraisal of the equity or fairness of government financing. Government expenditures must also be analyzed in terms of the distribution of benefits by income classes and other classifications. The distribution of benefits must be compared to the distribution of tax burdens. The studies made thus far indicate that government expenditures are of disproportionately large benefit to those with lower incomes, with steadily decreasing benefits as incomes increase. On this basis, even a proportioned tax system would have the effect of redistribution to those with lower incomes. It is thus doubly unjustified to criticize a particular tax, or a particular change in the tax system, because it is not, in and of itself, progressive.

Elimination of the credit for foreign income taxes or current taxation of foreign business income and substantial reduction of present depreciation allowances would, in my opinion, do great harm to the vitality of our national economy and our national well-being. It is, in fact, hard to conceive of two other changes in the taxation of business, other than adoption of an excess-profits tax, which would be equally damaging. The basic issues are clear though the analysis can be extensive and elaborate. I shall confine my comments to the essential elements.

When business is conducted in two or more countries, each country has a right to tax it in any way it chooses. If each country imposes its full rates of taxation, as it is entitled to do, the combined effect is almost certain to be destructive. Two successive income taxes of 50 percent, for example, give a combined tax of 75 percent and a net income of only 25 out of a pre-tax income of 100. The net of 25 is only one-half of that available from income entirely earned in either country alone.

For more than fifty years, various methods have been developed in different countries to alleviate what would have been double or even higher multiple taxation of international income. The United States and many other countries have used the tax credit method. The need for relief was recognized even when corporate tax rates were much lower than at present, of the order of 10 percent. At present levels, double taxation would be, to repeat the word, destructive.

No other major country fails to give relief from multiple taxation. If U. S. business were subjected to a double burden by denial of the credit for foreign income taxes it would generally become non-competitive. Foreign business assets would have to be sold, probably at distress prices. Income from foreign investment would dry up, still further weakening our balance of payments at a time when foreign exchange is so very important to pay for the vastly increased costs of our oil imports.

Some still contend that business investment abroad is against our national interests in that it reduces domestic employment and investment. The evidence is overwhelming, however, that business investment abroad actually increases domestic employment and our own exports. Foreign direct investment sustains rather than impedes our domestic economy.

It is also proposed to tax currently the undistributed income of foreign subsidiaries of U. S. corporations. This proposed change is sometimes referred to as a removal of a "deferral" of taxation of income from subsidiaries. The word "deferral" has come to be widely used in this connection but it is as thoroughly unjustified as are the phrases "tax expenditures" and "tax subsidies." It would not be far-fetched to assert, as an analogy, that the estate tax was "deferred" until death for those who lived beyond their expectancy. Since, on the average, estate taxes are payable when life expectancies run out, any one living beyond that time might be thought of getting a special tax break.

We have never taxed undistributed income of foreign subsidiaries, except in special cases involving tax havens. Nor has any other major industrial country taxed such income. Furthermore, to do so would bring in little, if any, revenue because foreign tax laws inevitably would be modified to impose their own taxes on whatever amounts we taxed as imported income to U. S. parent corporations. If we presume, for tax purposes, that the income of foreign companies is taxable to a U. S. company as though it had been received, when in fact it has not, the countries where the subsidiaries are located will presume, for their tax purposes, that the income has been paid out and hence taxable under their dividend taxes, even when in fact it has not been paid out. The net result will be more taxes paid to foreign governments and less retained earnings for investment by our foreign subsidiaries. Foreign governments will receive more taxes and the competitive position of U. S.-owned subsidiaries will be weakened. The proposal seems to reflect a fondness for taxation for the sake of taxation, even though the consequences are in no way in our national interest.

Other, more technical changes may be proposed regarding the taxation of foreign business income. All of them require thorough examination which is beyond the scope of my brief testimony today. The option of a per country or overall limitation on foreign tax credits was developed more than a decade ago by this committee. Each method is valid under different circumstances. Neither should be brushed aside without thorough review.

A proposal to require a minimum distribution from foreign subsidiaries may be less damaging than current taxation of all undistributed earnings, if some change is to be made. But a minimum distribution rule also would require careful analysis to determine the appropriate level of distribution and to define the income subject to the requirement. It appears, for example, that if the specified percentage were applied only to operating income rather than total income, a substantial tax barrier might be imposed against funds needed to meet competitive requirements abroad.

Another proposed general rule, imposing a U. S. tax on undistributed income of foreign subsidiaries if the foreign tax rate is below a specified level, raises another seemingly technical matter with far-reaching implications. The rule would appear to be particularly onerous if it were applied on a per country basis. Issues of this sort, though they may appear to be technical, can have major impacts on particular industries and companies, action on them deserves thorough review in hearings.

The foregoing comments are not intended to imply that the present tax treatment of foreign income is ideal. The application of section 482 and the proposed regulation under section 861 regarding the allocation of income and expenses between related companies need extensive revision along lines which have been advocated by many advisory groups. Regulations under these sections are complex. They may give great intellectual satisfaction to a perfectionist but they are an abomination to a practical man.

A threatened disallowance of expenses in the U. S. on the grounds that they are in part attributable to a sales branch abroad is enough to discourage a small or even a medium-sized company, from pushing its exports effectively. International agreement on rules for allocation of international income would be desirable but they have not been established. We have acted unilaterally and should not expect others to relieve our companies of unreasonable burdens which we impose on them in international business.

Criticisms of our DISC provisions also often ignore the realities of business. The DISC rules usually have been considered in terms of their impact on pricing of export goods and it is sometimes said that the possible effect on prices is not sufficient to justify this special treatment. What is overlooked is the simple fact that most products do not sell themselves. Sales effort is required and top management attention is necessary to stimulate and direct the sales effort. The DISC provisions can be significant in calling the attention of management to the advantages of exports. This is particularly important in the U. S. where the domestic market is the principal market for most companies, in contrast to the situation in many European countries and Japan where exports are a large part of total sales and accordingly regularly receive major attention.

With reference to depreciation allowances, the adoption of the Asset Depreciation Range method of calculating tax depreciation reduced the tax penalties against capital investment by U. S. companies to levels somewhat comparable to those in other major countries. I emphasize, along the lines of my opening comment, that present depreciation allowances are not a tax incentive. The corporation income tax is a major tax disincentive. Faster depreciation merely reduces this inherent tax penalty on business investment and activity. Even if all capital investments were written off, that is, expensed, in the year of acquisition, the income tax would still be a disincentive to business investment.

Our tax law has been among the most stringent in the world with respect to depreciation allowances, that is, it has embodied the most forceful disincentive. The process of improvement began in 1954 when declining-balance depreciation was adopted in this Committee on the recommendation of the Treasury. That was a relief measure compared to the previous requirement for straight-line depreciation. As was then recognized there was nothing sacrosanct about straight-line depreciation. Declining-balance depreciation is equally reasonable, perhaps more so. A decade later, less stringent group depreciation was authorized but its advantages were largely nullified by a reserve ratio test. The present treatment, first adopted by the Treasury and later incorporated into specific legislation, has at last put our tax law on a sensible basis for the first time since the issuance of the notorious T.D. 4422 forty years ago.

It would be peculiarly unfortunate if the tax disincentives on business were to be increased now by reversing the major improvements of the past 20 years.

The need for capital investment is particularly great and the usual sources of capital are unusually scarce or costly. High interest rates, which are the inevitable result of inflation, increase the cost of borrowed funds. Corporate profits are generally overstated by the extensive use of first-in first-out inventory accounting. Depreciation allowances based on historic cost fall even further short of covering replacement costs. The low level of the stock market makes new issues of corporate stock almost prohibitively expensive in terms of the dilution of the interest of existing stockholders. Only retained earnings remain as an available source of funds to meet normal requirements and make up the deficiencies in other sources.

An increase in corporate taxes through a reduction in depreciation allowances would, in the first instance, reduce the funds available for retention or, to the extent that higher taxes could be shifted forward, give a further twist to the inflation spiral through tax-induced price rises. Eash of these points deserve elaboration and I would be glad to develop any of them.

The current attack on corporate profits seems especially inappropriate and unreasonable. With returns of 8 to 10 percent available on passive investments, corporate profits must rise to secure new funds and to justify the use of whatever funds are available in corporation for business investments with all their inherent risks. It is, in fact, questionable whether normal uses of retained earnings are justified when profits are under attack and alternative uses are available at existing interest rates. Fortunately, tradition is strong and customary patterns of business behavior persists, but if there is a freeze on profits, or a reduction in income directly or indirectly through changes in the tax laws, the alternative uses of corporate funds will come to be considered by management or insisted on by stockholders.

The attacks on corporate profits by some groups represent an adversary point of view which, if it prevails, can have truly catastrophic effects on our economy -- and I do not use the word catastrophic lightly. An adversary point of view seems to prevail in England where individaul income tax rates on investment income have been raised to 98 percent. Such taxation represents, in the words of one English journal, "pure fiscal vindictiveness". The changes under consideration here fall far short of such an extreme, though some of them certainly reflect an adversary point of view, which approaches a punitive if not a vindictive attitude towards our system of enterprise. The proposals now under consideration for hasty change in the tax law require careful analysis and extensive review to avoid unintended repressive and even destructive consequences.

Inflation, Interest Rates and Profits

Dan Throop Smith

Actual or prospective increases in business profits are frequently criticized as unjustified -- and sometimes even condemned as "extortionate" or "unconscionable." But it is these criticisms which are themselves unjustified. In view of inflation and the present and prospective interest rates in the range of 7 to 10 percent, approximately double those of a decade and more ago, business profits must increase above traditional levels to provide adequate funds -- and to justify the use of whatever internal and external funds are available -- for business purposes.

Interest rates, inflation, stock prices and corporate prices are all interrelated in the capital markets. The causal connection between inflation and high interest rates is not clear. To some extent the influence is through the supply side, as lenders seek to protect themselves from the falling value of money. To some extent the higher interest rates arise from increasing demand, as potential borrowers of all sorts seek funds to buy assets in anticipation of further price rises.

Regardless of the relative weight of the various reasons, inflation and higher interest rates go together. And together, inflation and higher interest rates are the basis for these comments on the justification and need for business profits which are higher in both dollar amounts and in apparent rates of return on assets than have been customary in recent years.

The fact that 7, 8, 9 or 10 percent returns are available on passive, virtually riskless investments establishes a base against which both investments of corporate funds in business assets and purchases of common stock by individual and institutional investors, with all their risks and uncertainties, must be compared. A prospective 10 percent return after taxes on business assets may have been adequate when compared to a 4 or 5 percent on passive investment. But with a base of perhaps 8 percent available on passive investments in securities with no risk of default, return of much more than 10 percent is needed to justify commitments of funds to business risks.

Present levels of interest rates combined with rising prices due to inflation have many implications for business finance and investment, with ramifications throughout the entire economy. Among the principal consequences are the following four propositions, each of which could be developed at length. They are stated concisely here for the sake of brevity.

1) The direct adverse effect of higher interest rates on stock market prices is familiar to anyone who reads the daily financial news, though the underlying reasons are not self-evident.

A higher interest rate forces the price/earnings ratios of common stocks down. The price/earnings ratio of stock represents a capitalized value of anticipated corporate earnings. With interest rates at 5 percent, a price/earnings ratio of 20 might be regarded as comparable, if one ignores risks. A ratio of 20 represents a 5 percent "return" on the market value of the purchase price of stock, with some or all of the "return" consisting of earnings retained by the corporation. The greater risk in the corporate use of funds may be considered as roughly offset by the prospect of growth of earnings.

But with interest rates at 8 percent, a comparable price/earnings ratio would be 12.5/1. Only at that price would there be an equivalent 8 percent "return" on the purchase price of stock. And with growth prospects for corporate earnings jeopardized by widespread criticisms of profit levels, a much lower price/earnings ratio, and hence lower stock prices, would be expected to allow for the greater risk and inherent uncertainty in business ventures.

Present price levels and price/earnings ratios of corporate common stocks thus may not be a temporary aberration due to doubt and uncertainty about the immediate course of business but rather a delayed readjustment of stock values to conform to the base established by the higher level of interest rates which has developed during the past several years.

Shifts in portfolio investment policies by professional investment managers in response to present comparative yields in bonds and stocks may be slow, as they were a decade and more ago in the reverse situation when bond prices were high and stock prices relatively low in view of existing and prospective corporate profits. Now a fondness for growth stocks in preference to traditional portfolios seems to persist regardless of much higher yields from bonds. But justification for continued fondness for growth stocks -- and for stocks in general as an inflation hedge -- rests on continued growth of corporate profits -- and that is the point at issue.

2) A lower level of stock prices, the corollary of lower price/earnings ratios, discourages corporate financing by new stock issues. At lower stock prices, additional claims against corporate income

represented by new stock are likely to increase more than the earnings from new assets, thus diluting per share earnings. Dilution of earnings is and should be a major barrier to new financing. It is neither fair nor prudent to make corporate investments when the "cost" of new equity funds reduces the earnings of the existing equity interest.

The lower the price/earnings ratios, the larger the profits must be to support stock prices which will permit new stock issues without dilution. Thus by leading to lower price/earnings ratios, higher interest rates make higher profits necessary to permit new stock issues without dilution.

The popular presumption that corporate common stocks provide a hedge against inflation is nullified to the extent that corporate profits are held down to an earlier level. A realization of this fact would discourage investments in corporate stock, still further depressing stock prices and discouraging corporate financing by new issues of stock.

3) Higher interest rates also make higher profits necessary to justify retention of corporate earnings for business purposes. With passive investments yielding returns in the 7 to 10 percent range, returns from funds used in business activities should be commensurately larger to justify their use for business purposes.

The same point applies to internal funds arising through depreciation and other non-cash expenses. Replacement of plant and equipment, though customarily made with less regard to profitability than investments of funds from outside financing, really is justified only if the new assets yield profits sufficient to give a rate of return appropriately higher than that available on passive investments.

Use of corporate funds for passive investments, except as a temporary measure, is not among the alternatives regularly considered by management. Nor is a major increase in the proportion of earnings distributed to stockholders, let alone a partial liquidation of a company, ordinarily considered, even if stockholders might make more profitable use of the funds thus distributed. Many objectives other than maximum returns influence decisions on dividends, including desires of management for continuity and growth of the enterprise as a business entity. These other objectives may conflict with maximum rate of return on the equity segment of the total investment. In time, however, pressures from stockholders may be presumed to develop to force distributions of corporate funds which cannot earn returns commensurate with those available on passive investments.

4) Analysis of the level of business profits necessary to provide a reasonable margin above the returns available from passive investment must take account of the fact that during periods of inflation business profits are grossly overstated by conventional accounting practices. The critical factors are well known. Overstatements arise from a) inventory profits, through widespread use of first-in first-out inventory accounting and b) depreciation based on historical cost rather than replacement cost.

First-in first-out inventory accounting shows as profits amounts which are and must be automatically reinvested in inventory to maintain any given physical quantity of inventory. In periods of inflation, inventory "profits" are substantial in amount and completely unsubstantial in providing funds for business purposes.

Inflation also makes depreciation based on historical cost inadequate to replace old buildings, machinery and equipment. New funds, either from retained earnings or from new borrowings or stock issues, thus become necessary even to maintain an existing plant capacity when depreciation is based on historical cost. Still more funds are needed to cover the costs of new environmental standards and other social concerns.

It is thus particularly unreasonable to consider a prior <u>absolute</u> (dollar) level of corporate profits as a norm. With higher prices of commodities and higher costs of production, more funds are required for working capital to maintain a given level of physical inventory and also even to finance a given physical level of credit sales to customers. With higher costs for replacements of old plant and equipment and with the need for expanded capacity, more funds are required for fixed capital and hence larger absolute (dollar) profits are necessary even to maintain a given rate of return on capital.

But, to revert to the first proposition, even higher <u>absolute</u> (dollar) profits are inadequate if they are not enough higher to provide a higher rate of return on a larger investment of funds. The base established by the new level of interest rates thus justifies and indeed requires an increase in profits sufficient to yield a competitively higher <u>rate</u> of return on a <u>larger</u> investment.

Protests about corporate profits, whether spontaneous, stimulated or simulated, ignore the actual facts indicated by careful analysis, such as the conclusion of the National Bureau of Economic Research in its March 1974 Report (p. 6) that in 1973

> ". . . adjusted after-tax profits per unit of output fell by three per cent. As a matter of fact, the latter have remained at about the same level since 1971, and lower than in any year since 1948 except for 1969 and 1970. The contribution of this factor to the inflationary surge of 1973 was, if anything, negative."

The foregoing four points reinforce each other and support the general proposition that the present and prospective level of interest rates establishes a new and much higher base for returns on passive investments against which business profits must be compared. Unless business profits rise substantially above previous traditional levels, both in absolute (dollar) amounts and in rates of return, they will not provide adequate funds, or adequate incentives to use what funds are available, for business purposes. It is not only fair for the level and rate of profits to rise under the present economic circumstances. It is also necessary for profits to rise above past levels in dollars and in rates of return if investment in business assets is to be maintained. The case for increased profits deserves systematic and widespread support to offset misconceptions and criticisms regarding present and prospective profits.

Senator BYRD. The next witness will be Mr. Dennis P. Bedell, chairman of the AMC, American Mining Congress Tax Committee.

STATEMENT OF DENNIS P. BEDELL, CHAIRMAN OF THE AMERICAN MINING CONGRESS TAX COMMITTEE, ACCOMPANIED BY LAURENCE P. SHERFY, VICE PRESIDENT AND GENERAL COUNSEL OF THE AMERICAN MINING CONGRESS

Mr. BEDELL. Thank you, Mr. Chairman.

Senator BYRD. We are glad to have you, Mr. Bedell. You may proceed as you wish.

Mr. BEDELL. Thank you, sir.

For the record, my name is Dennis Bedell. I am appearing today on behalf of the American Mining Congress, which is a trade association representing all segments of the mining industry. Accompanying me is Laurence P. Sherfy, vice president and general counsel of the Mining Congress.

Mr. Chairman, we appreciate this opportunity to appear before the committee to express the concern of the mining industry with the proposed Senate floor amendments to H.R. 8217. This concern is essentially twofold: first, with the procedural situation in which the amendments are being considered; and second, with the very adverse effects that many of those amendments would have on the mining industry's ability to meet the challenges facing it.

PROCEDURAL SITUATION IN WHICH TAX AMENDMENTS ARE BEING CONSIDERED

I would like to briefly comment on the procedural situation. Traditionally, major tax legislation has received the very careful consideration of the tax-writing committees of Congress. One need only recall the Revenue Act of 1971, and Tax Reform Act of 1969, and the very lengthy hearings and extensive markup sessions in which the tax-writing committees deliberated, evaluating the proposals made and facts presented, in formulating that legislation.

The present situation makes it very difficult to pursue this orderly method of considering tax legislation. We commend the committee for having these hearings, but it appears unlikely that the Finance Committee will be able to give to the proposed amendments the degree of consideration which they warrant. And this, we respectfully submit, is a most unfortunate situation.

SERIOUS EFFECT OF CERTAIN AMENDMENTS ON THE MINING INDUSTRY

Of even greater concern to the mining industry, however, is the serious effect which many of the proposed amendments would have on the mining industry's ability to meet the challenges facing it in the years ahead.

We face a severe shortage of the minerals which are so essential to our economy. The Secretary of the Interior has projected the demand for and supply of, minerals in the United States for the year 1985 and the year 2000. In the year 1985, it is projected that domestic production of hard minerals will total $21 billion. Domestic demand, however, will be almost twice that or $40 billion, leaving a gap between domestic demand and domestic production of $19 billion.

In the year 2000 domestic production is projected to rise to the level of $26 billion. The projected demand, however, will be almost three times that or $70 billion, leaving a shortfall of $44 billion.

At the same time that this is projected to occur, demand around the world for minerals is increasing. Even though over the past years our consumption in the United States of minerals has increased, as a percent of worldwide production it has decreased. In the period 1950 to 1968, it decreased from 42 percent to 28 percent, indicating the increasing demand in other areas of the world for minerals.

Now, to meet the challenge of developing adequate domestic resources to fill this gap or to narrow it will require tremendous amounts of capital. We at this point have discovered most of our rich ore bodies. The ones that are left are generally low-grade deposits. This requires very sophisticated means of exploration to locate them and the use of costly equipment. The development of these deposits is extremely expensive. Many of them require underground operations which entail substantial additional costs.

In many cases, we must first develop the technology required to mine and process these minerals before it is economically feasible to do so.

Finally, the capital investment required for processing facilities once the minerals are extracted from the ground is of very large magnitude. The mining industry is also faced with substantially increased costs as a result of legislation which has been enacted in recent years in the area of environmental matters and health and safety.

This obviously will require a great amount of capital. The needed funds have to either come from internally generated cash flow of the mining companies or from external financing. A reasonable level of profitability is crucial to both of these.

The proposed amendments that would increase the minimum tax—in the case of corporations to a large extent the minimum tax is merely an additional tax on percentage depletion, and the repeal of the investment credit and the asset depreciation range system for an industry which is as capital intensive as the mining industry would severely increase its current tax burden and take from it very significant amounts of profits and funds, thereby seriously impairing its ability to meet the challenge of developing additional domestic resources.

The amendments also contribute to the climate of uncertainty that makes it very difficult to engage in an orderly development of our resources. The discovery of an ore body and the development of a mine is a long-term project, and a mining company must be able to estimate at the outset of that project with some degree of reasonableness the costs that will be incurred. If changes are to be made of a major magnitude in our tax laws on a cyclical basis, reinstating the investment credit and repealing it, adopting the asset depreciation range system and then repealing it, this makes it very difficult to plan and to engage in a rational manner in the undertakings which these expenditure programs require.

I would like to comment briefly on the importance to us of foreign sources of minerals. It is obvious that with the tremendous gap between domestic production and demand facing us, we will have to continue to rely on foreign sources of minerals in the short-run. In the long-run, even as we develop our domestic resources, there will be a need in the case of some minerals to continue to rely on foreign sources precisely because those minerals do not exist in this country. It is important for this purpose that U.S. mining companies be able to participate in the development of foreign mineral sources to help provide us with assurance that these supplies will be available to us.

For American mining companies to be able to do this they have to be able to effectively compete with mining companies from other major industrialized countries of the world such as the United Kingdom, France, Japan, and Germany.

The American Mining Congress had prepared for it a study by the accounting firm of Coopers and Lybrand of the relative tax treatment by various major capital exporting countries of investments by their companies in countries where mineral bodies are located. This study showed that of these major capital exporting countries, the U.S. tax system generally treats our companies in a worse manner in terms of the after-tax rate of return from the investment than do the tax systems of other countries.

Therefore, we are already at a competitive disadvantage abroad in trying to develop and maintain foreign mineral sources of supply. Changes which would further increase the tax burdens on foreign investments of U.S. mining companies, such as through cutbacks in the foreign tax credit or limitations on its use or the repeal of the Western Hemisphere Trade Corporation deduction, would worsen the already bad situation American mining companies face abroad.

Thank you, Mr. Chairman, for this opportunity to present our views to you.

MINERAL SHORTAGE

Senator BYRD. Thank you, Mr. Bedell.

You mentioned shortages of minerals.

Of course, that does not apply to all minerals, does it?

Mr. BEDELL. It does not, sir. There are some 104 minerals, most of which are represented in the American Mining Congress, and with respect to some the potential shortage is greater than others, and it is true that there is not a projected shortage with respect to every one.

Senator BYRD. Which minerals will be in the greatest short supply?

Mr. BEDELL. Some of the ones, running down the list—aluminum is projected to be in very substantial short supply. Calcium, nickel——

Senator BYRD. Well, nickel is in short supply now, is it not?

Mr. BEDELL. In this country it is, sir.

Senator BYRD. That is what I mean.

You are speaking of this country now?

Mr. BEDELL. Yes; I am speaking of domestic production versus domestic demand, and the shortage figures which I mentioned before were the gap between domestic production and domestic demand. We certainly agree with the policy Congress expressed in the Mining and Mineral Policies Act of 1970, that a strong domestic mining industry and the development of our domestic resources should be pursued with as much vigor as possible.

Tungsten is another one which is projected to be in very short supply. Gypsum. Many of the major hard minerals are included within the category where at projected production levels the demand is expected to substantially exceed the supply in the United States.

I would be happy to furnish a more extensive list to the committee if that is desired.

Senator BYRD. It might be helpful to the committee if those minerals that will show an appreciable short supply over a period of time, if a list of those minerals could be inserted in the record. I think it might be helpful.

Mr. BEDELL. I will be glad to furnish a list of those minerals for inclusion in the record, Mr. Chairman.

Senator BYRD. Thank you very much.

The committee appreciates your being here today. The proposed changes in the tax code could have widespread ramifications, I think, throughout industry, and I think it is important that before the Senate acts or before the committee acts—it may be taken out of the hands of the committee, but before the Senate acts that as much information as possible should be available, and your testimony today will be most helpful.

Thank you.

Mr. BEDELL. Thank you, Mr. Chairman.

[Material requested by Senator Byrd and Mr. Bedell's prepared statement follows:]

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NEW YORK ASSOCIATE
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20 EXCHANGE PLACE

June 12, 1974

Honorable Russell B. Long
Chairman
Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C.

Dear Mr. Chairman:

During my testimony before the Committee on Finance on June 11, 1974, on behalf of the American Mining Congress, I indicated in response to a question of Senator Byrd of Virginia that I would submit for the record information regarding those hard minerals which are presently in short supply in the United States (in terms of U.S. demand compared to U.S. production) and those hard minerals which are projected to be in short supply in the years ahead.

Data on these questions are found in the First and Second Annual Reports of the Secretary of the Interior to Congress pursuant to the Mining and Minerals Policy Act of 1970. In the Secretary's Second Annual Report, a chart on page 22 shows the percentage of U.S. demand for various minerals supplied by imports in 1972, which indicates the shortfall of domestic production for these minerals. A copy of such chart is enclosed as Exhibit I.

The Secretary's First Annual Report contains a tabulation on page 63 which sets forth actual U.S. demand and U.S. production in 1970 of most minerals and projected U.S. demand and U.S. production of those minerals in the years 1985 and 2000. A copy of such tabulation is enclosed as Exhibit II. It should be noted that in the long run most hard minerals are projected to be in short supply in terms of U.S. demand as compared to U.S. production.

Respectfully submitted,
American Mining Congress

Dennis P Bedell

Dennis P. Bedell
Chairman, AMC Tax Committee

EXHIBIT I

Fig. 2

IMPORTS SUPPLIED SIGNIFICANT PERCENTAGES OF TOTAL U.S. DEMAND IN 1972

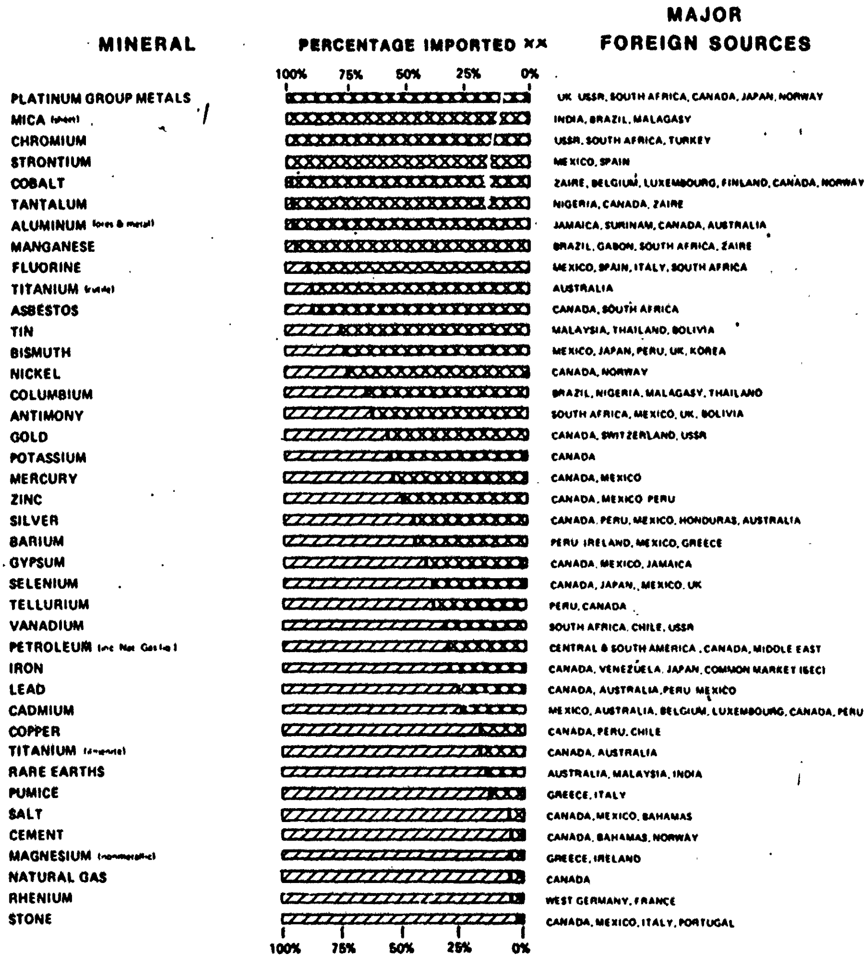

EXHIBIT II

Table 9. Comparison of U. S. Primary Demand with U. S. Primary Production: 1970, 1985, and 2000.

March 3, 1972

Notes:
(1) = Withheld to avoid disclosure of company confidential data

Commodity	Units	1970 ACTUAL PRIMARY DEMAND	1970 ACTUAL PRIMARY PRODUCTION	1985 PROJECTED PRIMARY DEMAND	1985 PROJECTED PRIMARY PRODUCTION*	2000 PROJECTED PRIMARY DEMAND	2000 PROJECTED PRIMARY PRODUCTION*
Aluminum	thousand ST	3,951	583	11,500	420	26,400	503
Antimony	ST	14,735	2,111	26,500	370	48,000	0
Arsenic	ST	(1)	(1)	28,000	1,300	38,000	1,240
Barium	thousand ST	787	478	1,000	140	1,380	419
Beryllium	ST	(1)	(1)	820	60	1,770	82
Bismuth	thousand lb	2,237	(1)	3,000	740	4,000	708
Boron	thousand ST	88	175	163	255	303	345
Bromine	million lb	342	350	414	457	500	600
Cadmium	thousand lb	9,108	3,555	16,600	4,400	30,800	4,510
Calcium	thousand ST	89,618	89,660	147,000	102,000	241,000	118,000
Cesium	lb	(1)	0	10,700	0	20,000	0
Chlorine	thousand ST	9,754	9,755	20,300	14,300	42,300	19,800
Chromium	thousand ST	462	0	700	0	1,120	0
Cobalt	thousand lb	16,190	(1)	20,000	0	24,700	0
Columbium	thousand lb	5,056	0	9,790	0	19,200	0
Copper	thousand ST	1,572	1,720	2,900	1,910	5,400	2,380
Fluorine	thousand ST	613	123	1,210	70	2,400	40
Gallium	kg	(1)	(1)	500	490	850	702
Germanium	thousand lb	40	28	50	3	75	0
Gold	thousand t. oz	6,147	1,743	9,200	1,270	14,300	1,000
Hafnium	ST	(1)	0	38	0	50	0
Indium	thousand t. oz	(1)	(1)	650	300	800	394
Iodine	thousand lb	5,062	(1)	8,900	565	15,500	470
Iron	million ST	84	59	113	51	153	50
Lead	thousand ST	829	572	1,090	420	1,430	470
Lithium	ST	(1)	(1)	5,920	4,100	10,000	5,880
Magnesium, metal	thousand ST	96	112	235	115	580	142
Magnesium, nonmetallic	thousand ST	1,057	1,029	1,510	1,410	2,160	1,670
Manganese	thousand ST	1,327	66	1,770	0	2,360	0
Mercury	thousand fl	54	27	66	37	80	44
Molybdenum	thousand lb	49,104	111,352	96,500	140,000	188,000	184,000
Nickel	thousand lb	311,400	30,600	492,200	60,000	770,000	84,900
Nitrogen, compounds	thousand ST	10,364	10,919	20,300	18,200	39,700	26,000
Nitrogen, gas & liquid	thousand ST	5,310	5,310	10,500	8,500	20,000	12,700
Palladium	thousand t. oz	539	10	780	28	1,060	39
Phosphorus	thousand ST	3,630	5,236	6,590	8,500	12,000	11,700
Platinum	thousand t. oz	407	7	634	0	1,000	0
Potassium	thousand ST	3,908	2,265	6,850	3,640	12,000	4,640
Rare Earths	ST	11,500	(1)	16,000	20,800	22,000	30,800
Rhenium	lb	3,150	5,900	6,250	7,690	12,700	12,000
Rhodium	thousand t. oz	36	0	55	1	85	2
Rubidium	lb	(1)	0	1,200	0	2,200	0
Scandium	kg	15	0	20	0	25	15
Selenium	thousand lb	1,105	975	1,340	916	1,620	988
Silicon	thousand ST	531	530	750	679	1,000	883
Silver	thousand t. oz	73,100	45,000	124,000	39,000	210,000	40,000
Sodium	thousand ST	20,337	19,668	37,000	27,000	67,700	36,000
Strontium	ST	(1)	0	25,600	0	34,200	0
Sulfur	thousand LT	9,132	9,549	16,500	11,800	30,000	14,500
Tantalum	thousand lb	1,120	0	2,100	0	4,010	0
Tellurium	thousand lb	285	158	322	204	366	215
Thallium	lb	(1)	(1)	8,000	3,910	9,000	4,600
Thorium	ST	(1)	(1)	700	49	1,500	44
Tin	LT	53,027	(1)	70,000	2	90,000	0
Titanium, metal	thousand ST	24	0	65	0	168	0
Titanium, nonmetallic	thousand ST	466	276	925	450	1,610	576
Tungsten	thousand lb	16,200	8,105	34,200	4,500	74,000	2,260
Vanadium	ST	7,066	5,594	14,700	10,000	31,000	13,000
Yttrium	ST	(1)	(1)	250	22	420	24
Zinc	thousand ST	1,302	534	1,820	500	3,000	486
Zirconium, metal	ST	(1)	0	10	0	20	0
Zirconium, nonmetallic	thousand ST	(1)	(1)	108	69	167	95
Asbestos	thousand ST	734	125	1,340	198	2,430	273
Clays	million ST	53	55	96	70	174	82
Corundum	ST	2,000	0	1,480	0	1,100	0
Diatomite	thousand ST	444	598	942	943	2,000	1,250
Feldspar	thousand LT	578	648	1,270	841	2,500	1,020
Garnet	thousand ST	16	19	28	29	53	38
Graphite	thousand ST	(1)	(1)	70	0	95	0
Gypsum	thousand ST	14,334	9,436	22,400	10,900	35,000	11,700
Kyanite	thousand ST	(1)	(1)	282	223	630	310
Mica, scrap & flake	thousand ST	119	119	231	180	448	272
Mica, sheet	thousand lb	6,514	0	1,970	0	600	0
Perlite	thousand ST	440	456	770	679	1,350	898
Pumice	thousand ST	3,497	3,132	6,500	5,910	12,000	8,120
Sand and Gravel	million ST	944	944	1,740	1,450	3,200	1,900
Stone, crushed	million ST	648	648	1,280	1,130	2,520	1,560
Stone, dimension	thousand ST	1,740	1,565	2,580	2,030	3,820	1,880
Talc	thousand ST	948	1,028	1,660	1,310	2,900	1,620
Vermiculite	thousand ST	221	285	400	354	725	434
Anthracite	thousand ST	8,248	9,729	5,000	0	2,300	0
Bituminous Coal & Lignite	million ST	517	603	845	612	1,000	690
Natural Gas (dry)	billion CF	21,367	21,015	38,200	31,400	49,000	42,400
Peat	thousand ST	800	517	1,400	1,070	2,200	1,450
Petroleum (inc. Nat. Gas Liq.)	million bbl	5,364	4,123	8,600	5,070	12,000	6,280
Shale Oil	million bbl	0	0	Shale Oil included in Petroleum above			
Uranium, metal	ST	8,320	10,827	51,000	21,100	62,000	28,400
Argon	thousand ST	154	154	390	223	772	329
Helium	million CF	587	647	1,220	1,570	2,500	2,230
Hydrogen	billion CF	2,340	2,340	4,955	3,620	10,500	5,270
Oxygen	thousand ST	13,090	13,090	41,300	24,300	64,500	35,500

* Projections based on the past 20-year trend, 1951-1970. However, the effects of economic, technological, environmental, political, and social factors may alter the supply-demand trends of a specific mineral commodity, and may also affect other commodities where interrelationships are involved. In such cases significant departures from the 20-year trends could result.

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Statement of the

AMERICAN MINING CONGRESS

by

Dennis P. Bedell, Chairman of the AMC Tax Committee

to the

Committee on Finance

June 11, 1974

Mr. Chairman:

My name is Dennis P. Bedell. I am appearing before you today on behalf of the American Mining Congress and am accompanied by Mr. Laurence P. Sherfy, Vice President and General Counsel of the American Mining Congress.

The American Mining Congress is a trade association representing all segments of the mining industry. It has approximately 500 members, including producers of industrial and agricultural minerals, iron ore, copper, sulphur, cement, lead, zinc, gold, and silver. Its headquarters are in Washington, D. C.

Summary of position

The proposed Senate floor amendments to H.R. 8217, which are the subject of these hearings, are of great concern to the American Mining industry. These proposed amendments are being considered in a procedural situation in which it is not possible for them to receive the careful and deliberate consideration which should attend the adoption of major tax legislation. It cannot be over emphasized that the proposed amendments involve very major changes in our tax laws. By imposing massive new tax burdens on the American mining industry, these amendments would seriously impair the industry's ability to obtain the capital needed for the development of our domestic mineral resources which must occur if we are to meet the challenge of narrowing the projected shortages of domestic mineral supplies in the years ahead. Moreover, the investment credit and Asset Depreciation Range system are essential elements of a rational capital cost recovery system. Their repeal would reintroduce into our tax laws a harmful bias against the capital investment which is so necessary at this time to effect the required expansion and modernization of our nation's productive facilities. Their repeal, as well as the imposition of new limitations on the foreign tax credit, also would worsen the competitive position of American industry abroad with resulting adverse effects on our balance of payments and our ability to obtain the imports of foreign minerals we vitally need.

Procedural situation

Changes of the magnitude and dimension of those embodied in the proposed amendments merit the most careful consideration of the Congress and particularly of this Committee and the House Committee on Ways and Means. Traditionally, changes in the tax law have received the careful consideration of the tax-writing committees of Congress. With their particular expertise in the tax area and the assistance of their highly qualified staffs, these committees have evaluated the facts and on the basis of that have formulated the appropriate changes in our tax laws. One need only look back over recent years to the consideration given the changes embodied in the Tax Reform Act of 1969 and the Revenue Act of 1971. Both of these Acts involved significant changes in our tax laws. And both Acts received the intensive scrutiny of the tax-writing committees in lengthy public hearings and markup sessions. When these bills were considered on the Senate floor, Senators had the benefit of the lengthy and thorough deliberations of this Committee on the subject matter contained in the bills.

The present procedure, however, involves a radical departure from this time-tested method of formulating major tax legislation. While the Committee on Finance through these hearings is affording interested parties, such as the American Mining Congress, the opportunity to present their views on the proposed amendments, and we commend the Committee for holding these hearings, it appears unlikely that the Committee will be afforded the opportunity to give to the proposed amendments the usual careful and studied consideration of its deliberations in markup sessions. As a result, Committee members and the Senate generally will not have the benefit of that consideration. This is, we respectfully submit, most unfortunate.

Challenges facing mining industry

Of principal concern to the American mining industry, however, is the serious adverse effect which the proposed amendments would have on the industry's ability to meet the massive challenges facing it.

In the Mining and Minerals Policy Act of 1970, Congress stated it was our national policy to foster and encourage private enterprise in the development of an economically sound domestic mining industry and in the orderly and economic development of domestic mineral resources. The critical importance of this national policy becomes readily apparent when it is realized that the United States presently faces a severe shortage of minerals, which are the lifeblood of our industrial economy and our national defense and are the basic products from which substantially all other products are derived.

Recent authoritative sources for data on the present and projected supply and demand for minerals are the First and Second Annual Reports of the Secretary of the Interior to Congress pursuant to the Mining and Minerals Policy Act of 1970. The Secretary's Annual Reports project that in the years ahead primary domestic demand for minerals will substantially exceed domestic mineral production at an ever-widening pace. In constant 1970 dollars the gap between domestic demand for, and domestic supplies of, hard minerals was $4 billion in 1970 and is projected to increase to $19 billion in 1985 and to $44 billion in the year 2000.

To meet this gap, we have been increasingly relying on foreign sources. The world production of principal minerals increased from $37.1 billion in 1950 to $77.4 billion in 1968 (in terms of 1968 dollars), but production of these same minerals in the United States increased only from $14.2 billion to $18.5 billion. During this same period our consumption of these minerals increased from $15.5 billion to $21.6 billion. Although our consumption increased almost 40 percent, it declined as a percent of world production from 42 percent in 1950 to 28 percent in 1968 -- illustrating that consumption in the rest of the world is increasing at an even faster rate.

It is obvious from these figures that as our needs increase the even higher rate of mineral consumption in other countries and the resulting increased world-wide competition for minerals will make it increasingly difficult for us to obtain the minerals we need unless the projected gap between domestic demand and domestic production can be narrowed.

Need for capital

To meet this challenge will require the expenditure of tremendous amounts of capital. Existing facilities must be expanded and modernized to more effectively exploit known mineral deposits. New deposits must be discovered and developed.

The discovery of minerals in the United States is becoming more and more costly. Most of the rich ore beds have already been discovered, and low grade deposits are the only ones left. Today, the industry must expend great sums of money on exploration in the United States, requiring sophisticated and expensive geological, geochemical, and geophysical equipment. Exploring underground is particularly costly. In many cases, the deposits that are discovered are of such a low grade that the technology required to make it economically feasible to mine and process them must first be developed. Also, to process low grade ores at a low cost per ton requires tremendous capital investment in facilities for large scale operations.

In addition to these expenditures, the American mining industry is faced with large increases in costs as a result of the great amount of environmental and health and safety legislation affecting the industry which has been enacted in recent years.

Where will the enormous amount of capital required to meet these needs come from? The mining industry historically has met its capital needs by means of internally generated cash flow. This, however, is no longer true. In recent years the industry has been required to turn increasingly to debt financing, thereby significantly increasing the industry's debt burden and its debt/equity ratio. The industry's ability to generate capital internally and to attract outside capital is dependent on its profitability for that determines its cash flow and return on investment. The lower the industry's profits are, the less funds are generated internally to meet capital needs. Moreover, decreased profitability would seriously impair the industry's ability to obtain external financing. Its ability to service new debt burdens would be impaired if it was even able to attract with its decreased profitability the needed funds in the first instance.

Effect of proposed amendments

This imposition of the massive tax increases on the mining industry that would result from the adoption of the proposed amendments would so drastically reduce its cash flow as to seriously impair its ability to obtain the enormous amount of capital funds needed to meet the challenges of achieving the policy expressed in the Mining and Minerals Policy Act of 1970 of a self-sufficient and sound domestic mining industry. Tho substantial increase in the minimum tax, the repeal of the Asset Depreciation Range system and the repeal of the investment credit would through the resulting increased taxes deprive the American mining industry of very large amounts of needed capital. Indirectly, the repeal of percentage depletion for oil and gas would adversely affect the mining industry through the resulting increased costs for energy of which the mining industry is a heavy consumer.

In addition to the adverse effect of the proposed amendments on the mining industry's ability to meet its capital needs, the amendments would effect changes in our tax laws which are not sound from a tax policy standpoint. The present minimum tax is in reality an additional tax, not a minimum tax. For the mining industry and corporations generally, it is essentially an additional tax on percentage depletion deductions. The only aspect of the 10-percent minimum tax which gives it any resemblance to a minimum tax is the deduction allowed for the regular income tax. This deduction would be eliminated by the proposed amendments, leaving an additional tax on percentage depletion deductions. This makes no sense from a policy standpoint. Similarly, the repeal of the investment credit and the Asset Depreciation Range system would be a most unwise policy. This would result in a bias in our tax laws against capital investment at precisely the time when modernization and expansion of our nation's productive facilities is needed. The maintenance of reasonable tax incentives for capital investment is especially important at this time when significantly higher replacement costs for business assets are being encountered as a result of inflation. Our productive capacity must be modernized and expanded if we are to solve our economic problems at home and maintain our competition position abroad.

These proposed amendments also would contribute to the climate of uncertainty which is inimical to the orderly development of our domestic mineral resources. The discovery of an ore body and the development of a mine is a long-term, 5 to 10 year project. A mining company must have a reasonable estimate of the costs to be incurred for the project before it is undertaken. Mine development plans and capital expenditure programs currently underway or in the planning stage have been formulated on the basis of the present tax structure including the Asset Depreciation Range system and the investment credit contained in the Revenue Act of 1971.

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The repeal of these measures so soon after their consideration by Congress in 1971 would create a climate of uncertainty and instability and seriously impair the industry's ability to plan and undertake in a rational and sound manner the needed expenditure programs.

Foreign mineral sources

At the same time as we are vastly expanding our domestic mineral capacity, it will still be essential for us to rely on foreign sources of minerals. Moreover, for certain minerals foreign sources of supply may have to be relied on for the foreseeable future since sufficient amounts of these minerals may not exist domestically. The mining of foreign reserves by U. S. companies provides a greater assurance that these foreign minerals will be available to us, although there are, of course, risks arising from the uncertainty of the political environment in some foreign countries. Because of economic conditions, the state of the technology and the lead time required for the development of new deposits, however, increased production of domestic minerals is simply not a viable means of meeting projected domestic demand in the short run.

This is not to say that the significantly increased efforts which are necessary for further exploration and development of those minerals which exist in the United States should not be undertaken from a long-run standpoint. These efforts must be pursued, but they should be pursued hand in hand with those efforts necessary to continue to assure ourselves of needed supplies of foreign minerals. The size of the projected gap between domestic demand and domestic supplies of hard minerals is so great in the long run that very substantial increases in domestic production -- even a doubling of production -- will still leave a gap which must be filled by substantial imports of foreign minerals. The U. S. mining industry should be allowed to effectively participate in the development of these foreign minerals. In addition to providing us with additional assurance that the minerals will be available to us, this will also tend to mitigate the balance of payments effect of imports since the profits arising on the imports from U. S. mining companies will be at least in part repatriated to the United States.

The United States mining industry has already made very substantial investments abroad for mineral exploration and development and for the very substantial capital investments for facilities which are required for the processing and transportation of minerals. Obviously, substantial additional capital investments will be required to find and develop additional supplies of foreign minerals.

In attempting to carry on these activities, American mining companies must compete with mining companies from other capital exporting nations, such as the United Kingdom, France, Japan and Germany. To the extent American mining companies receive less favorable tax treatment from the United States than companies of other capital exporting countries receive from their countries, the U. S. companies are placed at a competitive disadvantage. As a means of comparing, in fairly precise terms, the relative tax treatment applied by capital exporting countries to the foreign activities of their mining companies, the American Mining Congress had a comparative study made for it by the accounting firm of Coopers & Lybrand. This study focused on the effect which the tax systems of important capital exporting countries in conjunction with the tax systems of a varied range of capital importing countries have on after-tax rates of return of mining companies. The objective of this study was to apply a common measurement standard (i.e., after-tax rate of return) to the tax systems of the United States and its principal capital exporting competitors. After-tax rate of return was chosen as the standard of comparison because it is the most objective measure of the profitability of a mining company's investment in connection with a foreign mineral deposit, because it is a reasonable measure of an investor's capacity to make concessions to the host country and thereby outbid other potential investors who have significantly lower rates of after-tax return, and because it serves as a measure of a company's ability to borrow funds, or to allocate internally generated funds, for the needed capital investments.

This study concluded that even today the United States tax treatment of mining operations abroad is significantly less favorable than that of a number of other major capital exporting countries. Generally, the United States ranked fifth or sixth among the nine major capital exporting countries in terms of the tax treatment of these investments. This disparity would be worsened by the adoption of amendments, such as additional limitations on the foreign tax credit or the repeal of the Western Hemisphere Trade Corporation deduction, which would increase the tax burdens of American mining companies operating abroad.

Respectfully submitted,

AMERICAN MINING CONGRESS

By ______________________
Dennis P. Bedell
Chairman, Tax Committee

Senator BYRD. The next witness is Mr. B. Kenneth Sanden, of Price Waterhouse & Co.

STATEMENT OF B. KENNETH SANDEN ON BEHALF OF PRICE WATERHOUSE & CO., CHAIRMAN OF THE U.S. TAX COMMITTEE OF THE BUSINESS AND ADVISORY COMMITTEE TO THE OECD; VICE CHAIRMAN, U.S. COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE; FORMER MEMBER OF THE PRESIDENT'S TAX FORCE ON BUSINESS TAXATION AND THE TAX POLICY ADVISORY COMMITTEE TO THE COUNCIL ON ENVIRONMENTAL QUALITY

Mr. SANDEN. Thank you, Senator.

Senator BYRD. Nice to have you here, Mr. Sanden.

Mr. SANDEN. I do not want to appear to be redundant and go over a lot of the ground that the former Assistant Secretaries of the Treasury for Tax Policies have covered so well, and also the matters covered by those gentlemen that have been concerned with the natural resources industries. However, I am pleased to present briefly some of my views on the proposals to increase taxes, which, in a large measure to me appear inequitable, uneconomic, and perhaps even unwise.

CONCERN OVER ATTEMPTS TO REDUCE ALLOWANCES FOR DEPRECIATION

As a former member of the President's Task Force on Business Taxation and the Tax Policy Advisory Committee to the Council on Environmental Quality, I am particularly concerned about the attempts to reduce the allowances for business depreciation, which in my mind are already inadequate in many instances. As Chairman of the U.S. Tax Committee of the Business and Industry Advisory Committee to the OECD in Paris, I am disappointed at the lack of understanding of the role of the foreign tax credit in international trade and balance-of-payments problems.

Senator BYRD. May I interrupt you at that point?

Mr. SANDEN. Yes, sir.

Senator BYRD. In regard to depreciation, let me get your professional advice. It is a postponement of taxes, not a cancellation of taxes.

Mr. SANDEN. That is right, sir. Business cannot make a profit until it gets costs back. Under our tax laws, as Dr. Smith has pointed out, we only recover our costs, over a relatively long period.

I might just at this point, Senator, rather than go on to some of the points I have in that regard, I have submitted a statement, which perhaps you have in front of you. At the very end of the statement is the comparison that Dr. Smith referred to, of the cost recovery allowances granted by the various industrialized countries of the world as compared with the United States.

This comparison had its origin in the work that our committee performed for President Nixon back in 1969, when at that time we were attempting to determine what were the major problems of the business community in the United States, and we focused on the major problem being that of a proper allowance for depreciation. We found that in the United States there was the largest percentage of overaged equipment of any industrialized nation. We found that we were falling clearly behind in the proportionate part of our gross national product devoted to investment in productive facilities. We took a look at the various countries of the world in which our businesses compete. Not only do we go across to compete in those countries, but they also send their goods and production to our country. Obviously their costs affect us both competitively at home and abroad.

Senator BYRD. But if I interrupt you at that point——

Mr. SANDEN. Yes, sir.

Senator BYRD. In looking at it from the point of view of the Government, the Government eventually gets the tax. The depreciation schedule merely permits the tax to be deferred for a period of time.

Mr. SANDEN. From an accountant's standpoint it is the other way around. The business is allowed to recover that cost ultimately over a long period before it pays tax.

Senator BYRD. That is right.

But is it not correct, though, that if you reverse that, that the Government in the long run gets the money?

Mr. SANDEN. Only on the excess, Senator. It never gets the amount of money that has been invested in the equipment, because that will be depreciated over some period of time. Therefore, it is a matter of pace and not concept.

Senator BYRD. What I am speaking of, whether you have a low depreciation rate or a high depreciation rate, in the long run the Government will get the same amount of money.

Mr. SANDEN. Yes, sir.

Senator BYRD. Is that not correct?

Mr. SANDEN. That is correct. You are only allowed your cost once, therefore, the Government receives the same amount of tax out of the income over a period of time.

Senator BYRD. That is what I am really trying to get at.

Mr. SANDEN. Obviously, to the business, however, it makes a tremendous difference if it has to defer its cost recovery over a tremendously long period and the interest costs are such that it cannot make an adequate return. Therefore, it in effect does not get the allowance.

Senator BYRD. I think many Members of the Congress have the feeling that permitting accelerated depreciation on a business tax return that the business does not pay as much tax. But the business in the long run pays the same amount of tax.

It just takes longer to pay that tax, is that not right?

Mr. SANDEN. That is correct, sir.

I do not quite understand why it is not better understood that this is not a tax gimmick or a loophole, it is merely a recovery of a cost which has been an investment. It is not in the area of gimmicks, loopholes, or even an incentive. It is clearly the allowance of a normal business expense. If we had a completely equitable tax burden, we probably would ask for an allowance of the capital cost first before we paid any taxes on the basis that we had not yet earned anything until the capital cost was recovered.

That is not practical, however, from a tax standpoint, nor is it necessarily good accounting. We have to compare ourselves with the rest of the world to see what have they done. In the United States in 1962, when we had an investment tax credit, but not the ADR system of depreciation, we were the lowest country in the world in our allowances of depreciation of any industrial country.

In 1969, when we repealed, erroneously I believe, the investment credit and we did not yet have the ADR system, we fell completely behind the rest of the world. If you will look at the last column, for example, we only recovered at the end of 7 years on normal machinery and equipment some 66 percent of the costs, whereas other countries of the world were getting back as much as 130 percent because they have additional incentives.

In 1971, when we restored the investment credit and put into effect the ADA system recommended by the President's task force, we were tied for last. So at this particular moment we are still the lowest of any country in the world except, as I say, tied with two other countries, and that is Japan and Switzerland. If we take into account their special allowances, all three countries are about the same. Every other industrialized country with which we compete does a better job of granting an allowance.

At this particular time, as Dr. Smith has indicated, with indexation being one of the subjects before Congress, with the cost of pollution controls, environmental controls being something that business must take into account, and the depressed capital market, it is necessary that we at least maintain this pace of depreciation, if not accelerate it if at all possible.

Senator BYRD. I assume in your judgment this is not the time to tighten the depreciation laws.

Mr. SANDEN. This could very well be catastrophic, as Mr. Bedell indicated just a moment ago. Its effects on the mineral industry would be tremendous. We know what it could do to the stock market at this particular time, to indicate that business would have to borrow more money in order to finance its productive facilities. This would probably be the worst thing that we could do to the stock market, and surely it would not allow people to go into their accounts, to invest heavily into productive facilities, which we need at this particular time.

With respect to the other items that I want to comment on, I just have a few brief comments that I would like to make with respect to taxation of foreign source income.

If you will permit me, I think there is a complete misunderstanding of what the foreign tax credit is. The allowance of the foreign tax credit is an essential factor in the avoidance of double taxation in world trade economies. It has been universally adopted as a means of neutralizing the differing tax systems of the world without the need for amortization.

The credit is consistent with the aims of all international Government organizations concerned with the elimination of artificial barriers and incentives, and of course have been a basic concept for the U.S. tax laws for over 50 years. It should be understood that the foreign tax credit is not unique to the United States. It does not encourage foreign investment to the exclusion of domestic investment. It does not reduce the U.S. tax liability on U.S. source income, and is not a tax preference or a loophole. It is merely a means that has been adopted in the world to neutralize, as I say, the differing tax systems without the impossible task of trying to harmonize what the various countries of the world have developed over the years.

Essentially, the rest of my paper is devoted to the same general concept, and that is that we should not at this stage of our economy and our situation in the United States do anything which would put a further bias against capital investment. Surely the disallowance or the repeal of the percentage depletion allowance would do exactly that, and surely an extension of the minimum tax to further penalize capital investment through the treatment as tax preferences of investment income or allowances that have been granted by the Internal Revenue Code, would put further biases against capital investment at a most inappropriate time in our history.

The other two provisions, the DISC provision and the foreign income tax credit provisions are not necessarily capital provisions. They are punitive against capital or biased against capital, but they are neutral provisions which are in our law presently to neutralize the effects of other tax systems and incentives around the world so that American business can compete at home and abroad on a comparative basis with the internationals of other countries.

I have submitted a detailed statement with far greater information in it, and I would like to have that go in the record, I will be pleased to answer any questions.

Senator BYRD. Yes, Mr. Sanden.

Your complete statement will be published in the record.

Senator BYRD. I think the points you raise are extremely important ones. I think there is a misunderstanding as to the role of depreciation. I gather that if you were able to alone make the decision as to what should be done that you would be inclined to increase the rate of depreciation.

Mr. SANDEN. Yes, sir. At the time we recommended the institution of the asset depreciation range system, we did not have a galloping inflationary spiral. This was in 1969. We had gone along a relatively long period of a stable inflationary trend of a couple of percentage points a year. We did not have a situation where the tremendous cost of environmental gadgets and pollution control devices were necessary. We felt at that time that the depreciation granted in the United States should be increased by 40 percent over the normal straight line.

The Congress did not adopt that recommendation, but instead put in a 20 percent variation, as you know, in the ADR system from the normal guideline lives. However, by reinstituting the investment credit, the combination of the investment credit and the 20 percent brought us about back to where the 40 percent would have come out on our schedule. Therefore, we felt very pleased about that in 1969. But today the economy is different, with interest rates of over 11 percent, the high prime rate and with other factors such as depressed market conditions. Business has to recover its investment at a faster pace in order to keep up with inflation and increasing costs.

You are correct that if I had my choice I would perhaps go back to the 40 percent rather than the 20 percent variation from guideline lives.

Senator BYRD. So business uses the—am I correct on the technical term, double declining balance?

Mr. SANDEN. That is right, sir.

Senator BYRD. So if business uses double declining balance versus the straight line, then it uses up its depreciation in a much quicker rate.

Mr. SANDEN. Yes, sir.

Senator BYRD. And then at that point, after its depreciation is used up, then it pays a heavier tax.

Mr. SANDEN. Well, it has recovered its capital, so it is ready and willing to pay the tax.

Senator BYRD. That is right.

Mr. SANDEN. That is all business is seeking in depreciation. It is not an incentive or a loophole. Business is merely asking to recover its costs, and when those costs are recovered, naturally it is ready and willing to pay its tax.

Senator BYRD. So as I understand your testimony, while you would prefer to liberalize, so to speak, the depreciation rate, you do not see that as being in the cards at the moment, so what you are anxious to have done is not to contract it and not to make it less liberal than it is now.

Mr. SANDEN. I certainly feel that way, Senator. I also feel that business must have a reliable and stable base on which to project its growth and refinancing. We have been changing the rules of capital recovery every few years in the last decade with the off again, on again investment credit with the ADR system of depreciation and so forth. It is high time that we stopped tinkering with the capital recovery allowance system in the United States so that business, particularly those businesses such as the natural resource industries, which must plan a long time in advance, know what their base is. We should stop tinkering with the depreciation allowances. I would prefer that we grant additional incentives, but at least we should stop changing the depreciation system and we should keep it where it is, which as I say, is tied for last place in the industrialized world.

Senator BYRD. In regard to the investment credit, we put it on in 1962. President Johnson recommended and the Congress took it off in 1966, and then we put it back in 1967, and then we took it off again in 1969, and we put it on again in 1971.

Mr. SANDEN. Yes, sir.

Senator BYRD. Well, no wonder business is confused. I do not see how the managers of business can plan.

Mr. SANDEN. Obviously long range plans are drastically affected by such off again, on again changes.

Senator BYRD. My thinking has been from the beginning, although I originally opposed the investment credit, I think I was wrong about it and I support it now, but regardless of whether we support it or oppose it, it seems to me that Congress ought to make up its mind whether it wants to have it or it does not want to have it, and stick in one way or another, either have it or do not have it.

Mr. SANDEN. I agree with that.

Senator BYRD. And not keep changing it.

Mr. SANDEN. Absolutely, Senator.

Senator BYRD. Thank you very much.

The committee appreciates your being here this afternoon.

Mr. SANDEN. Thank you, sir.

Senator BYRD. These hearings are now adjourned, subject to the call of the Chair.

[The prepared statement of Mr. Sanden follows:]

Committee On Finance
United States Senate

Hearings On Tax Increase Proposals

Statement Submitted by
B. Kenneth Sanden, Partner
Price Waterhouse & Co.

I am pleased to have this opportunity to present briefly my views on certain proposals to increase taxes which in large measure appear inequitable, uneconomic and unwise. They may well also result from a failure to differentiate between incentives and loopholes and between gimmicks and normal business expenses.

As a former member of the President's Task Force on Business Taxation and the Tax Policy Advisory Committee to the Council on Environmental Quality, I am particularly concerned about the attempts to reduce the allowances for business depreciation - which in reality are already inadequate in many instances. As chairman of the U.S. Tax Committee of the Business and Industry Advisory Committee to the OECD, I am disappointed at the lack of understanding of the role of the foreign tax credit in international trade and balance of payments problems. My comments on the specific proposals follow.

Proposal

- Eliminate the more rapid depreciation of machinery and equipment permitted under the Asset Depreciation Range (ADR) system.
- phase out the 7 percent investment tax credit for property costing more than $100,000.

Statement - After over 35 years of administrative complexities and needless controversies, the United States finally has a cost recovery system - simple in concept and certain of result. This, coupled with the reinstitution of the investment credit, has placed its industries on a basis generally competitive with those of other industrialized nations. However, with increasing inflation, growth within proper environmental bounds, and depressed financial markets, there is need for further economic liberalization of capital recovery allowances rather than an elimination of the ADR system and investment tax credits presently allowed.

Background

The way in which business income is taxed has a significant influence on how the production capability of the economy is used, and how rapidly it grows, on the expansion of employment opportunities, and on the ability of producers to compete effectively in the world economy. It is clearly important that the expansion and modernization of production facilities not be discouraged by the taxing system. Business generally will not invest in production facilities unless it is assured of recouping the cost of and realizing a fair return on the investment. This principle is recognized by all the industrialized countries of the world in varying degrees.

The present system of capital recovery allowances in the United States has its origins in The Report of the President's

Task Force on Business Taxation. This task force was established by President Nixon in 1969 to make recommendations for long-range goals for business tax policy--concentrating on the role of taxes in promoting economic growth, full employment, and a strong progressive economy. Appropriately, it devoted a substantial portion of its deliberations to the effect of the U.S. tax system on modernization and enlargement of the nation's production facilities. A brief review of the tax provisions with which the task force was concerned appears in order.

Investment Credit

The decade of the 1960's in the U.S. has a checkered history of attempts to stimulate investment, discourage investment and otherwise play politics under the guise of tax reform. For years, representatives of business had urged the liberalization and simplification of the allowance for depreciation for tax purposes. In 1961, extensive hearings were held by the House Ways & Means and Senate Finance Committees arising from the proposal of President Kennedy to institute a tax credit for new investment in production facilities. Mindful of the adverse balance of payments and dwindling trade surplus, the President's message stated "...our friends abroad now possess a modern industrial system helping to make them formidable competitors in world markets. If our own goods are to compete with foreign goods in price and quality, both at home and abroad, we shall need the most efficient plant and equipment." The Secretary of the Treasury, Douglas Dillon, credited the rapid build-up of production facilities outside the U.S. as "...due in good part to the vigorous policies of European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances, and investment credit."

Although business generally testified in favor of depreciation reform as the major incentive needed in the capital recovery area, Congress adopted the investment credit in 1962 as the best identifiable method of stimulating investment. Somewhat inconsistent therewith, it originally provided that the credit would reduce the base otherwise subject to depreciation allowances but eliminated this reduction in 1964.

Business fears that the investment credit would not permanently take the place of liberalized depreciation allowances were realized in 1966 when President Johnson requested its suspension as a means of alleviating inflationary pressures. With the turndown in the economy which followed the suspension, the credit was reinstated in March 1967 on the basis that the inflationary pressures had lifted. To the surprise of the American business community, President Nixon, shortly after his election, successfully proposed the outright repeal of the investment credit as of April 1969.

Depreciation Allowances

In 1954 the Internal Revenue Code was amended to permit accelerated allowances for depreciation through application of the "sum-of-the-years" and the "declining balance" methods of depreciation. These methods provided greater deductions in the earlier years than the time honored "straight line" method.

Although the methods might have accelerated the deductions, the useful life concept generally followed on examinations at that time resulted in stretching out the recovery periods. Bulletin F set forth individual lives for countless types of assets with the Internal Revenue Service applying overall tests of the ratio of reserves for depreciation to the total asset accounts.

In recognition of the demands for depreciation reform, the Treasury Department in 1962, attempted to simplify and liberalize the computation of allowances. Under Revenue

Procedure 62-21 guideline lives were established for about 75 broad classes of assets. The guideline lives were initially determined to be 30-40% shorter than the Bulletin F useful lives. The reserve ratio test, however, was formalized in that depreciation allowances would be reduced once the ratios were breached. In order to allow taxpayers to adopt actual depreciation practices which would conform with the guidelines, the reserve ratio test was suspended for a period of years. Not only was the application of the reserve ratio an extremely complex determination but it had uneconomic incentives to dismantle and discard standby and surplus facilities in order to maintain normal depreciation allowances.

Task Force Recommendations

On the basis of the repeal of the investment credit and the impending imposition of the reserve ratio test the Task Force recommended a depreciation program as follows:

1/ Substitute a capital cost recovery allowance system for the system of deductions based on the useful life of the property.

2/ Eliminate the reserve ratio test.

3/ Allow full recovery of cost in a period 40 percent shorter than the Treasury Department guideline lives.

4/ Permit the use of a longer period at the election of the taxpayer.

5/ Permit the write-off of the unrecovered cost of an asset retired from a multiple asset account prior to the expiration of the recovery period.

All of the methods of depreciation previously allowable were to be continued but the depreciation recommendations were limited to machinery and equipment and special related structures.

This limitation was arrived at only by a strong feeling that it was not possible, from a revenue standpoint, to extend favorable treatment to all buildings and structures and yet it was also extremely difficult to draw a line between facilities that should quality, such as a factory, and those that perhaps should not, such as a shopping center.

It was intended that the adoption of the recommended system of capital cost recovery would:

Encourage the expansion of production facilities in order to sustain and accelerate real economic growth.

Bring the U.S. tax treatment of investment in production facilities more closely in line with those of the other major industrial nations.

Moderate the adverse effects of inflation on the real value of cost recovery allowances and on the capacity of United States business to finance additions to the stock of production facilities.

Simplify the provisions of the law and regulations, thereby reducing the burdens and expense of compliance by taxpayers and the areas of disagreement between them and the Internal Revenue Service.

Encourage the Expansion of Production Facilities

A revenue system largely based on the income tax, which is true of the U.S. system, is naturally biased against savings and capital accumulation. To the extent that taxes are borne disproportionately by investment, the supply of that investment is reduced. Complete neutrality could clearly be achieved in the capital investment area by a 100 percent recovery in the year of acquisition but this would also largely wipe out the corporate income tax. A more logical step, in the view of the Task Force, was to increase the rate of recovery sufficiently to encourage investment at a faster pace.

Comparison With Other Industrial Nations

Other industrialized nations have generally adopted provisions relating to cost recovery allowances and capital investment incentives on a more favorable basis than the United States. Some of this stems from the need to rebuild to overcome the ravages of war. But perhaps there has been a greater realization that rising productivity creates a rising level of per capita income and a better standard of living. In the United States, we appear to have relied more on rising demand to stimulate production while at the same time remaining complacent about the need to modernize and keep up with technology.

Not only have the European nations adopted tax policies fostering capital investment but they are relying ever more heavily on indirect taxes, such as the value-added tax which does not impose a tax burden on investment, to finance government expenditures. In the absence of such a neutral tax, U.S. investment bears a larger share of the cost of government than its trading partners.

A comparison of the cost recovery allowances for industrial machinery and equipment in leading industrial countries with similar allowances in the United States is included as Appendix A. It will be seen that prior to the recent amendments in U.S. law, the cumulative allowances were substantially below all the other countries and thereafter approximate the allowances granted by the least favorable nation.

Effects of Inflation

In common with all consumers, business must pay more for its machinery and capital equipment as prices continue to spiral.

Depreciation allowances determined on original cost become inadequate to provide for replacement or renewal. Too little attention has been given in the U.S. to the factor of inflation in eroding cost recovery allowances. As set forth in the report of the Task Force, the prices of production facilities have been rising steadily since 1945 and it is estimated that business underdepreciation amounted to nearly $10 billion in 1970. We are only too keenly aware of what has happened to prices since then--especially with the double digit inflation of recent months.

Price level depreciation is frequently proposed as the answer to underdepreciation--and it might well be--but there are many other items affected by inflation. In the meantime, shortening the cost recovery period and accelerating the depreciation methods allowed reduces the improper tax burdens borne by capital investment.

Simplification of Cost Recovery Determinations

Most advocates of tax reform agree that simplification of compliance is the major hope of taxpayers generally. Frustration with forms and record keeping can readily erode an otherwise sound tax system. Depreciation allowances have been a contentious area since the 1930's when Treasury Secretary Morgenthau set about increasing the taxes on business by examination and not enactment. Clearly, a cost recovery system based on standard groupings with broad categories, has the possibilities of substantially reducing the complications and controversies inherent in the useful life concept.

Adoption of New System of Depreciation

On January 11, 1971 President Nixon proposed a policy of liberalized depreciation--largely based on the Task Force recommendations--seeking economic objectives and the reduction of administrative controversies. On March 12, 1971 the Treasury issued proposed regulations for a system of permissible variations from the guideline lives and on June 22, 1971, after extensive hearings, adopted the Asset Depreciation Range (ADR) System.

This new system provided for the recovery of cost over a period from twenty percent shorter to twenty percent longer than guideline lives. With the abandonment of useful life as the depreciation allowance criteria, the United States became the last industrialized nation to recognize a capital recovery period shorter than such life. This recognition had an unexpected major hurdle placed in its path when Ralph Nader and other groups challenged the authority of the Treasury to grant allowances on other than on an experience basis. However, to the relief of all who had worked so long on the matter, Congress, in enacting the Revenue Bill of 1971, adopted the Treasury ADR system concept and renamed it the "Class Life System".

Overview of Class Life System (ADR)

The most publicized feature of the class life legislation is the flexible write-off period. At the election of the taxpayer, an asset's cost may be recovered over a period from 20 percent shorter to 20 percent longer than the asset's class life which is the same as the old guideline life. Although the Task Force had recommended a 40 percent variation the reinstatement of the investment credit gave a combined benefit approximating that originally proposed.

ADR is effective for assets placed in service after December 31, 1970. Assets acquired before 1970 are not eligible for ADR. Such assets may, however, now be depreciated over guideline lives for post 1970 years without the necessity of meeting the experience requirements of the "reserve ratio test". Similarly, the IRS will make no adjustments under ADR for an experience pattern at variance with the cost recovery period selected.

Also, a part of the ADR package is the "repair allowance" which seeks to end the controversies which arise over whether an expenditure is a "repair" or a capital addition. This is done by permitting expenditures with rather strong capital characteristics to be expensed so long as the total "repairs" are within a specified percentage of the particular class of assets.

Proposals for Change

The adoption of ADR and the restoration of the investment credit has done no more than raise the level of U.S. capital recovery to the point where we are about tied for last among the industrial countries. Capital recovery, however, is not a gimmick or loophole. There is no one who would contend that depreciation of business assets should not be allowed as a tax accounting principle. The only argument is one of pace and not concept. It is incongruous that on the one hand we should be debating the value of indexation as a means of combating the ravages of inflation while on the other hand suggestions are being made to overturn the modest level of cost recovery allowed through the combination of ADR and the investment credit.

The increased cost of such a move to American business would have its repercussions throughout the economy. Economists do not agree whether taxes are passed on to consumers or absorbed by shareholders--in either event the effect is the same in the long run. If the return to shareholders is unsatisfactory operations must be curtailed or revenues increased. All costs must be recovered or a business succumbs. Business must also have a reliable and stable base on which to project its growth and financing. Changing the rules of capital recovery every two or three years has contributed its share to the economic difficulties we have experienced in the last decade. The time to stop is now.

Taxation of Foreign Source Income

Proposal	- Limit the use of the foreign tax credit.
Statement	- The allowance of the foreign tax credit is an essential factor in avoidance of double taxation in world trade and commerce. It has been universally adopted as a means of "neutralizing" differing tax systems without the need of harmonization. The credit is consistent with the aims of international governmental organizations concerned with elimination of artificial barriers and incentives and has been a basic concept of the U.S. tax law for over half a century.
Proposal	- Repeal the tax provisions allowing deferred reporting of part of the overseas income of a domestic international sales corporation (DISC).
Statement	- The DISC legislation diminished the effectiveness of foreign tax incentives by allowing U.S. manufacture and production of goods destined for foreign consumption to obtain temporary tax deferral. At the time of proposal it was indicated that it would be retained as a permanent feature of the U.S. tax laws and business was encouraged to structure their organizations accordingly.

It is too soon, however, to judge the extent to which DISC has achieved its intended purpose of materially increasing the export of U.S. goods. This unique incentive should not be unilaterally terminated at this time.

Background

We subscribe to the philosophy that the economic interests of the United States--and the world-- are best served if national boundaries do not impede the free flow of goods, services, ideas and capital; and we believe it should be the policy of the United States, and the other countries of the world, to exercise their sovereign rights of taxation in a manner which does as little as possible to interrupt such a free flow. Accordingly, tax policies should be adopted which in general are non-discriminatory and neutral in order that the economic resources of the world be allocated with maximum benefit to all.

We believe that the retention in full of the foreign tax credit is fundamental to the continued growth of U.S.-international trade and investment. The attacks on the foreign tax credit appear to stem primarily from a misunderstanding of what it is and how it works. It is therefore necessary to dispell what are believed to be four fundamental misconceptions regarding the foreign tax credit. It should be understood that:

1. The foreign tax credit is not unique to the United States.

2. The foreign tax credit does not encourage foreign investment to the exclusion of domestic investment.

3. The foreign tax credit does not reduce the U.S. tax liability on U.S. source income.

4. The foreign tax credit is not a tax preference or loophole.

Taxation of income from foreign sources

It is generally accepted that taxes on international business should be "neutral"; that is, they should be imposed in a way that business decisions are made on their own merits, and not because of tax considerations. And it is also generally accepted that the cornerstone of tax neutrality is the elimination of international double taxati n.

The major industrial nations of the world eliminate double taxation either by following the "territorial" concept of taxation or by granting a credit for taxes paid by domestic taxpayers to foreign jurisdictions.

Under the "territorial" approach income from commercial activity is taxed only by the country in which it is generated. France and the Netherlands are among those who follow this concept. Under the foreign tax credit system, on the other hand, a country taxes the worldwide income of citizens and domestic corporations, but allows a credit for taxes paid foreign countries. The United States, Japan and the United Kingdom, among others, use this system. Both systems recognize that the host nation is entitled to priority in taxing domestic commercial activity; for it is the host nation which supplies the financial, social and economic stability which permit profitable commercial activity. The tax credit system, in addition, permits the investor nation to tax foreign profits to the extent its tax rate exceeds that of the host nation.

From a theoretical standpoint, the territorial concept best meets the tests of non-discrimination and neutrality. It could be subject to abuse, however, as encouragement would be given to the establishment of tax-haven operations in countries soliciting businesses solely on the basis of tax savings. This could well foster the spread of stricter controls on capital and technology flows and limitations on transfer prices for goods and services. In general, tax holidays, tax sparing and similar incentives to international business should be limited in time and application to recognized economic objectives such as assistance to under-developed countries on a temporary basis.

U.S. taxation of foreign income

U.S. controlled foreign corporations pay no U.S. tax on income earned outside the United States. Under present law, such foreign earnings are subject to U.S. tax only at the shareholder level, and then, only when such earnings are repatriated. (In certain circumstances, which are discussed later, U.S. shareholders are subject to taxation currently under the foreign personal holding company and Subpart F provisions.)

We favor the continuation of this policy which, in general, taxes the earnings of foreign corporations only as they are paid to U.S. shareholders as dividends. Among the reasons for this view:

1. It is consistent with the legal concept that a corporation is a judicial person, separate and distinct from its shareholders.

2. Subjecting the undistributed earnings of controlled foreign corporations to current taxation would adversely affect our competitive position in world trade vis-a-vis the other principal trading countries. Only Canada, of all the industrial nations, currently taxes foreign income more harshly than the United States.

3. Experience indicates that the existing system has not been subject to abuse; that is, funds

surplus to the business needs are repatriated as soon as possible, without regard to U.S. tax considerations.

4. To subject U.S. shareholders to tax on the undistributed earnings of controlled foreign corporations could well be challenged as an incursion on the sovereignty of the host nation; and, regardless of the legality of such a tax, would be deeply resented by the host government, employees, suppliers, creditors, and especially minority shareholders. Even if direct legal action could not be taken, the resentment could well cause the host nation to take retaliatory action against United States interests.

5. Having regard to the relative rates of tax in other industrialized nations the immediate taxation of undistributed earnings would result in little additional income tax in the United States after allowance of the foreign tax credit. Forced distributions might only result in greater foreign withholding taxes and lesser amounts invested in the business without U.S. revenue gains.

Limitation on foreign tax credit

The United States tax law limits the foreign tax credit to the amount of U.S. income tax attributable to foreign income. Without such limitation, foreign taxes would be permitted to offset the U.S. tax on U.S. commercial activity.

A taxpayer may compute the foreign tax credit limitation on either a "per country" or an "overall" basis. Under the per country limitation the limitation is computed separately for each foreign country; that is, the credit is limited to the U.S. tax attributable to the income, computed according to U.S. tax rules, from each country in which the U.S. company does business. The "overall" basis, on the other hand, limits the foreign tax credit to the U.S. tax attributable to all foreign income; thus permitting the use of "excess" credits from a country with a tax rate higher than the United States when, because of other foreign income from a low rate country, the average foreign tax rate is no more than that of the United States.

We support the present U.S. system, which permits taxpayers to use either method, with the proviso that once the overall basis is elected it must be used for all subsequent years unless the Treasury gives permission to return to the per country method. This limited flexibility appears necessary because of the vastly different situations confronting U.S. overseas investors. On the one hand, there is the fully integrated multinational company which manufactures and distributes throughout the world, with raw materials, components, and finished goods criss-crossing national boundaries; and it is equitable and fair that its foreign tax credit limitation be computed on a worldwide basis. On the other hand, certain basic industries, in particular the extractive companies, are called upon to spend substantial sums for exploration and start-up expenses in remote corners of the world long before profitability is reached, if ever. These losses, if taken into account in computing a worldwide limitation, would unfairly restrict or completely eliminate the foreign tax credit to which the business is otherwise entitled. It appears clearly to be in the national interest to encourage the discovery and development of foreign natural resources as against a "deplete America first" policy.

Under either method of foreign tax credit computation a U.S. taxpayer will pay the higher of the U.S. or foreign income tax rate on its foreign income. There is thus no ultimate income tax incentive in operating abroad for such taxpayers. This may be contrasted with the alternative territoriality approach which may well give encouragement to foreign production in lower tax countries.

The substitution of a deduction for foreign income taxes as against the credit allowance would result in economic double taxation of international business. Operations in a country having a rate equal to the U.S. rate of 48% would be subject to an effective tax rate of almost 73%. It has been suggested that the treatment of state income taxes as a deduction requires consistent treatment of foreign income taxes. Perhaps the consistency argument is sound but then non-discrimination and equity in U.S. operations would be better served by the allowance of state income taxes as a credit also. It should be recognized, however, that present nominal rates of state taxes might well be raised under this system passing on the full cost to the U.S. Treasury and taxpayers in general.

Special provisions

There are special provisions in the United States tax laws which appear to conflict with the basic concept of neutrality in the taxation of foreign income. These provisions were adopted to establish incentives, or neutralize foreign incentives, considered desirable as national objectives at the time. They include favorable treatment of:

1. Domestic International Sales Corporations (DISC)

2. Western Hemisphere Trade Corporations (WHTC)

3. Possessions Corporations (931 exemption)

DISC

Under the DISC legislation a "domestic international sales corporation" can shield up to 50% of its export profit from U.S. taxation so long as the deferred income is invested in "export assets". Thus, under the DISC concept, manufacture and production intended for foreign consumption need not take place abroad in order to obtain temporary tax deferral. Several thousand DISC elections have been made since DISC became effective in January 1972. It is too soon, however, to judge the extent to which DISC has achieved its intended purpose of materially increasing the export of U.S. goods and accordingly we strongly recommend that DISC be continued.

The principal objection to DISC is that it deals in half measures, apparently the result of legislative compromise. It grants a 50% deferral at a time when our balance of payments deficit is a matter of grave national concern. It is recommended the original proposal be reinstated that 100% of the export profit be deferred so long as it is invested in export assets. In addition, the current DISC legislation does not defer income on exports which are to a material degree finished abroad. In many cases only certain production stages can be economically performed in the United States; or foreign restrictions require local assembly or manufacture. Accordingly, it is also recommended that the limitation on finishing products abroad be eliminated or greatly softened.

Western Hemisphere Trade Corporations and Possessions Corporations

The Western Hemisphere Trade Corporation (WHTC) provisions, enacted in 1942, grant a 14 point tax rate reduction to U.S. Corporations engaged principally in commerce in Latin America and Canada. The purpose of the legislation was to encourage trade with and investment in these areas. The provisions have worked well for over 30 years and have become an ingrained part of our tax structure. Their repeal would surely cause a decrease in our exports to countries in this hemisphere at a time when competition, particularly from the East, is intense.

It should be noted that GATT, to which the United States is a signatory, prohibits the granting of new export incentives, although incentives in existence at the time of the GATT agreement were not required to be repealed. Hence the WHTC provisions, which predate GATT, can remain in effect, but apparently could not be reenacted if they were once repealed.

The Possessions Corporation provisions of the tax law (section 931) exempt U.S. corporations from taxation on business profits generated in U.S. possessions so long as a corporation's primary business activities are in such possessions. In practice, section 931 is availed of almost exclusively for activities in Puerto Rico. When used in conjunction with the Puerto Rican Industrial Incentives law, a U.S. corporation can operate in Puerto Rico tax free for periods up to 17 years. It goes without saying that this tax climate has been a major factor in the extensive U.S. investment in Puerto Rico since the Incentives law was first enacted in 1947; and such investment has, in turn, been a major factor in the six-fold increase in per capita income of Puerto Ricans from 1950 to 1972. Conversely, the Incentives law would have provided no incentive at all if U.S. corporations had been subject to current U.S. tax on their Puerto Rican activities.

It appears to be in our national interest to raise the standard of living of the citizens of Puerto Rico; and we believe that the section 931 exemption is an efficient and economic way of subsidizing the development of an industrial base which will do just that.

Recommendations for change

We believe the present system of taxing remitted foreign income, allowing the use of foreign tax credits and the special treatment of certain types of corporations to be appropriate in the area of taxation of foreign income. There are, however, inequities, inconsistencies, and unnecessary administrative roadblocks which could be minimized to the benefit of taxpayers and government alike.

Subpart F

Prior to the introduction of Subpart F in 1963, none of the earnings of controlled foreign corporations was taxed until repatriated. (Foreign personal holding companies constituted a very limited exception.) Subpart F provides generally that the U.S. shareholders of a controlled foreign corporation are taxed currently on income arising f om several specified types of transactions which were deemed to be artificial arrangements serving primarily a tax avoidance purpose. The section has been complicated in application and unproductive of U.S. revenues as foreign tax savings measures have been nullified. The improper use or retention of funds abroad could more readily be highlighted and dealt with properly under an extension of the concept in section 531 relating to the improper accumulation of surplus.

Pending reconsideration of the basic merits of Subpart F, we believe two of the tainted classifications should be amended to better reflect today's economic realities. The areas for change are the definitions of "United States property" and "foreign base company income".

Section 956 provides that "investments in United States property" are Subpart F income, and defines "United States property" to include tangible property located in the United States and the stock of domestic corporations. In view of our balance of payments problems, and the tax concessions being made foreigners to invest in the United States, it is inequitable to penalize such investment by U.S. controlled companies. In fact, it would be more desirable to have the ownership of U.S. corporations vested in foreign corporations which are controlled by U.S. interests than those that are not. Section 956 should be amended so that only investment which directly benefits the U.S. shareholders be treated as Subpart F income.

"Foreign base company income" (i.e., Subpart F income) includes income from sales channeled through tax haven corporations for foreign tax avoidance purposes. There is clearly no point in penalizing such arrangements so long as the tax being avoided is not that of the United States. Most of the major trading nations do not have Subpart F type provisions in their taxing statutes; hence, for the United States to invoke a penalty tax, when no U.S. tax is at stake, serves only to hurt our competitive position abroad. As a practical matter the net effect of this provision has been that more foreign tax has been paid which has resulted in additional foreign tax credits and no additional U.S. tax.

<u>Section 367</u>

The Internal Revenue Code recognizes that certain shifts in the direct ownership of property within a controlled group of corporations, or between shareholders and their controlled corporations, often serve a business purpose, and that such shifts do not constitute taxable events. Such tax-free exchanges, however, are intended to postpone rather than eliminate a taxable event. Hence, an exchange of appreciated property with a corporation beyond the taxing authority of the United States could result in tax avoidance; likewise, corporate profits earned tax-free abroad could be returned to the U.S. parent tax-free under Section 332 through liquidation of a foreign subsidiary. Section 367 provides that the gain, but not the loss, on such exchanges shall be recognized unless, <u>before</u> the exchange, the Treasury has ruled that the "exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes".

The Treasury has tempered Section 367 somewhat by its policy (Rev. Rul. 68-23) of issuing advance rulings, even though a portion of the exchange is considered in pursuance of tax avoidance, so long as the taxpayer agrees to report the tainted portion as income (i.e., pay a "toll charge").

It is recognized that the protection of the tax revenues requires that there be controls on tax-free transfers beyond the taxing jurisdiction. However, it appears that Section 367 should be modified as follows in the interest of both equity and commerce:

1. The advance ruling requirement should be eliminated. Under present law, absent an advance ruling, an exchange is taxed even though the bonafides of the transfer are obvious. Further, the advance ruling requirement causes the delay of commercial transactions; and there is no effective way to obtain judicial review of an adverse ruling. It is clear that subjecting such exchanges to the normal post-transaction review of the Internal Revenue Service would be just as effective in protecting the tax revenues. The recent trend toward publication of rulings also requires that the volume be reduced wherever possible.

2. The statute should be amended to provide that only the tax avoidance portion of an exchange will be taxed regardless of whether an advance ruling is obtained. A taxpayer should be able to protect the overall tax-free status of an exchange at any stage of the proceedings by paying a "toll charge" on the tainted portion of the exchange.

3. As a general rule losses should be recognized at least to the extent they offset recognized gains. The recognition of loss should, however, be denied where the taxpayer clearly has not acted in good

faith or where the recognition of losses would give the taxpayer a windfall.

4. All aspects of Section 367 should be subject to judicial review. It should go without saying that a taxpayer is as entitled to his day in court for Section 367 as for any other tax matter.

Current proposals for tax reform

At the present time, the basic tenets of U.S. taxation of international business are being seriously challenged. The proposals for change range from immediate taxation of all foreign earnings without credit for foreign taxes paid to limiting the taxable earnings to taxpayers investing in "tax-holiday" countries or "runaway plants", or to, in any event, construing a portion of foreign earnings taxable whether distributed or not. All such proposals would ultimately serve to reduce the competitive position of U.S. businesses abroad to a greater or lesser degree.

U.S. companies located abroad must have similar business climates to their foreign counterparts. If earnings were subject to U.S. tax, whether or not distributed, the cost of doing business would increase to the extent the foreign effective rate is lower than the U.S. rate. The resulting loss in competitive position could well mean a decrease in taxable income in the United States and a need for additional investment abroad. Forced dividend distributions would only enrich foreign treasuries through the premature payment of withholding taxes.

The United States cannot unilaterally curb the practice by foreign countries of granting incentives they consider necessary or appropriate. If they distort normal economic decisions by establishing improper inducements, the more appropriate remedy would appear to be through bilateral action under the GATT rules or treaty negotiations. The United States should not give up economic benefits presently available to its investors without attempting to secure other inducements in the bargain.

The EEC, GATT and OECD, among other organizations, are currently concerned with the role of tax incentives in international trade--including the U.S. DISC provisions. In connection therewith, changes will undoubtedly be required in the tax structures of various countries. Penalizing U.S. business in the interim under current economic conditions appears to be a foolhardy voyage.

It should also be recognized that the United States does not have a monopoly of many essential commodities and resources which have unfortunately been placed beyond our borders. Many plants located abroad supply a substantial part of their production to the U.S. Proposing higher taxes on such operations owned by U.S. investors would only ensure that all of them will be foreign owned in the long run.

The tax systems of many industrialized countries have recently changed substantially. The enlarged Common Market is relying more heavily on indirect taxation as a result of the value added tax. Their exports, accordingly, bear a smaller proportion of the cost of general government than in the United States as well as encouraging savings and investment. Their capital cost recovery allowances are also generally more favorable--and even then the U.S. allowances are under attack. France, Germany and England extend, in whole or in part, the benefits of corporate tax payments to the shareholders, thus substantially encouraging capital accumulation and investment. In the meantime, trade barriers are being reduced and tax harmonization is moving forward throughout the EEC.

At such time it seems incongruous indeed that the tax posture in the United States should be that of encouraging investment in U.S. businesses by foreigners and the scaling down of U.S. participation in the growing trade throughout the world.

Percentage Depletion

Proposal - Repeal the percentage depletion allowances for oil and gas production.

Statement - The U.S. natural resource companies, by properly availing themselves of incentives to encourage exploration and development, have provided the world with a relatively inexpensive and plentiful supply of energy. That the tax laws should be reappraised as conditions change is obvious. Congress, however, has been considering the role of percentage depletion in the equitable taxation of income from natural resources for approximately 50 years. Meanwhile, most of the U.S. businesses involved adopted operating practices and financial policies on the basis of this long established tax structure. Elimination, or reduction, in tax allowances will require drastic changes in how risk capital is raised and expended and by increasing the costs of doing business exacerbate rising price levels in a specialized portion of the energy industry.

Background

Percentage depletion is not an aberration in the U.S. tax laws but an appropriate economic incentive based on recognition of the inherent risks and costs involved in the exploitation of natural resources. In petroleum operations, in particular, large amounts of money must be spent in exploration and development of a mineral deposit well in advance of the knowlege of whether any minerals will be found or, if found, what quantities will finally be recovered. It takes five years or more to develop a field for production and perhaps twenty to thirty or even more years to complete production. During that period there will be substantial changes in the estimated volume and value of mineral deposits because of changes in extractive technologies, changes in market demand or errors in estimates of reserves.

The unique features of mineral discovery should be recognized. Most industries create a salable product by combining raw materials, capital and labor, the value of each being measurable by its cost. The sum of these values constitutes the cost of the product. The relationship of total cost to total goods produced is relatively constant and the marketplace is generally aware of this relationship.

In the case of oil and gas, the entrepreneur is seeking a natural resource having an intrinsic value totally unrelated to the cost of finding or development. One only has to compare the costs involved in securing oil from the hot sands of Saudi Arabia to those involved in wresting similar treasures from the frozen North Slope to realize this is so. It may cost a very great deal of money to find a small amount of oil or gas or, more likely, no oil or gas at all. A luckier or more intelligent entrepreneur might find a great deal of oil or gas with a relatively small expenditure. In either event, the oil and gas discovered has a utility value in the marketplace which has no predictable, constant relationship to the individual costs of exploration or development. This natural resource is limited in amount and, consequently becomes harder and harder to find with relatively longer periods for development before revenue can be realized.

The U.S. tax laws early in their history attempted to grope with the economics of the industry with discovery value provisions. The inequities and complications that arose ultimately resulted in an admittedly arbitrary solution of percentage depletion allowances based on revenue. In coping with this form of encouragement to the exploitation of oil and gas, complicated contractual arrangements affecting transfer and ownership of operations have been developed over many years of experience. Dismantlement of these arrangements would create temporary chaos to a vital industry as well as major inequities to those who invested on the basis of well established income tax rules. The initial costs to the individuals and businesses involved would be sustantial. The ultimate costs to the consumer could be no less.

Restricting the incentive to smaller producers would, of course, reduce the number of parties injured by the dislocations. The tax policy involved, however, relates to the overall economics of the industry not variations in the size of units making up the industry. Discrimination on the basis of production would create - and necessitate - new areas for tax planning and contractual complications. On the basis of recent experience such maneuvers might, in themselves, call for additional tax reform measures when investors and operators succeeded in meeting the economic challenges involved in the tax differentials. Alternatively, a minor scaling down of the incentive percentage would accomplish the same revenue effect without the complexities and inequities of an allowance based on daily production.

Minimum Tax

Proposal - Increase the present minimum tax

Statement - The minimum tax concept rests on the premise that several selected items of income or deductions are tainted. To the contrary, the items presently subject to the minimum tax are contained in the Internal Revenue Code because Congress appropriately put them there. To penalize taxpayers who structure their affairs so as to utilize these provisions is counter-productive, confusing and inequitable. Any proposals to increase the minimum tax liability of corporate taxpayers again fails to recognize that U.S. corporations are simply conduits and all cost increases encountered including federal income taxes, are effectively borne by the general public through higher retail prices and/or a lower return on its invested capital.

Background

Prior to 1969, it was established that a limited number of taxpayers did not pay federal income taxes on a large part of their economic income primarily as a result of the receipt of various kinds of tax-favored income and the allowance of special deductions. The present minimum tax provisions, originally enacted in 1969, were promoted on the basis that such cases of undue tax advantages would be largely eliminated by the payment of a special 10% tax on certain "preference" items. Although early deliberations were directed to the wealthy individuals who were using tax preferences to avoid the payment of taxes, a last minute proposal extended the minimum tax to corporations.

The basic problem with the present minimum tax concept is that it attempts to eliminate certain disparities which arise under our tax system by arbitrarily assessing a special tax on a few selected items - almost with an unmistakenly clear inference that such items are tainted or improper. To the contrary, the items subject to the present minimum income tax are in the Internal Revenue Code because Congress, in the exercise of its good judgment, put them there. To penalize the individuals who structure their affairs so as to utilize these provisions is counter-productive. We believe that any apparent abuses which may, in fact, result from the inclusion of specific provisions in our tax law must be measured and accepted as part of the overall cost of implementing or continuing such provision. If it is deemed desirable, for example, to change the effective tax rate on capital gains, the normal approach is to consider the subject on its merits. To effect an indirect tax increase on capital gains by assessing an additional minimum tax is confusing, inequitable and frustrates the attempts to simplify the tax structure. This is not to say that tax incentives and allowances should not be reviewed from time to time to ascertain whether, under present conditions, they meet the criteria and results originally envisioned.

Serious consideration should be given to the elimination of the minimum tax at the corporate level. As indicated previously, the extension of the preference tax to corporations was a last minute change reflecting the pressures of the day to finalize the 1969 tax reform package. In theory, the minimum tax should really never have applied to corporations. Increasing the minimum tax liability at the corporate level fails to recognize that corporations are simply conduits through which shareholder investment is combined with labor and material to produce for consumption. Any increase in the tax liability of corporations, whether in the form of a higher minimum tax or otherwise, will in the end be passed through to the ultimate consumer, the general public. Even if the argument is accepted that income taxes are largely borne by shareholders rather than the initial consumers, in the long run this capital bias must be overcome if the business is to remain viable.

Appendix A

Comparison of Cost Recovery Allowances

The following table summarizes a comparison of cost recovery allowances for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the foreign countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants or deductions generally permitted. The deductions in the United States have been determined under the double declining balance method without regard to the limited first year allowances for small businesses.

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of cost of assets)[1]		
		First taxable year	First 3 taxable years	First 7 taxable years
United Kingdom	1	100.0	100.0	100.0
Canada	2[6]	50.0	100.0	100.0
Netherlands	5[10][17]	10.0	50.0	100.0
Sweden	5[18]	60.0[3]	95.7	130.0
Italy	6[10]	20.0[11]	65.0[12]	100.0
Switzerland -	8[2]	12.5	50.8	84.4
" -	6-2/3[2][19]	15.0	58.4	90.0
France	8[7][8]	31.3	67.5	94.9[9]
W. Germany	9[20]	16.7[21]	49.6	88.8[22]
Belgium	10[2]	20.0[3][4]	48.8	89.0[5]
Luxembourg	10[2]	28.0[16]	60.4	94.4
Japan -	11[13]	34.5[15]	56.9	81.4
" -	11[14]	37.1	63.9	88.1
United States				
1962 Law[23]	13[2]	21.7[26]	47.9	80.1
1969 Law[24]	13[2]	7.7	33.9	66.1
1971 Law[25]	10-1/2[2][27]	23.5[26]	54.7	88.5

Appendix A
(con'd)

Footnotes

(1) It is common practice in many countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to a rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowances presented in the table above.

(2) Double declining balance method.

(3) Full year allowance in first taxable year.

(4) Although not considered, installation costs allowed as current deduction which reduces recoverable base cost.

(5) Method changed to straight line in fifth taxable year. Straight line rate applied to original cost for fifth, sixth and seventh taxable years.

(6) Effective 5/8/72 machinery and equipment acquired for manufacturing or processing of goods in Canada can be written off over two years (50% per year). Proposed Law subject to approval of Parliament.

(7) 250% declining balance method.

(8) Although not considered, effect is given to multiple shift operations by reducing service life of assets used under shift conditions.

(9) Method changed to straight line in sixth taxable year.

(10) Straight line method.

(11) Includes additional foreshortened allowance of 15%.

(12) Includes additional foreshortened allowances of 15%, 15% and 10% in first, second, and third taxable years respectively.

(13) Modified double declining balance method; 18.9% per Japanese Government rate table, salvage built into rate.

(14) Depreciation in addition to ordinary depreciation in (13) above is allowed to give effect to multiple shift operations. Depreciation multiplied by factor of 1.28 gives effect to 8 hours of daily average excess usage of an item of machinery and equipment.

(15) Includes special first year allowance of 25%; allowance reduces recoverable base cost in second and succeeding taxable years.

Appendix A
(con'd)

(16) Includes 18% allowance equivalent of 9% investment credit at effective 50% income tax rate; credit does not reduce recoverable base cost.

(17) Depreciation periods are fixed by agreement. With multiple shift operations, a five year life is normal.

(18) Modified declining balance method - 30% rate plus additional 30% allowance in first taxable year (such additional allowance does not reduce recoverable cost); accumulated cost recovery may not be less than 20% of cost for each year asset is in service.

(19) Normal life of 8 years reduced to 6-2/3 years to reflect multiple shift operations.

(20) The average cost recovery period for machinery and equipment in Western Germany is 8 to 10 years to which additional allowances are permitted for multiple shift operations: 25% of allowance for two shift operations and 50% of allowance for three shift operations. Allowances may be further increased when plant is located in certain areas such as Berlin, areas bordering on iron curtain countries, and undeveloped areas.

The above table sets forth cost recovery allowances based on an average cost recovery period of 9 years. The double declining balance method is used. A 25% additional allowance for two shift operations is taken into account beginning with the fifth year when the method is changed to straight line. The corporate depreciation rate thus computed is slightly over the maximum 20% rate permitted on a declining balance method to reflect that:

(A) The straight line method produces more depreciation than does the double declining balance method for certain short-lived assets; and

(B) Items of machinery and equipment costing under U.S. $200 can be expensed.

(21) Full year allowance in first taxable year for assets acquired in first half of such year; half year allowance for assets acquired in second half.

(22) Method changed to straight line in fifth taxable year. See (20) above.

(23) With investment credit but without ADR.

(24) Without either investment credit or ADR.

(25) With both investment credit and ADR.

Appendix A
(con'd)

(26) Includes 14% allowance equivalent to 7% investment credit at effective 50% income tax rate. Credit does not reduce recoverable base cost.

(27) 13 year recovery period reduced by 20% and rounded to nearest one-half year. Double declining balance method.

[Whereupon, at 3:20 p.m., the committee was adjourned, subject to the call of the Chair.]

Appendix

COMMUNICATIONS RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THESE HEARINGS

STATEMENT BY SENATOR J. GLENN BEALL, JR., BEFORE THE SENATE FINANCE COMMITTEE REGARDING THE HISTORIC STRUCTURES TAX ACT AND THE BICENTENNIAL CELEBRATION CONTRIBUTION TAX CREDIT ACT

Mr. Chairman, on August 3, 1973, I introduced S. 2347 a bill to amend the Internal Revenue Code of 1954 to encourage the preservation of historic buildings and structures and for the rehabilitation of other property. This legislation has subsequently been cosponsored by Senators Alan Bible, Robert Dole, Pete V. Domenici, Peter H. Dominick, Barry M. Goldwater, Jacob K. Javits, Charles Mathias, Thomas J. McIntyre, Lee Metcalf, Frank E. Moss, Charles H. Percy, Ted Stevens, and John Tower. Similar although not identical legislation has been introduced in the House of Representatives by our distinguished colleague from New York, Representative Barber B. Conable, Jr. (H.R. 5584).

Mr. Chairman, I feel that our current system of tax incentives works in a very direct and definitive way against enlisting private funds in historic restoration projects. We can no longer continue to systematically destroy our Nation's history, weaken the fabric of our communities, and deplete our resources as we have in the past. As our National values readjust to the concept of a finite world it is important for us to update our tax system so as to help redirect and achieve socially desirable goals.

As we approach our Bicentennial Celebration, more and more Americans are becoming committed to the cause of Historic Preservation. It is truly an idea whose time has come and I think it is incumbent upon the 93rd Congress to move expeditiously with legislation designed to achieve that goal. By preserving our heritage we can strengthen the social fabric which unites Americans of different ethnic, racial, and religious backgrounds.

Mr. Chairman, I have prepared a section by section analysis of the proposed Historic Structures Tax Act and I would ask that it along with the environmental impact statement prepared by the Department of Treasury be printed in the Record of this hearing, at the conclusion of my statement. (Exhibit 1)

Shortly after I introduced S. 2347 I wrote to various federal, state and local agencies, historical societies and other interested individuals and organizations asking each to comment on S. 2347. I was gratified by the large number of letters I received, many of which contained the reoccurring theme which was summed up in a quote by the late Dr. Henry Nelson Snyder who said: "An institution which tends to forget its past will soon have a past not worth remembering."

In a letter addressed to the Chairman of the Senate Finance Committee, Mrs. Eleanor Stearns, Assistant to the Administrator of the Octagon—a National Historical Landmark administered by the American Institute of Architects Foundation, Incorporated—stated:

To what extent, and under what conditions, we can hope to protect our environment and architectural heritage in a meaningful and adaptive manner is up to speculation. Yet, what is real is our unique opportunity to do something constructive now before the wrecking ball takes its toll—and along with it, tangible and material symbols of our past with which we are able to identify.

This is not to say that all old buildings are viable and must be preserved but, rather, that those buildings which are potentially adaptive—as so many are—should be treated in such a manner as to encourage preservation, and not destruction. S. 2347 provides such incentive.

Mr. Chairman, S. 2347 would harness the constructive aspects of our federal tax system so as to preserve historically significant buildings, encourage the rehabilitation rather than the demolition of older buildings in our urban centers and increase the development of additional open spaces for public use. The Historic Structures Tax Act is a modified version of legislation that has received the strong support of the President and the Honorable George Shultz, former Secretary of the Treasury. In a letter to the President of the Senate dated February 19, 1973, former Secretary Shultz stated that——

"The bill would . . . encourage greater rehabilitation, rather than demolition, of older buildings in our urban areas. The legislation is similarly designed to make restoration of historic structures more appealing to private investors. Finally, the bill modified certain restrictions on the deductibility of charitable gifts of partial interest in land to be used for conservation purposes."

Although I have modified the legislation originally transmitted to the Senate by Former Secretary Shultz, I believe that I have preserved three of the major substantive initiatives contained in the draft bill, and I am confident that this legislation is completely compatible with the program of the President and will receive the administration's enthusiastic support.

In his State of the Union Address, President Nixon referred to Historic Preservation by saying that "We have an irreplaceable historic and architectural heritage." The President went on to say that he had proposed legislation "to discourage the demolition of historic structures and to encourage the rehabilitation." In a letter dated October 17, 1973, Mr. Dana G. Mead, Associate Director of the Domestic Council, reinforced the President's interest in this legislation by stating that "we have no objection to your legislation and would support S. 2347." Mr. Chairman, I would ask that Mr. Mead's letter be printed in its entirety at the conclusion of my statement (Exhibit 2).

The National Council on Historic Preservation, which was created by the National Historic Preservation Act of 1966, plays a significant role in coordinating the federal effort to preserve our Nation's heritage. I wrote to each member of the National Advisory Council on Historic Preservation relative to this legislation. Many cabinet members and heads of federal agencies serve on this council and I was pleased to receive favorable report from many of them. In addition, the staff of the National Advisory Council on Historic Preservation has prepared an excellent memorandum on this bill and I would ask that it be printed in the hearing record at the conclusion of my remarks. (Exhibit 3)

On March 20, 1974, I received a memorandum from the Economics Division of the Congressional Research Service of the Library of Congress summarizing the provisions of S. 2347. I would ask that the text of this memorandum be printed at the conclusion of my statement. (Exhibit 4)

In a letter dated December 19, 1973, the Honorable Claude S. Brinegar, Secretary of Transportation stated:

"This Department has followed the legislative history of the Administration's environmental proposals with considerable interest. We believe that these proposals could provide a much needed financial incentive for increased environmental concern at the same time that they would eliminate certain loopholes in our current tax structure which have acted as deterrents to the preservation of historic structures . . ."

The Assistant Secretary of the Treasury, Frederick W. Hickman, noted that "This bill would help encourage greater rehabilitation, rather than demolition, of older buildings in urban areas; make restoration of historic structures more appealing to private investors and encourage charitable gifts of partial interests in land to be used for conservation purposes. The encouragement of rehabilitation in urban areas, the preservation of historically significant buildings and increased dedication of open space for public use are essential goals which will enhance our environment."

Mr. Kenneth M. Brown, Legislative Counsel to the Department of the Interior in a letter dated November 5, 1973 said:

"The President, in his State of the Union Message on Natural Resources and the Environment of February 15, 1973, called for revision of our tax laws to encourage rehabilitation of older buildings. S. 2347 would help to implement this policy by providing tax benefits and disincentives to encourage rehabilitation of certain historic structures. It would also provide tax benefits for certain transfers for conservation purposes.

"We strongly support the historic preservation provisions of S. 2347, as well as the provisions allowing charitable deductions for certain transfers for conservation purposes."

Mr. Chairman, in addition to the above mentioned correspondence, S. 2347 has received the endorsement of a number of other Federal agencies, private organizations, as well as State and local officials who are committed to making our Nation a better place to live. I ask that the text of these selected letters be printed in the hearing record at the conclusion of my remarks. (Exhibit 5)

In introducing S. 2347 I was looking to the long-range impact the historic preservation movement could have on our Nation. I personally believe that a knowledge of and respect for our Nation's history is vital to maintaining our sense of national unity. On the eve of our Nation's Bicentennial celebration, we find our Nation deeply divided and troubled by internal dissension. Now more than ever we need to strengthen the bonds which unite all Americans, which maintain our esprit de corps as a nation, and which will enable us to weather our current adversity as we have done so often in the past.

One of the great unifying elements in this Nation is our common historical experience. Since 1776, our Nation has demonstrated its ability to endure the rigors of a Valley Forge, the invasions of 1812, a bloody civil war, the First World War, the Great Depression, World War II, Korea, Vietnam, and the sometimes oppressive burden of world leadership which has devolved onto us since 1945.

A heightened awareness of and appreciation for our historical heritage will strengthen our sense of national unity and purpose, preserve our history, reinvigorate our communities, and hopefully help to protect our environment. We can do this by constructively utilizing our Federal tax system so as to encourage the long range and highly desirable socioeconomic and environmental goals which we as a Congress have set for our Nation.

Mr. Chairman, if we are to preserve historic sites we must go beyond the current Federal, State, and local programs designed to preserve our Nation's past. At the rate we are going a very large number of historically significant structures are being destroyed for the sake of modernization. Approximately 25 percent of the buildings recorded by the Historic American Buildings Survey of 1933 have since been destroyed. Our tax system does not favor the restoration and rehabilitation of such buildings, especially those that are privately owned. The incentive, as it currently exists in our Federal tax structure, actually encourages the demolition rather than the retention of older structures. This produces increasingly less diversity in our urban centers, destroys buildings of historical significance, and I believe makes our cities increasingly less pleasant and desirable places to live.

Because of the shortness of our Nation's history, I believe it is doubly important for us to protect, preserve, and restore those sites that have historical significance. But it is not enough for us to preserve our history in remote battlefield monuments and sterile museums which are primarily utilized by history buffs and scholars. If the truisms of our history are going to have an impact on our Nation in the last quarter of the 20th century, we must make them an integral part of our lives today, and adhere to the principles they teach us in our daily lives.

Mr. Chairman, our Nation is held together by the commonality of our historical experiences and the consciousness of our national unity. We are truly a nation of immigrants and our 210 million people comprise a varied mixture of racial, religious, and cultural backgrounds. I believe that a knowledge of and respect for our Nation's history, and the principles it teaches us, is vital to strengthening the bonds which united all Americans and it will enable us to weather our current adversity as we have done so often in the past.

Mr. Chairman, I would like to briefly address myself to S. 3184, the Bicentennial Celebration Contribution Tax Credit Act, which I introduced on March 19, 1974. This legislation would provide for a special Bicentennial tax credit for small contributions to officially sanctioned Federal, State and local Bicentennial projects.

The American Revolution was successfully fought with the active support of approximately one-third of our Nation's citizens. Another third actively opposed the efforts to win independence from the British Crown while the remaining third were indifferent to the outcome of the struggle. I am deeply concerned that current efforts to celebrate the Bicentennial of the American Revolution have failed to rally measurable support from our citizens.

To be truly successful, the Bicentennial effort must blend historical scholarship, festive celebrations and a reaffirmation of the basic values and principles upon which our Nation was founded. America needs a successful Bicentennial effort to show us that we have not lost our way.

In addition, the Bicentennial celebration should not be viewed as being limited in 1976 but should include the events leading up to and following the declaration of our national independence. In fact, we are already well into the Bicentennial era and numerous opportunities to mark significant occurrences have already

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been missed. The objective of the Bicentennial tax credit bill will be to mobilize grass roots support for Bicentennial efforts.

I am seeking to involve small contributors, the people who file the standard short tax form, in the spirit of the Bicentennial. Several years ago, Congress decided that it was important for small contributors to give to political campaigns. An individual who contributes $25 to the party or the candidate of his choice is allowed to deduct that amount or take a tax credit of $12.50. A couple is allowed a $50 deduction or a $25 tax credit.

S. 3184 was patterned along the same lines and is designed to achieve the same basic objectives. People who contribute $25—($50 per couple)—to an officially sanctioned Bicentennial project on either the Federal, State, or local levels will be able to deduct that amount from their income tax or take a tax credit of $12.50—($25 per couple). This legislation will take effect upon enactment and will expire on December 23, 1983, a date which marks the Bicentennial of General Washington's resignation of his commission as Commander-in-Cnief of the Continental Armies in Annapolis, Maryland.

If enacted, the Bicentennial Tax Credit should help to mobilize grassroots contributors to the cause of historic preservation and the Bicentennial celebration. If we are successful, I believe these efforts can make a significant contribution to the cause of national unity which has been so badly tattered in recent years.

Mr. Chairman, I urge the Finance Committee to give prompt and favorable consideration to S. 2347 and S. 3184.

[Exhibit 1]

THE PROPOSED HISTORICAL STRUCTURES TAX ACT OF 1973—SECTION-BY-SECTION ANALYSIS

TITLE I—SHORT TITLE

Title I labels the Act as the Historical Structures Tax Act of 1973 and specifies that all amendments contained in the Act are amendments to the Internal Revenue Code.

TITLE II—PRESERVATION AND REHABILITATION OF HISTORIC STRUCTURES

Title II contains provisions intended to encourage preservation of historic buildings and structures certified by the Secretary of the Interior as registered or qualified for registration on the National Registry. In addition, the Bill limits depreciation to the straight-line method in the case of buildings constructed on sites which were formerly occupied by demolished historic structures.

Section 201

Section 201 adds a new section 189 to the Code, permitting a 5 year write-off of rehabilitation expenditures incurred with respect to historic structures which are used in the taxpayer's trade or business or held for the production of income provided that property acquired in connection with such expenditure is otherwise eligible for the depreciation allowance.

On the disposition of a certified historic structure, gain would be treated as ordinary income to the extent that the special write-off provided under this section exceeded the depreciation deduction which would have otherwise been allowable (without regard to this provision). This section would apply with respect to all expenditures made after February 15, 1973.

Section 202

Section 202 would add a new section to the Code providing that no deduction would be allowed for amounts expended in the demolition of a registered historic structure, or for the undepreciated cost of such a structure. Both items would have to be allocated to the basis of the land. The section would apply to all demolitions occurring after the date of enactment.

TITLE III—REHABILITATION OF OTHER PROPERTY

Section 301

Section 301 would add a new subsection (o) to the general depreciation rules of section 167. Under this new provision, if a taxpayer substantially rehabilitated depreciable property, he would be permitted to elect to compute depreciation with respect to his pre-existing basis in the building as though the entire structure was first placed in service by him. This will permit a taxpayer who purchases a used building and rehabilitates it to utilize so-called accelerated methods of depreciation, a privilege which is not now accorded taxpayers under the law.

In order to qualify for this special treatment, the amounts added to capital account during a 24 month period must be at least $5,000 in amount and must be greater than the undepreciated cost of the property, determined at the beginning of the 24 month period. The provision is effective with respect to such expenditures incurred after June 30, 1973.

TITLE IV—CHARITABLE TRANSFERS FOR CONSERVATION PURPOSES

Title IV provides several amendments to the charitable contribution provisions in section 170 of the Code, the effect of which is to permit a charitable contribution deduction for certain types of transfers which are not presently allowed under the law. Specifically, section 401(a) provides that a charitable deduction will not be denied on the transfer of a partial interest in property, where the interest is either an easement of 15 or more years duration granted exclusively for conservation purposes, or is a remainer interest in real property which is granted exclusively for conservation purposes. "Conservation purposes" mean the preservation of open land areas for public outdoor recreation or education, or scenic enjoyment; the preservation of historically important land areas or structures; or the protection of natural environmental systems.

These amendments would apply with respect to contributions made after February 15, 1973.

TAKEN FROM THE ENVIRONMENTAL IMPACT STATEMENT

(Prepared by the Department of the Treasury)

Rehabilitation.—These changes would seek to minimize the difference in tax treatment between demolition and rehabilitation of buildings. At the present time, the destruction of older structures and their replacement with new buildings or with parking lots and related low-density facilities are given tax benefits unavailable to the owner who wishes to substantially rehabilitate the original structure. The resulting loss of architectural variety, especially in the downtown areas of cities, and the continued deterioration of older buildings until a decision to demolish is made, have resulted in degradation of the urban environment. In order to counter this trend, the proposal would provide accelerated depreciation rates now available for new buildings to the undepreciated cost of old buildings which are substantially rehabilitated.

Historic Preservation.—Several changes are proposed to encourage the preservation of historically significant buildings. With the high rate of building demolition and replacement in the United States, it has been estimated that more than 25 percent of the buildings recorded by the Historic American Buildings Survey since 1933 have been destroyed. Present economic incentives do not favor the retention and restoration of these buildings, particularly those in private ownership. Maintenance costs are high and restoration expenses often exceed potential future returns for buildings held for commercial purposes.

The new proposals would seek to readjust these incentives so as to favor retention and restoration. They would allow a five-year writeoff of rehabilitation expenditures on depreciable property, would require capitalization of the costs of demolition and the undepreciated cost of the demolished building, and would limit depreciation on new structures placed on the site of a demolished or substantially altered Registered structure to the straight-line method.

Charitable Transfers.—The preservation of natural areas, scenic landscapes, unique ecosystems and other environmentally important lands is appreciably aided by the willingness of private landowners to dedicate their property to conservation purposes. Whether the gift is of the entire property or of rights over it that protect it from abuse, there are non-profit organizations which are empowered to receive such donations and to protect the areas from environmental degradation. Additionally, local and state governments are increasingly more involved in these activities. However, some provisions of the 1969 Tax Reform Act have had the unfortunate result of discouraging these important conservation undertakings. In dealing with a broad range of tax abuses in the area of charitable deductions, the reforms inadvertently swept in many transactions that would have these beneficial environmental impacts.

The changes now being proposed would rectify the treatment given for the charitable donation of land or rights in land for environmental purposes. Specifically, they would allow deductions for all donated conservation-related easements, even those granted for less than perpetuity. They would allow the deduction of remainder interests when donated for a wide range of conservation purposes.

Environmental Impact of the Proposed Changes

The rehabilitation proposals are specifically aimed at preserving a variety in the size and architecture of urban structures by offering to the investor an attractive alternative to the demolition of older buildings. Center city commercial areas have been particularly affected by a tendency to convert land usage to large multi-story structures or to parking lots and other low density uses often related to motor vehicle accommodation. The resultant loss in the character and charm of our cities is a permanent concession to economic realities. While the 1969 reforms provided special amortization for low and moderate income rental housing, these proposals would apply regardless of income level, although the tax incentives for low and moderate income units would continue to receive most favored treatment. Recent changes in other aspects of depreciation deductions allowable make it difficult to predict the pace of change as a result of these proposed provisions.

The proposed changes in the tax law are in no way intended to replace local and state governmental decisions related to the proper planning and regulation of land use. Nor will they have much effect absent a strong and creative effort by those levels of government to deal with the problems of urban blight. Nevertheless, over the long term the effect of moving toward more equal tax treatment of demolition and rehabilitation should result in greater variety and character in the urban environment. More older structures should be retained and renovated. Downtown areas should provide a broader range in architecture as the ages of buildings will be more varied. Smaller older structures should be saved and used where before they might have been converted to parking lots. Residential areas with a high number of rental units should show geater numbers of rehabilitated structures. Fewer structures should be abandoned and left to decay.

The historic preservation provisions are intended to provide to the taxpayers strong incentives to save those buildings and neighborhoods of such historical importance as to warrant a place on the National Register. It is estimated that as a result of these provisions increased expenditures will be made to restore and rehabilitate such structures, added efforts will be made to preserve them, and they will become desired structures that will be used and kept in good condition.

While these tax benefits may cause increased pressure for commercial use of such structures as offices and so forth, many of the buildings are now located in commercial areas, are unsuited for residential use, and are often objects of the demolition crews. Additionally, other proposals are being made outside the tax area that will provide benefits for owner-occupied historical buildings. Finally, provision of special tax treatment for Registered buildings will provide added interest in the possibility of registration and may result in a significant expansion in future years in the number of structures on the National Register.

The changes in the tax provisons governing the deduction of charitable donations of land and interests in land should increase the attractiveness of this alternative for many taxpayers. Along with related changes being considered in the valuation methods used by the Internal Revenue Service in some of these cases, these proposals should make the donation of land for conservation purposes one of the most advantageous of gifts. If past actions are indicators, it is expected that many of these donations will be of attractive large estates near urban areas, which would provide scenic and open space opportunities beyond the capabilities of most local governmental budgets. Additionally, the variety of possible uses for such lands—recreation, natural preserves, study areas, research areas, and scenic beauty to name a few—will allow for a varied balance of use and protection. Different conservation groups and public bodies will decide how best to use their own areas, hopefully providing a variety of outdoor experiences for the public.

Irreversible and Irretrievable Commitments of Resources

While the proposals require no commitment of present resources by the Government, they will cause a small revenue loss.

[Exhibit 2]

THE WHITE HOUSE,
Washington, October 17, 1973.

Hon. J. GLENN BEALL, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR: Thank you for your recent letter concerning the Historical Structures Tax Act of 1973. I appreciate your bringing this legislation to my attention.

As you know, on February 19th of this year, Secretary Shultz resubmitted to the Congress the Environmental Protection Tax Act. This legislation was introduced on March 14 by Congressman Conable as H.R. 5584. Your bill and H.R. 5584 are quite similar, differing only in the provision dealing with coastal wetland areas, and while we would prefer to see the enactment of H.R. 5584, we have no objection to your legislation and would support S. 2347.

Thank you again for your letter.

Best personal regards.

Sincerely,

DANA G. MEAD,
Associate Director, Domestic Council.

[Exhibit 3]

THE ENVIRONMENTAL PROTECTION TAX ACT AND THE HISTORIC STRUCTURES TAX ACT, AN ANALYSIS FOR THE ADVISORY COUNCIL ON HISTORIC PRESERVATION, SEPTEMBER 24, 1973

INTRODUCTION

While certain safeguards have been established, notably at the Federal level to guide governmental undertakings in a manner consistent with preservation objectives, little control presently exists over private actions that may adversely affect historic properties. This is particularly true in the case of a private individual planning to alter or redevelop a historic building that he owns. In the absence of direct government regulation, economic factors generally determine the fate of such privately-owned historic structures. The unceasing growth of the Nation creates constantly changing economic conditions that affect the continued use of historic properties in their traditional functions. The opportunity for greater gain through redevelopment, or the inability to make an adequate return due to an obsolete physical plant, compels the owner of a historic property to undertake its replacement. Thus suburban sprawl presses for housing developments on the Antietam and Manassas battlefields and high-rise technology forces New York's Pennsylvania Station and Chicago's Old Stock Exchange to yield to new buildings producing greater revenue per square foot.

Many of these economic threats to historic properties are caused by rapid growth, especially in urban areas. Little can be done, other than imposing direct controls on development, to influence private economic decisions in those situations. However, the natural pace and direction of growth are often accelerated by governmental policy determinations, especially those affecting tax apportionment. Indeed, some economic decisions in the private sector affecting historic properties are made solely on the basis of tax consequences. Consequently, diminishing or increasing the tax liability accruing from a certain action can have a significant effect on the decision to undertake that action. While tax policy at all levels of government influences action in the private sector, changes in the Federal revenue laws generally have the most pronounced effect on the taxpayer's burden. Therefore, modifications in the Internal Revenue Code present considerable potential for establishing tax incentives (and disincentives) to stimulate private preservation activity.

Having recognized the impact of tax policies on private economic decisions, it can be demonstrated that the present Federal tax structure encourages the replacement of old buildings, including those of historical significance, with new ones. Two bills now in Congress, the Environmental Protection Tax Act (H.R. 5584) and the Historic Structures Tax Act (S. 2347), will remove tax-generated pressures for the replacement of historic structures and will provide additional positive incentives for private action that further the objectives of historic preservation. It should be noted that the provisions of both bills regarding historic properties are virtually identical and will be considered accordingly.[1]

[1] For simplicity, all section numbers referred to in this paper will be those of H.R. 5584.

The Problem and Proposed Solutions

The proposed amendments deal with three major areas of conflict between the present Internal Revenue Code and historic preservation policy. These are the treatment of demolition costs and loses, the depreciation and amortization of rehabilitation expenses, and the deduction of gifts of interests in property as charitable contributions. To appreciate the inherent limitations on the proposed bill's reforms, it is important to note that the Code only allows deductions of depreciation, amortization, and demolition costs when charged to commercial properties, including those used for rental purposes. This well-established doctrine admits of no exceptions, and it would require a radical change of long-standing tax policy to extend those deductions to noncommercial properties. It should also be noted that the primary concern of the drafters was the threat to historic buildings in declining urban commercial districts, and the bill reflects this. A related proposal was directed to noncommercial properties, providing for FHA home improvement loans of up to $15,000 for National Register properties as opposed to the regular limit of $5,000, and an extension of the repayment period from 7 to 15 years. This proposal was introduced in Congress last year, but was not acted upon before adjournment. Finally, a portion of H.R. 5584 is concerned with the preservation of costal wetlands and, consequently, will not be covered in this analysis.

Demolition Costs and Losses

Present provisions of the Internal Revenue Code encourage the demolition of old commercial structures regardless of their historical or architectural merit. This encouragement derives from two sources. First, the Code allows the owner of such a building to deduct from his income the expenses of demolition and his unrecovered investment in the building (undepreciated cost).

Example 1: T owns a building with an undepreciated cost of $100,000 and spends $50,000 to demolish it. The $150,000 deduction reduces T's taxes by $75,000 based on the corporate tax rate of approximately 50%.

The second incentive is found in the Code's allowance of accelerated depreciation[1] on the new building constructed on the cleared site, when that building is used for business purposes. Accelerated depreciation induces new investment by permitting the deduction of a larger portion of the investment in a shorter time than the normal straightline depreciation method allows.

Example 2: T constructs a building that costs $1,000,000 and has a useful life of 20 years. Its depreciation treatment and resulting tax savings would be as follows:

Year	Straightline method		Declining balance method	
	Deduction	Tax reduction	Deduction	Tax reduction
1	$50,000	$25,000	$200,000	$100,000
2	50,000	25,000	160,000	80,000
3	50,000	25,000	128,000	64,000
4	50,000	25,000	102,400	51,200
5	50,000	25,000	81,920	40,960
6	50,000	25,000	65,536	32,768
7	50,000	25,000	52,428	26,214
8	50,000	25,000	41,923	20,971
9	50,000	25,000	33,555	16,777
10	50,000	25,000	26,844	13,422
20	50,000	25,000	3,000	1,500
Total (20 years)	1,000,000	500,000	987,939	493,964

Note: Depreciation is defined by sec. 167(a) of the code as "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."

While both methods produce essentially equal deductions and savings over the long run, accelerated depreciation is obviously attractive to the taxpayer attempting to minimize his tax burden. He can sell the building after about five years and reinvest in a new commercial structure that qualifies for accelerated depreciation, thereby starting the entire process over again. Present tax law does not extend this treatment to old buildings that may be historic and, therefore, makes them less attractive to purchasers than new buildings.

The proposed amendments to the Internal Revenue Code would change the treatment of demolition costs and depreciation when a historic building used in a trade or business is involved. Section 302 denies deduction of the undepreciated cost of the building and the expense of demolishing it when the building is a "certified historic structure."[3] Rather than taking the deduction as shown in Example 1, the taxpayer would be required to add those sums to his investment (basis) in the land on which the demolished historic structure stood. This would then be considered in the computation of his capital gain when the property was sold.

Example 3: The cost (basis) of the land in Example 1 is $100,000. Under the new provision, T must add the $100,000 undepreciated cost of the demolished building and the $50,000 demolition cost to that figure, thereby resulting in an adjusted basis of $250,000. He sells the land for $500,000. His gain is $250,000 and his tax, at capital gains rates, is $62,500. Under the old provision, he would have received the $150,000 deduction at the time of demolition, representing a tax saving of $75,000. I would then compute his gain from a $100,000 basis on his property. Thus $400,000 gain would incur a tax of $100,000 at the time of sale. However, since he has already received a $75,000 reduction in his taxes at the date of demolition, his net tax liability for the entire transaction is $25,000. This compares with $62,500 liability from the same set of circumstances under the proposed amendments.

	Present code	Proposed amendment
Deduction for demolition plus loss	$150,000	0
Immediate tax saving	75,000	0
Addition to basis	0	$150,000
Capital gain on sale for $500,000	400,000	250,000
Tax on sale	100,000	62,500
Net tax from demolition and sale	25,000	62,500

Not only does the amended provision reduce the tax benefit accruing from the demolition of a historic building, but it also defers the realization of this reduced benefit until the owner of the land chooses to sell. Consequently, the owner who clears for redevelopment is denied the incentive existing in the present Code.

A second amendment addresses the depreciation incentive. Section 201 requires that any improvement "in whole or in part" constructed on a site previously occupied by a certified historic structure that was demolished or substantially altered must be depreciated on the straightline method. Excepted are rehabilitations approved by the Secretary of Interior pursuant to Section 301 discussed below. As indicated by Example 2 and the related discussion, the straightline method of depreciation is generally the least conducive to new investment in properties. Denying accelerated depreciation on a building constructed on the site of a historic structure makes that site substantially less attractive to a redeveloper and will induce him to consider other sites for new construction that are not historic and, therefore, not restricted by the tax laws. For the owner of the parcel, demolition and rebuilding becomes economically less rewarding and, pursuant to Section 401 discussed below, rehabilitation becomes more attractive.

Rehabilitation Expenses

The tax treatment of rehabilitation expenses of historic properties used for commercial purposes is the second major area affected by the Environmental Protection Tax Act and the Historic Structures Tax Act. While the Code does not define rehabilitation expenses, it is clear that these expenses, as covered by the amendments, are limited to capital expenditures and do not include items properly classified as maintenance expenses.[4]

[3] "Certified historic structure" is the term used by the bill for those properties covered by its provisions. As defined in Section 301(d)(1), the term includes any building or structure subject to depreciation which is: (1) listed individually on the National Register; or (2) is located in a Registered historic district and is certified by the Secretary of the Interior or his delegate as being of historic significance to the district. The term "subject to depreciation" means that the building must be used in a trade or business or for the production of income, as in the case of a rental property.

[4] The Code defines capital expenditures as amounts spent on "permanent improvements or betterments made to increase the value of any property." These expenses are not deductible from income as maintenance expenses are and must normally be added to the basis of the property. In Jones v. Commissioner, 242 F. 2d 616 (5th Cir. 1957), a taxpayer who reconstructed a building in the Vieux Carre was required to treat "general rehabilitation" costs as capital expenditures.

Restoration costs would not likely be included as rehabilitation expenses under the proposed amendments. Present treatment of rehabilitation expenses requires that they be added to the basis of the property and, therefore, would provide only a deferred and reduced tax benefit when the property is sold (see Example 3).

The proposed amendments would alter the treatment of rehabilitation expenses in two respects. Section 301 would allow the owner of a historic building used for business or rental purposes to deduct his rehabilitation expenses from his annual income over a period of five years.[4] To qualify for this treatment, the building would have to meet the requirements of a "certified historic structure," and the rehabilitation would have to be certified by the Secretary of the Interior or his delegate as being consistent with the historic character of the property or the historic district in which it is located. It is further required that the rehabilitation expenses exceed the cost of the property and $5,000.

Example 4: T spends $100,000 to rehabilitate a historic building, which cost him $75,000. Under the existing law, this amount would be added to the basis of the property. Upon sale, it would reduce T's gain by $100,000 and, at corporate tax rates, reduce T's tax liability by $25,000. Under the new provision, T would be able to deduct $20,000 annually from his income for five years. This would result in an annual tax saving of $10,000 or $50,000 for the five-year period, twice the benefit received under present law.

Section 401 provides an alternative incentive to rehabilitation. The current Internal Revenue Code permits only straightline depreciation to be taken on a building constructed before 1953. As shown by Example 2, this makes a post-1953 structure more attractive to a buyer considering the potential tax consequences, because the newer building would qualify for accelerated depreciation while a pre-1953 structure must be depreciated on the straightline method.[5] Section 401 would permit the owner of a "substantially rehabilitated property" to utilize accelerated depreciation methods. To qualify, the investment in rehabilitation must be at least $5,000 over two years and must exceed the original value of the structure at the beginning of that two-year period. This Section 401 treatment is not limited to "certified historic structures" and, therefore, would benefit properties of less than Register caliber as long as they were used for business or rental purposes. Accelerated depreciation under Section 401 would be an alternative to amortization of rehabilitation expenses under Section 301. This is attractive to the owner of an expensive building, because as the cost of the building increases in relation to the rehabilitation costs, depreciation becomes a larger factor and amortization a lesser one.

Example 5: T purchases a historic building for $1,000,000. He invests another $1,000,000 in rehabilitation. Useful life of the structure is 20 years, and the tax is computed at the corporate rate, 50%. The tax consequences under the various provisions would be as follows:

	Present code, straightline depreciation of cost only		Proposed amendment: Sec. 301, amortization of rehabilitation expenses, straightline depreciation of cost			Proposed amendment: Sec. 401 (declining balance depreciation of cost rehabilitation expenses)	
			Deduction				
Year	Deduction	Tax saving	Depreciation	Amortization	Tax saving	Deduction	Tax saving
1	$100,000	$50,000	$50,000	$200,000	$125,000	$400,000	$200,000
2	100,000	50,000	50,000	200,000	125,000	320,000	160,000
3	100,000	50,000	50,000	200,000	125,000	256,000	128,000
4	100,000	50,000	50,000	200,000	125,000	204,800	102,400
5	100,000	50,000	50,000	200,000	125,000	163,840	81,920
6	100,000	50,000	50,000	0	25,000	131,072	65,536
7	100,000	50,000	50,000	0	25,000	104,856	52,428
8	100,000	50,000	50,000	0	25,000	83,886	41,943
9	100,000	50,000	50,000	0	25,000	67,110	33,555
10	100,000	50,000	50,000	0	25,000	53,688	26,844
20	100,000	50,000	50,000	0	25,000	6,002	3,001

[4] The process of deducting capital expenditures such as rehabilitation costs from income, rather than adding them to the basis of the property, is referred to as amortization.

[5] The basis for depreciation in either case would be the purchase price plus any capital improvements subsequently made in the building.

Charitable Contributions

The third area of revisions contained in the Environmental Protection Tax Act and the Historic Structures Tax Act is the deduction of property interests as charitable contributions. Recent tax reforms have generally, with the exception of easements perpetual in terms, abolished the deduction of less than fee interest in land—such as easements, options to purchase and long-term leases—donated for charitable purposes. This eliminates any tax incentive for the donation of a scenic or facade easement on a historic property except when given for a perpetual term. Also, charitable deductions for remainder interests[6] have been limited to residences and farms, preventing the donor from realizing any of the tax benefits previously available and thereby removing an incentive to give.

Section 501 proposes modifications to current Internal Revenue Code provisions to encourage the donation of less than fee and remainder interests to organizations for preservation purposes. Any lease, option to purchase, or easement of not less than 30 years duration could be granted to a recognized charitable organization, including State and local governments, for conservation purposes and qualify the donor for a deduction from his income equal to the value of the interest conveyed. Under Section 501(a)(4), conservation purposes include "the preservation of land areas for public outdoor recreation or education, or scenic enjoyment; the preservation of historically important land areas or structures; or the protection of natural environmental system." The section would also permit the deduction by the donor of a remainder interest in a commercial or rental property granted for conservation purposes. This would allow the owner of a historic property to donate it to a preservation organization while retaining the right to use the property until his death. In the meantime he would realize immediate tax benefits from his gift, and the recipient of the remainder interest would have certain rights to prevent the deterioration or alteration of the property. Finally, the bill changes the estate and gift tax provisions to allow the deduction of these same interests for conservation purposes, thereby encouraging bequests of such interest.

In summary, the Environmental Protection Tax Act and the Historic Structures Tax Act would redress much of the imbalance in the present tax system that mitigates against the preservation of historic properties employed in commercial use. The existing encouragement of new construction, through deduction of demolition costs and losses and accelerated depreciation, is reversed in the case of recognized historic structures. Rehabilitation of historic buildings is favored by the write-off rehabilitation expenses and the allowance of accelerated depreciation for substantially rehabilitated structures. Finally, the deduction of charitable contributions of less than fee and remainder interests for conservation purposes is permitted. Besides the obvious incentives to private preservation activity, the inducement of preferred tax treatment should be a spur to enrollment of properties on the National Register because that listing is the basis for qualifying for the proposed incentives.

Status of the Bills

The Environmental Protection Tax Act was drafted jointly by the Council on Environmental Quality and the Department of the Treasury. With the Administration's backing, Representative Byrnes of Wisconsin, ranking minority member of the Ways and Means Committee, introduced the bill on April 27, 1972. As H.R. 14669, the bill was referred to the Ways and Means Committee but no further action was taken during the 92nd Congress. In February 1973, the President transmitted his 1973 Environmental Program to the Congress, including a request for action on the Environmental Protection Tax Act. On March 14, 1973, Representative Conable of New York reintroduced the measure. Designated H.R. 5584, the Environmental Protection Tax Act of 1973 is currently pending before the House Ways and Means Committee.

On August 3, 1973, Senator J. Glenn Beall of Maryland introduced S. 2347, the "Historic Structures Tax Act of 1973." This measure embodies all the historic preservation incentives found in the proposed Environmental Pro-

[6] A remainder interest is a right to ownership of a property that does not take effect until the expiration of another's interest in the property. For example, if T donated a remainder interest in his home to the National Trust, subject to a life estate in T, the Trust would not acquire full title to the property until T died. The Trust would have certain rights over T's use of the property during his lifetime.

tection Tax Act and analyzed in this paper. S. 2347 is currently pending before the Senate Finance Committee.

[Exhibit 4]

THE LIBRARY OF CONGRESS,
CONGRESSIONAL RESEARCH SERVICE,
Washington, D.C., March 20, 1974.

To: The Honorable J. Glenn Beall, Jr.
From: Economics Division
Subject: Summary of tax law affected by S. 2347, Historic Structure Tax Act

This memorandum is in response to your request for a summary of present tax law which is relevant to the provisions of S. 2347, Historic Structures Tax Act, and the changes which would be effected by enactment of this bill. Following is a summary covering the three basic objectives outlined in your letter. The first two objectives are covered as a unit since present law and the provisions of S. 2347 are overlapping in their applicability.

1. Encourage the preservation of historic buildings and structures certified by the Secretary of Interior.

2. Encourage the rehabilitation, rather than the demolition, of existing structures.

PRESENT LAW

Under present tax law, accelerated depreciation is available for new building construction. For new real property (other than residential housing) constructed after July 24, 1969, depreciation may be computed under the 150 percent declining balance method (1½ times the straight line rate is applied in each year to the balance of the cost, without construction of salvage value), or it may be computed under any other consistent method which does not give greater allowances in the first two-thirds of useful life than the 150 percent declining-balance method. Used real property acquired after July 24, 1969 is generally limited to straight line depreciation. Exceptions to these methods are provided for both new and used residential rental property.[1] Thus, under present law, an older building or historical structure could be demolished, and a taxpayer could receive accelerated depreciation on the new commercial building constructed on the cleared site. In addition, deductions are permitted for the expenses of demolition and the unrecovered investment in a building.

CHANGES PROPOSED BY S. 2347

S. 2347 would provide incentives for the rehabilitation of older structures rather than their destruction. It would provide accelerated depreciation rates now available for new buildings to the undepreciated cost of old buildings which are substantially rehabilitated. If a taxpayer substantially rehabilitates depreciable property, he would be permitted to elect to compute depreciation with respect to his preexisting basis in the building as though the original use of the property began with him. This will permit him to use the accelerated method of depreciation. In order to qualify for this special tax treatment, the amounts added to capital account during a 24 month period must be at least $5,000 in amount and must be greater than the adjusted basis of the property as determined at the beginning of the 24 month period. The changes made by this provision would apply to additions to capital account made after June 30, 1974.

In the case of a certified historic structure (certified by the Secretary of the Interior as registered or qualified for registration on the National Register), S. 2347 would permit a five year write-off of rehabilitation expenditures if the structures are used in the taxpayer's trade or business or held for the production of income. Deduction for depreciation would also be allowed with respect to the portion of the adjusted basis which is not amortized.

On the disposition of a certified historic structure, gain would be treated as ordinary income to the extent that the special write-off provided under the bill exceeded the depreciation deduction which would have otherwise been allowable (without regard to this provision). The changes made by this provision would apply to additions to capital account made after February 15, 1973.

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[1] In addition, a special provision was enacted in 1969 which included incentives comparable to those in S. 2347. This provision permits taxpayers to elect to compute depreciation for rehabilitation expenditures on buildings for low- and moderate-income rental housing which are made after July 24, 1969 under the straight line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more.

S. 2347 provides that no tax deduction would be permitted in the case of the demolition of a certified historic structure, or for the undepreciated cost of such a structure. Both items would have to be allocated to the basis of the land. Structures located in a registered historic district would be treated as a certified historic structure unless the Secretary of the Interior certified, prior to demolition, the structure was not of historic significance ot the district. The changes made by this provision would apply to demolitions occurring after the date of enactment.

If a certified historic structure is demolished or substantially altered, but not in conformity with the rehabilitation provisions included in the bill, S. 2347 provides that any new construction, after February 15, 1973, on the site previously occupied by the historic structure would be eligible only for straight line depreciation. The changes made by this provision apply to property placed in service after December 31, 1973.

3. Encourage charitable transfers of property for use of parks, open spaces, or other conservation purposes.

PRESENT LAW

Under Federal income and estate and gift tax law, a charitable deduction is not allowed for contributions (not made by a transfer in trust) of a partial interest in property unless the contribution would be deductible if that interest had been transferred in trust. This disallowance does not apply, however, to contributions of (1) a remainder interest in a personal residence or farm, or (2) the undivided portion of the taxpayer's entire interest in the property. For example, a deduction will be allowed where an individual makes a gift of his residence to charity and retains the right to live in the residence for his life. Also, a gift of an open space easement in gross is considered a gift of an undivided interest in property where the easement is in perpetuity, and is, therefore, deductible.

A deduction is allowed for contributions transferred in trust except under certain circumstances. These exceptions involve contributions of remainder interests and income interests, as follows:

Remainder interests—no deduction is allowed for contribution of a remaider interest unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust, or a pooled income fund.

Income interests—no deduction is allowed unless the interest is in the form of a guaranteed annuity, or the trust instrument requires that the charity receive an annual fixed percentage of the fair market value of the trust property determined annually.

CHANGES PROPOSED BY S. 2347

S. 2347 would revise the tax treatment of the charitable donation of land or rights in land for environmental purposes. S. 2347 would provide that a charitable deduction under income and estate and gift taxes would not be denied for the transfer to a qualifying organization or a partial interest in property where the interest is either a lease on, option to purchase, or easement with respect to real property of not less than 30 years' duration or is a remainder interest in real property which is granted exclusively for conservation purposes. Qualifying organizations are those to which individual contributions are eligible for the maximum 50 percent deduction. They include public charities, private operating foundations, and private nonoperating foundations which either distribute the contributions they receive to public charities or private operating foundations within 2½ months following the year of receipt, or qualify as community foundations. The term "conservation purposes" means the preservation of land areas for public outdoor recreation or education, or scenic enjoyment; the preservation of historically important land areas or structures; or the protection of natural environmental systems.

[Exhibit 5]

DEPARTMENT OF AGRICULTURE,
OFFICE OF THE SECRETARY,
Washington, D.C., January 2, 1974.

Hon. J. GLENN BEALL, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: This is in reply to your request of October 5, 1973, for a report on S. 2347, a bill "To amend the Internal Revenue Code of 1954 to encourage the preservation and rehabilitation of historic buildings and structures and the rehabilitation of other property, and for other purposes."

The bill, Title I, cites the Act as the Historic Structures Tax Act of 1973. Title II encourages the preservation of historic buildings and structures certified by the Secretary of the Interior as registered or qualified for registration on the National Registry, and limits depreciation to the straight-line method for buildings constructed on sites which were formerly occupied by demolished historic structures. Title III encourages the rehabilitation of existing structures, rather than their demolition. Title IV permits charitable deductions for certain types of transfer of property, not presently allowed under the law, for conservation purposes.

The Department is in full agreement with the objectives outlined in your letter and we believe that your bill would be helpful in achieving them. While the Department has no responsibility for urban buildings, we are concerned with historical buildings in rural areas and with parks, open spaces, and resource conservation.

Enactment of the bill might very well encourage the establishment of Living Historical Farms in rural areas, particularly near our urban centers. These farms, which are essentially outdoor operating museums reproducing farm practices of a particular time in a particular area, serve both as a source of knowledge and as an outdoor recreational facility. The Department believes that these farms, whatever their time period, offer a worthwhile addition to our Bicentennial plans. A few of such farms, reproducing conditions under which some of our past leaders grew up, are in existence today and more are needed.

While the Department supports the provisions of S. 2347, we would prefer the enactment of H.R. 5584. The latter, an Administration bill, is substantially identical to S. 2347 except that it additionally contains some important tax provisions designed to help preserve the coastal wetlands areas.

The Office of Management and Budget advises that there is no objection to the presentation of this report from the standpoint of the Administration's program.

Sincerely,

J. PHIL CAMPBELL, *Under Secretary.*

U.S. DEPARTMENT OF COMMERCE,
DOMESTIC AND INTERNATIONAL BUSINESS ADMINISTRATION,
Washington, D.C., October 23, 1973.

Hon. J. GLENN BEALL, JR.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: This is in reply to your letter of October 5, 1973, to me and to Mr. Clarence C. Pusey of my staff regarding S. 2347.

As the representative and alternate for the Department of Commerce on the Advisory Council for Historic Preservation, we both are knowledgeable and enthusiastic supporters of this bill. The legislation is timely and if enacted should provide a major impetus to the preservation of our historic property and structures for future generations.

We hope that the bill is favorably considered.

Sincerely,

J. WILLIAM NELSON,
Director, United States Expositions Staff.

SMITHSONIAN INSTITUTION,
Washington, D.C., March 25, 1974.

Hon. J GLENN BEALL, JR.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: Last fall you very kindly requested my comments on S. 2347, the Historical Structures Tax Act of 1973 "a bill to amend the Internal Revenue Code of 1954 to encourage the preservation and rehabilitation of historic buildings and structures and the rehabilitation of other property and for other purposes."

Because the Smithsonian Institution has traditionally supported efforts to preserve historic buildings and to conserve natural environmental systems I felt that the proposed legislation warranted the attention of the Board of Regents of the Institution. I am happy to report that at their meeting in January the Regents endorsed the objectives of S. 2347 and any similar legislation that would create tax incentives for the preservation and restoration of historic structures and neighborhoods; to encourage rehabilitation instead of demolition of older buildings in urban environments; and to promote charitable contributions of land and rights for conservation purposes.

The Office of Management and Budget advises that it has no objection to the submission of this report and that enactment of S. 2347 would be in keeping with the Administration's program.

Sincerely yours,

S. DILLON RIPLEY, *Secretary.*

GENERAL SERVICES ADMINISTRATION,
Washington, D.C., December 10, 1973.

Hon. J. GLENN BEALL, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR BEALL: This is in response to your request for our comments regarding S. 2347, the Historical Structures Tax Act of 1973, which you have introduced to encourage the preservation and rehabilitation of historic buildings and structures and the rehabilitation of other properties and for other purposes.

The preservation and rehabilitation of historically significant Federal buildings has been a major continuing program of the General Services Administration (GSA). In addition to the nomination of such buildings to the National Register of Historic Places, of which we recently submitted fifteen, GSA has recently successfully completed the restoration of the Pioneer Courthouse in Portland, Oregon, to use as a Court of Appeals and office space.

Under the provisions of Public Law 92-362, we conveyed to local governing bodies within the past year the Federal Courthouse and Post Office in St. Paul, Minnesota, and the Post Office in Battle Creek, Michigan, which had been declared excess but will now be preserved as viable historic monuments in perpetuity. The significant feature of Public Law 92-362 is the provision for partial use of such historic monuments for income-producing purposes to bear the cost of repair, rehabilitation and maintenance. Any excess revenues will be used for parks, recreation, and other local historic preservation projects.

Where Public Law 92-362 provides budget funding relief for local political bodies, we believe S. 2347 will furnish similar incentives to private owners of historically significant buildings. Several such buildings, including the Stock Exchange in Chicago designed by Louis Sullivan might have survived demolition in recent years had the provisions of S. 2347 been available. We concur with the Treasury Department's analytical observations and concern for the growing casualty list of historically significant buildings.

In view of the President's statement at the signing of Public Law 92-362 on August 4, 1972, and the historic preservation program of the General Services Administration, we fully support the objectives of S. 2347.

Sincerely,

ARTHUR F. SAMPSON, *Administrator.*

NATIONAL ENDOWMENT FOR THE ARTS,
A FEDERAL AGENCY ADVISED BY THE NATIONAL COUNCIL ON THE ARTS,
Washington, D.C., February 5, 1974.

Hon. J. GLENN BEALL, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR BEALL: I greatly appreciate your giving me the opportunity to comment on the Historical Structures Tax Act of 1973 (S. 2347). The objectives and approach of this legislation are commendable, and the National Endowment for the Arts wholeheartedly endorses its enactment. The legislation will provide forceful mechanisms to promote the preservation and rehabilitation of historic buildings across the country.

The amendments to the Internal Revenue Code as proposed in S. 2347 are needed and timely in several respects. First, they would effectively complement the Nation's preparations for the Bicentennial celebration. Moreover, the proposed amendments would be of great benefit in furthering the goals expressed by the

President in his Executive Order No. 11593 on the Protection and Enhancement of the Cultural Environment. Finally, the legislation could promote Federal energy conservation objectives which, no doubt, will be a matter of increasing national concern. In this respect, S. 2347 is especially timely, as it would encourage substantial energy savings by fostering the imaginative reuse of older buildings and by minimizing the consumption of energy-expensive materials required in new construction.

The strength of the proposed legislation lies in its three-faceted approach to the problem, combining tax measures to discourage the demolition of historic buildings, along with incentives for rehabilitation and for the transfer of less-than-fee interest in real property for conservation purposes. Taken together, these devices should result not only in the preservation of structures now severely endangered by demolition pressures, but also in the economically feasible reuse of these structures.

The adaptive use or "recycling" of older buildings has become the focus of an increasing number of Endowment activities. The agency's Architecture and Environmental Arts program is supporting, through its grants, numerous projects of this nature, particularly through its City Edges and City Options programs. Moreover, the Endowment is now listed among those Federal agencies responsible for commenting on Environmental Impact Statements relating to historic preservation, architecture and archeology, and neighborhood conservation. Through these efforts, the Endowment has become aware of the urgent need for revisions in Federal tax policy as outlined in S. 2347. We strongly urge the enactment of the Historical Structures Tax Act of 1973.

The Office of Management and Budget has advised us that it has no objection to the submission of this report, but that the Administration would prefer enactment of H.R. 5584, a more comprehensive measure containing the substance of S. 2347 and also provisions designed to preserve the coastal wetlands.

Sincerely,

NANCY HANKS, *Chairman.*

NATIONAL ENDOWMENT FOR THE HUMANITIES,
Washington, D.C., December 6, 1973.

Hon. J. GLENN BEALL, JR.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: Your proposed legislation, S. 2347, the Historical Structures Tax Act of 1973, creates an unusual and important option in a distinctly important area. The preservation and effective use of historic buildings and the creation of parks and open spaces can only further the historic awareness and the general good of the people of this country. Although the Endowment is not permitted by its act to fund the actual costs of preservation, we have encouraged it by funding research and education projects that have led to the preservation of such buildings. To preserve the past as it is significant to our present is a fundamental act of the humanities. Being unacquainted with the tax aspects of the situation, I am unable to assess the relative costs and benefits which the legislation would bring about. Nevertheless, as the purpose of your proposed legislation is to continue and increase such preservation, I believe it merits serious and careful consideration.

The Office of Management and Budget has advised us that it has no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

RONALD S. BERMAN, *Chairman.*

NATIONAL TRUST FOR HISTORIC PRESERVATION,
Williamsburg, Va., November 28, 1973.

DEAR SENATOR BEALL: I have been most pleased and encouraged to receive a copy of your recent letter to Gordon Gray and to read the details of your Historic Structures Tax Act.

Much of the recent history of the kind of demolition that is homogenizing urban scenes throughout the nation can be attributed to tax treatment that has favored destruction over rehabilitation. Your proposal is one that would go far toward rectifying this inequality and encourage a more logical and sensitive attitude toward the preservation of landmark structures. I compliment you on initiating such a sound and imaginative program.

Gordon Gray wrote you that he has now relinquished the chairmanship of the National Trust for Historic Preservation. His contributions to national historic preservation in terms of leadership, legislation, and dedicated personal interest have been nothing short of spectacular. As I embark on my new assignment as his successor, I do so with great confidence that our efforts at the National Trust will be supplemented by legislative assistance from persons such as you, who perceive that the ultimate benefits of urban preservation must really grow from solutions to the fundamental problems of practical rehabilitation.

I shall look forward with keen interest to news of your scheduled hearings, and to meeting you. I am a native of your state and was born and brought up in Hagerstown. In addition, I had the pleasure of working with your father when I was Deputy Under-Secretary of State in the late 1940's and early 50's.

Sincerely,

CARLISLE H. HUMELSINE, *Chairman*.

NATIONAL TRUST FOR HISTORIC PRESERVATION,
Washington, D.C., November 7, 1973.

The Hon. J. GLENN BEALL, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: The National Trust for Historic Preservation is most pleased to know of your support for amending the Internal Revenue Code by the provisions contained in S. 2347, the Historical Structures Tax Act of 1973.

The National Trust was pleased to have worked with the Tax Policy Advisory Committee of the Council on Environmental Quality when it was conducting its 1970–71 study of the effect of federal tax policy on our environment. We are pleased to note that the provisions of S. 2347 are identical to those sections of H.R. 5584 which relate to historic structures.

We support the provisions of S. 2347 and urge the prompt scheduling of hearings before the Senate Finance Committee.

The enactment of this legislation would be among the most significant contributions to the conservation of our worthy man-built environment during our nation's Bicentennial era.

Sincerely,

JAMES BIDDLE, *President*.

INSTITUTE OF EARLY AMERICAN HISTORY AND CULTURE,
SPONSORED JOINTLY BY THE COLLEGE OF WILLIAM AND MARY
AND COLONIAL WILLIAMSBURG FOUNDATION,
Williamsburg, Va., October 16, 1973.

Hon. J. GLENN BEALL, Jr.
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: I am very grateful to you for your letter of October 5, calling attention to S. 2347, the Historical Structures Tax Act of 1973, which you have recently introduced. I have also read your more detailed statement from the Congressional Record and the full text of the proposed act. The legislation you have proposed is in my judgment extremely desirable and most appropriate in this period of the Bicentennial.

That part of the legislation that would encourage owners to preserve and, if necessary, rehabilitate historical structures through tax advantages has, I think, a number of very desirable features. Among them I would include the following:

1. It would, as I understand it, encourage private owners to preserve their historic buildings, thereby making possible the preservation of individual buildings of historic importance that are not so situated so as to be conveniently included among the properties administered by an organized historical restoration, historical society, or the like. This is extremely important in situations where a valuable historical building is located in some isolation from similar structures.

2. The legislation would, moreover, by encouraging more restoration activity by private individuals, take some of the burden off restorations, museums, historical

societies, or state and federal agencies who are already hard pressed to preserve and maintain the historic properties currently under their jurisdiction.

3. The additional amount of preservation that would result from the bill would be accomplished at very small cost to the federal government.

4. To me an important—and relatively hidden—benefit of the legislation is the extent to which it would encourage the preservation of buildings that would then be occupied and used as residences or for appropriate business activity. As much as we need organized restoration and preservation activity, in which the buildings are used only for exhibition to the public, this approach works best for sites of major importance or for large clusters of buildings. The men responsible for administering such properties are themselves the first to admit, moreover, that they must work very hard to prevent such buildings from becoming museums that convey very little sense of having been lived in and from seeming frozen and lifeless. Buildings preserved by persons who would continue to use them (which your legislation would encourage) would have the advantage of giving these historic properties that sense of life, vitality, and continuity with the past that is, I think, the highest goal of historic preservation.

I very much hope that the legislation will be favorably acted on in this session of Congress. If there is anything further that I can do to support it, I should be happy to do so.

Sincerely,

THAD W. TATE, *Director.*

ORGANIZATION OF AMERICAN HISTORIANS,
OFFICE OF EXECUTIVE SECRETARY,
Bloomington, Ind., November 1, 1973.

Senator J. GLENN BEALL, JR.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: Thank you for informing this office of the proposed Historical Structures Tax Act. The objectives are in harmony with those of the Organization of American Historians, the largest organization of historians specializing in American history, and I see no reason to believe that the tax power could not be used effectively for these objectives as it has been for many others.

I am bringing your letter to the attention of the chairman of our Committee on Historic Sites, Dr. Clement M. Silvestro, the Director of the Chicago Historical Society. The Committee serves as liaison between the OAH and local and federal agencies interested in historic sites. You may wish to call upon Dr. Silvestro for assistance.

With best wishes.

Sincerely yours,

RICHARD S. KIRKENDALL,
Executive Secretary.

AGRICULTURAL HISTORY SOCIETY,
EDITORIAL OFFICE: AGRICULTURAL HISTORY CENTER,
UNIVERSITY OF CALIFORNIA,
Davis, Calif., December 28, 1973.

Hon. J. GLENN BEALL, JR.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: The Agricultural History Society is pleased to learn of S. 2347, The Historical Structures Tax Act of 1973. We believe that this legislation would be of benefit in the preservation of historical buildings. At the same time, we believe that its provisions should be extended only to those structures certified by the Secretary of the Interior.

It is our hope that this Act would encourage the development of Living Historical Farms. These farms, depicting agriculture as it was at a particular time in a particular area, are a rather new development in the historical and museum field. Legislation which would encourage their development, as we believe your bill would, is most desirable.

We hope that your bill will become law.

Sincerely,

WAYNE D. RASMUSSEN, *Executive Secretary.*

MARYLAND BICENTENNIAL COMMISSION FOR THE COMMEMORATION OF THE AMERICAN REVOLUTION, MARYLAND DEPARTMENT OF ECONOMIC AND COMMUNITY DEVELOPMENT,
Annapolis, Md., November 6, 1973.

Senator J. GLENN BEALL, JR.,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BEALL: May I thank you and congratulate you on introducing S. 2347, the Historical Structures Tax Act of 1973. It is certainly worthy of consideration by the Congress and I feel it will be well received.

As Chairman of the Maryland Bicentennial Commission, I see every day the importance of the preservation of historic buildings and it is only during our time that these buildings can be saved. Certainly when we celebrate our Tricentennial they will all be gone unless we do our job and do it now.

Again, I commend you for your well thought out proposal and I wish you every success.

Sincerely,

LOUISE GORE,
Chairman, Maryland Bicentennial Commission.

WASHINGTON, D.C., *October 29, 1973.*

Sen. J. GLENN BEALL, Jr.,
U.S. Senate, Committee on Finance,
Washington, D.C.

DEAR SENATOR BEALL: I am writing in response to your letter of October 5, 1973, on the Historic Structures Tax Act of 1973. As a member of the National American Institute of Architects Committee on Historic Resources and Chairman of the Subcommittee on Legislation I would like to confirm the AIA endorsement of this legislation.

With respect to both preservation and appearance problems in our environment, there is no better way for renewing our declining communities than private economic incentive, particularly when meshed with orderly, planned government action. Specifically, our present income tax laws encourage real estate ownership and investment. Pending legislation, such as S. 2347, may add preservation incentives. Real estate taxes are currently encouraging continued community deterioration. Real estate tax now rises when existing buildings are preserved, improved or even well-maintained—this should be replaced by escalating taxes for deterioration, possibly boosted by assessments and fines. Our local government should make negligence unprofitable. There could be no quicker way for improving some of the country's worst neighborhoods, stabilizing declining areas, and protecting those that are still good.

Sincerely yours,

DONALD B. MYER, AIA, *Chairman,*
Subcommittee on Legislation,
Committee on Historic Resources/AIA.

SMITHSONIAN INSTITUTE,
THE NATIONAL MUSEUM OF HISTORY AND TECHNOLOGY,
Washington, D.C. October 19, 1973.

Hon. J. GLENN BEALL, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BEALL: I am grateful for your letter of the 12th inviting my comments on your Historical Structures Tax Act (E. 2347). I have long been deeply concerned with historic preservation, during which time it has been continuously evident how far we lag behind most of the European nations in offering tangible inducements to the owners of historic structures who might be inclined to undertake preservation. Your bill appears to be the instrument needed to bring some balance to this situation.

My principal and specific preservation concern has been for the structures of American technology—manufacturing, processing, and engineering structures, which traditionally are disregarded by preservationists, despite their extraordinary significance in the nation's development. I would, therefor, offer the suggestion that your bill be amended to specifically mention structures relating to "technology, industry, and engineering," as a reminder to both owners and the IRS that it is fully as important to preserve the remains of this aspect of our heritage as houses and churches. An indication that recognition of this is becoming more widespread is the fact that the number of factory and mill buildings; bridges; tunnels; canals; utilities structures; mines; and so forth, included on the National Register, is increasing proportionally with time. Maryland, in fact, has been one of the most enlightened states in this regard, and is one of the few having a member of its professional review board for the National Register concerned expressly with technological structures (who happens to be myself).

If you would keep me informed of the act's progress, I would be grateful.

With all best wishes, I am

Yours sincerely,

ROBERT M. VOGEL,
Curator, Division of Mechanical and Civil Engineering.

RESOLUTION IN SUPPORT OF THE HISTORICAL STRUCTURES TAX ACT OF 1973

Whereas, one of the most attractive features of the Washington Metropolitan Area is its large number of sites of historic significance, its architectural diversity, and its impressive open space system; and

Whereas, the Metropolitan Washington Council of Governments has through its development policies and planning program recognized the importance of these elements as a valuable resource of the area worthy of promotion and protection; and

Whereas, the Historical Structures Tax Act of 1973 (S. 2347) introduced in the Senate by Senator Beall of Maryland and the Environmental Protection Act of 1973 (H.R. 5584) introduced in the House by Representative Conable of New York are designed to achieve, by amending the Internal Revenue Code, the following three objectives:

1. Encourage the preservation of historical building sites and structures certified by the Secretary of the Interior, as listed on the National Register of Historic Places, or within a district listed on the National Register, or on the inventory maintained by state and local jurisdictions,
2. Encourage the rehabilitation, rather than the demolition, of existing structures for compatible and where possible profitable reuse,
3. Encourage charitable transfers of property for use as parks, open spaces, or other conservation purposes; and

Whereas, these objectives will serve to support COG in its effort to preserve the character and improve the quality of life within the Washington Metropolitan Area

Now, therefore, be it resolved, by the Regional Open Space Technical Advisory Committee and the Land Use Policy Committee of the Metropolitan Washington Council of Governments that the Committees support Congressional efforts aimed at promoting the principles of historic preservation and open space conservation and urges a thorough consideration of S. 2347 and H.R. 5584 by the Congress in the light of these principles.

STATEMENT OF CONGRESSMAN BOB PRICE

My name is Bob Price and I represent the 13th Congressional District of Texas. I appreciate the opportunity to testify before this committee on the effect of a phase-out or elimination of the percentage depletion allowance on oil and natural gas for the domestic petroleum industry.

In a word, the effect would be devastating. Here is why I believe this is so.

It has already been well established that the nation faces the continuing threat of energy shortages. Since this fact has been adequately documented before this committee, I will not review those facts now. However, one essential element of our energy situation must be clearly understood. That is, that in the short term of the next twenty years or so, we have no alternative to relying on oil and natural gas for the bulk of our energy needs. The most secure, least costly and most readily accessible source of petroleum is onshore in the lower 48 states where over one half of our vast potential of petroleum reserves are estimated to exist.

The question then is how do we locate these new reserves of oil and gas? The answer is simple. We, in Congress, must provide what economic incentives are necessary to maximize the domestic exploration and development efforts.

It has been documented that approximately 85 percent of the exploratory wells in the United States in 1972 were drilled by independent explorer producers. In my own district, the Panhandle of Texas, independent producers are responsible for 88% of drilling.

Thus the question of how to get more domestic oil and gas reserves narrows to—how do we maximize the exploratory efforts of the independent producer? How do we in Congress preserve and strengthen this essential part of our energy industry?

Let us examine the mode of operation of the independent producer.

As a general rule, the independent producer raises about three-quarters of his risk capital from outside passive sources. These investors are, to a large extent, investors in high tax markets. I am told that one essential element in inducing these investors to put their capital in the high risk "wildcat" exploration ventures is the percentage depletion allowance.

In addition, the independent producer himself relies on the revenues from the depletion allowance to finance his capital needs, such as his inventory of non-producing bases, producing case equipment and servicing and repayment of debt obligations.

It should be observed that, if the depletion allowance is perceived to be an indispensable element in financing the exploratory effort by the independent, we in Congress must strive to preserve and increase this incentive—certainly not abolish it!! The elimination of percentage depletion may fall more heavily on the independent oil producers than on the major oil companies because the present depletion allowance is worth more to individual taxpayers in brackets above 50 percent than it is to corporations in 48 percent brackets.

And just considering abolishing it has caused so much uncertainty in this industry that the flow of outside risk capital into the independent segment has slowed. Marginal wells are now being abandoned to recover the pipe for drilling new wells. The oil recoverable in these abandoned wells is estimated at 50 million barrels of oil. This is regrettable.

In view of the recent Arab oil embargo and the continued threat of other embargoes, we could not have chosen a worse time to consider altering a known, workable tax provision which has become deeply imbedded in the economics of the domestic industry.

Thank you Mr. Chairman and Members of this Committee.

HEDRICK AND LANE,
Washington, D.C., June 12, 1974.

Re Tax Reform Proposals Involving Foreign Income

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: This letter contains the comments of Metropolitan Life Insurance Company and the Prudential Insurance Company of America in support of a proposal reflected in H.R. 11883 introduced by Representative Carey of New York, and attached hereto. This letter is in response to the announcement of the Committee on Finance of May 31, 1974 inviting written comments by interested persons on various tax reform proposals, including proposals involving the taxation of foreign income.

In connection with its consideration of various provisions in the tax laws dealing with the treatment of foreign income, on May 29, 1974, the Ways and Means Committee tentatively agreed to permit mutual life insurance companies maintaining separate life insurance operations in countries contiguous to the United States to exclude these operations for U.S. income tax purposes. The proposal adopted was similar to that contained in H.R. 11883, except that the tentative decision is limited to mutual companies and imposes a tool gate tax as a condition of eligibility for election.

Metropolitan and Prudential are leading U.S. mutual life insurance companies that have conducted Canadian operations since 1872 and 1909 respectively. The proposal reflected in H.R. 11883 has been endorsed by the American Life Insurance Association, which represents the life insurance industry in the United States. This change in law has been requested also by the Canadian government, which has included the change on its agenda of needed treaty amendments.

Description of U.S. Life Insurance Operations in Canada

The bulk of U.S. life insurance company operations in countries other than the United States is in Canada. However, the U.S. share of the Canadian market has steadily declined over a period of time. At the beginning of this century, U.S. companies had approximately 40% of the Canadian market; while at the end of 1972, our share of the market had declined to under 25%. U.S. mutual companies have approximately 80% of the U.S. share of the Canadian market, and Metropolitan and Prudential are the major U.S. mutual life insurance companies operating in Canada.

In most significant respects, Prudential and Metropolitan operate their Canadian branches as if they were separate Canadian companies. The capital for these Canadian branches is furnished by Canadians, the assets arising from insurance operations in Canada are invested and held in Canada, and, in general, Canadian business assets cannot be removed from Canada without the consent of the Canadian Government. Most significantly, the income of these Canadian branches is generated by Canadian insurance and investment activities, and the Canadian branch income inures to the benefit of Canadian policyholders. This is because the pricing systems and policyholder dividend scales for Canadian policies are based upon Canadian investment, mortality, morbidity and expense experience.

Current U.S. Law Is Unfair

Under current law, U.S. income tax is imposed on these Canadian branch life insurance operations. While a foreign tax credit is allowed for Canadian taxes, U.S. taxes on these operations currently exceed allowable credits.

The present system of taxation is basically unfair because the burden of the higher U.S. tax inevitably falls on the Canadian policy owners of these Canadian branches and because the income that is taxed is produced entirely by Canadian capital, investments and other activities that take place in Canada. Under these circumstances, imposition of the U.S. tax runs counter to the generally accepted tax principle that a country does not tax the foreign source income of nonresidents.

Moreover, because of the added cost produced by the U.S. tax, U.S. companies are subject to competitive disadvantages, and, in some cases, are effectively precluded from competing in Canada with non-U.S. companies.

For example, U.S. tax law has substantially deterred sales of Canadian qualified pension and profit-sharing contracts by U.S. companies. Under U.S. law, the earnings on qualified pension plan funds are for the most part not subject to tax and Canadian qualified plans enjoy similar tax treatment under Canadian law. However, because of uncertainty under U.S. law as to whether the Canadian retirement and profit-sharing plans qualify under the U.S. definition, U.S. companies have been faced with a difficult choice. On one hand, they may choose to participate in the Canadian qualified market on a basis that guarantees contract-holders that their benefits will not be reduced by U.S. income tax charges, with the resultant risk that the companies might have to absorb the tax. On the other hand, if they do not choose to participate on this basis, the companies may not sell these contracts at all since they cannot sell contracts that reflect an income tax cost when they are competing with other companies that can sell on a tax free basis.

It has generally been recognized that the problems of life insurance taxation are unique ones requiring unique solutions. Canada and the United Kingdom, the countries where our chief competitors in Canada are incorporated, have dealt with foreign life insurance company branch operations in a unique way. Neither Canada nor the U.K. impose a tax on the foreign branch life insurance operations of their companies even though both of these countries do tax the worldwide income of other domestic companies, including insurance companies other than life. Thus, there are precedents in international law for excluding Canadian branch life insurance company income of U.S. life insurance companies. Moreover, the proposed amendment, which applies to Mexico as well as Canada, is based upon a precedent in the Internal Revenue Code that applies special treatment to U.S. business activities with our neighbors in "contiguous countries." [1]

WHY INCORPORATION OF CONTIGUOUS COUNTRY BRANCH IS NOT APPROPRIATE

Mutual life insurance companies are faced with a number of impediments to the incorporation of foreign branch operations. These include federal income tax problems, problems of insurance regulation, and the difficulties of obtaining policyholder consent for major changes within the framework of existing mutual company laws. Thus, in the case of mutual companies, incorporation of a subsidiary does not appear to be a satisfactory solution to the problems outlined above.

NO EXPORTATION OF JOBS OR CAPITAL

The life insurance company branch operations described above are fundamentally different from the operations of controlled foreign corporations which have been subject of such proposals as the Burke-Hartke Bill. This is because Canadian branch operations do not involve the exportation of U.S. capital and jobs and because in the case of our Canadian branch operations, ultimate beneficiaries of the Canadian branch operations are Canadians.

PROPOSED AMENDMENT

If adopted, the proposed amendment would eliminate the problems described by applying sound concepts to the special circumstances applicable to Canadian branches of U.S. life insurance companies. The general design of the proposal is intended (1) to exclude from the computation of U.S. life insurance company taxable income all of the items that relate to insurance contracts issued in contiguous countries, (2) to require the inclusion in U.S. income of any amounts repatriated from the contiguous country branch to the United States, and (3) to make the foreign tax credit inapplicable to the extent that the contiguous country branch income is excluded.

From a technical standpoint, the proposed legislation employs familiar tax concepts and allows relative ease of administration. The U.S. revenue effect of the proposed legislation is difficult to estimate and may vary from year to year. It is expected, however, that an annual revenue loss of about $3 million will be sustained (based on 1972 data), although the resolution of several unresolved U.S. tax issues might cause this figure to vary. It also should be noted that in some future years the revenue loss may be negligible because of a variety of factors that may, from time to time, cause Canadian taxes to increase and U.S. taxes to decrease. In the absence of an amendment, competition could eventually result in a substantial decrease in Canadian income by U.S. life insurers so that, over the long haul, the annual revenue loss from the proposed amendment is minimal.

Very truly yours,

F. CLEVELAND HENDRICK, Jr.,
THEODORE R. GROOM,
Attorneys for The Prudential Insurance Company of America.
EUGENE M. THORE,
Attorney for Metropolitan Life Insurance Company.

STATEMENT BY CARL E. BAGGE, PRESIDENT, NATIONAL COAL ASSOCIATION

Mr. Chairman: I am Carl E. Bagge, president of the National Coal Association. The membership of the National Coal Association consists primarily of producing coal companies, the operations of which comprise over half the commerical production in the United States. We appreciate this opportunity to present our views.

Because each of those amendments to which I will direct my comments would prove injurious to our industry's efforts to meet current and future requirements for coal, I believe some background of the industry, its projected production demands, its financial condition and other related problems is warranted.

[1] Section 1504(d) of the Internal Revenue Code of 1954.

BACKGROUND

Project Independence, with a goal of energy self-sufficiency for the nation by 1980, will not be met unless the coal industry can more than double its production by that date. This will not be accomplished without a favorable financial climate for the industry. Today, in spite of the obvious demands that coal will face and the knowledge that markets will exist, investing in coal is extremely speculative, with little return on capital.

Coal industry economists estimate, on the assumption that Mid-East oil will continue to be available, that coal's capital needs would be as high as $17 billion by 1985 to meet demand requirements. This is projected in 1970 dollars. For an industry with a current capitalization of $4 billion the magnitude of the task seems almost unattainable.

However, this is a realistic national goal if coal can make the necessary investment now in coal production capacity and if the nation is willing to construct the type of institutional framework favorable to the rapid development of coal. A pivotal ingredient in such a framework is an equitable and realistic tax structure for coal.

Coal must compete for its investment funds. To do so successfully it must be an attractive investment opportunity with a competitive short- and long-range rate of return. Currently the industry simply does not have such a rate of return and thus the potential for development remains only that—a potential.

Coal production in 1973 was 590 million tons. This represents a decline from 595 million tons produced in 1972, and 603 million tons mined in 1970. Tragically, coal's productive capacity has remained stagnant for over twenty years. We can produce little more coal today than we could during the Korean conflict. This static condition cannot be permitted to continue. The industry must substantially increase production, and the cost will be high.

While capital costs may vary according to the terrain and the depth of the seam, it is generally accepted in the coal industry that the capital cost of installing a new deep mine is $20 to $25 per ton of annual production. Thus, a medium-large mine, with a capacity of 1 million tons a year, represents $20 million to $25 million investment by the time it begins commercial production.

Since the industry needs to replace about 5 percent of its capacity every year simply to replace mines that are worked out, it must open new mines with about 30 million tons of capacity annually just to stay even.

One way, perhaps the best way, to encourage the financial community to invest in new mines would be to increase the depletion allowance for coal. In addition, the tax structure must provide incentives to encourage the investment in the conversion of coal into low-pollutant synthetic liquids, gases, and solids.

Some of the very incentives so desperately needed by the coal industry are proposed to be eliminated by some of the amendments currently under consideration.

I will address my remarks first to those amendments proposed to H.R. 8217 which would have a direct and immediate adverse impact on our industry. In addition, I will comment on one amendment, which while not directed at the coal industry, is obviously a harbinger of future possible legislation, which would prove disastrous to our efforts to increase production.

In brief, the National Coal Association supports the retention of the investment credit, favors liberalizing rather than restricting the Asset Depreciation Range System, favors an increase in depletion allowances, particularly for coal, opposes retention of the minimum tax in any form, supports the concept of the Domestic International Sales Corporation, and in general, opposes any amendments to the Internal Revenue Code which would increase the tax burden on our industry, thereby undermining our attempts to increase our production to meet current and future demands for coal. Therefore, as set forth below in more detail, we oppose many of the amendments under consideration.

AMENDMENT 1247

This amendment would, among other things, phase out the investment credit for property with a cost basis ranging from $50,000 to $100,000 and would eliminate the credit for assets with a cost basis over $100,000.

This ill-conceived proposal strikes at the very heart of the coal industry's struggle to increase production to a level sufficient to help make this country self-supporting in energy.

The coal industry is extremely capital-intensive. Most of the mechanized equipment used in underground mines falls easily within the $50,000 to $100,000 category. With respect to surface mines most of the invested capital relates to expenditures for large draglines and shovels ranging in cost from $1.5 million to as much as $3.5 million. A common bulldozer, necessary to reclaim surface mined lands costs over $100,000. For an industry strapped for venture capital, the investment credit has proven to be a valuable incentive. Elimination of the investment credit would only deter the coal producer from continuing to strive for modernization and increased production.

In fact, we believe that rather than eliminating or diluting the tax credit, its value to industry could and should be improved.

Sec. 46(a)(3) of the Code provides that the investment credit may not be used to offset the tax imposed by Sec. 56 (minimum tax on the tax preferences). This restriction on the use of the credit defeats, in part, the objective of encouraging investment in capital goods.

In those industries, such as the coal industry, whose profits have been depressed, notwithstanding continuing investments of large amounts of capital, the investment credit has not provided the full stimulus intended. On the other hand, the minimum tax payable by coal producers can be substantial.

A change in the Internal Revenue Code permitting the investment credit to be offset against the preference tax imposed by Sec. 56 would provide encouragement looking toward the making of such investment.

The present law requires a taxpayer with both investment credit and preference income to pay more minimum tax than a taxpayer who has no investment credit but the same amount of preference income. Further, taxpayers with unused investment credit at the date the minimum tax became law must pay more minimum tax than a like taxpayer with no unused investment credit at such date. A further result is the taxpayers in this position have a slower utilization of their qualified investment credit.

The necessary change in the Internal Revenue Code can be made by eliminating from the second sentence of Sec. 46(a) (3) the words "Section 56 (relating to minimum tax for tax preferences)."

AMENDMENT 1316

This amendment would eliminate the use of the asset depreciation range (ADR) system for all property placed in service after April 30, 1974. The incentive arising from ADR is one of the reasons the coal industry has been able to upgrade and modernize its production facilities in spite of abysmally low profit margins. Why it is impossible to quantify on an industry-wide basis, I am certain that ability to more rapidly amortize the very expensve equipment used in both underground and surface mining has contributed immensely to the growth only now beginning to take place in the coal industry. To remove this or other tax incentives would stagnate our efforts to meet the projected demands noted above.

AMENDMENT 1318

This amendment would terminate the use of a Domestic International Sales Corporation (DISC) effective upon enactment. If this amendment were enacted into law it would be not only detrimental to businesses utilizing a DISC and exporting overseas, but a highly discriminatory action. Those coal interests which utilized a DISC did so in good faith, relying on existing law and negotiating contracts based on the export incentive incorporated in the law. Many of these contracts have years to run without provisions to compensate the American coal producers for loss of the DISC benefits, should the provision be repealed. For an exporter to be forced to honor such a contract without the concomitant advantages of a DISC would be patently unfair.

AMENDMENT 1324

Enactment of this amendment to modify the minimum tax by reducing the $30,000 exclusion to $10,000, and eliminating the deduction for taxes paid would deal a severe set-back to the coal industry's attempt to attract capital and develop our nation's indigenous energy sources. The arguments set forth with respect to preceding amendments are similar, if not identical, with respect to increasing the adverse impact of this insidious tax, which in fact, is not a "minimum tax" at all, but an additional tax as applied to corporations.

The minimum tax was originally conceived to insure that a select group of very wealthy individuals would be subjected to some measure of income taxation. As intended, and originally passed by the House in the Revenue Act of 1969, that end would have been accomplished. However, in the process of legislation, the provisions of the limitation on tax preferences (LTP) changed considerably.

Ultimately, it came to apply to corporations as well as individuals, and encompassed a series of "preferences" which were not part of the original Treasury package.

From the coal industry's point of view, the LTP bears most heavily with respect to the depletion allowance. It is a pronounced detraction from what incentive exists with respect to the depletion allowance. In the coal industry, or any other mining operation for that matter, there is already a restriction on the depletion allowance, since the depletion deduction is limited by the 50 percent of taxable income rule.

The 10 percent "minimum tax" is suspect as valid tax policy when applied only to individuals. As applied to corporation it is completely fallacious. Essentially, it is a penalty tax for following existing tax law. If tax provisions are improper, then Congress has the authority to review them. But no one should be penalized for adhering to the law. It is a restriction on virtually all the attempts by the federal government to encourage business expansion through the tax system, most of which are under attack by the various amendments to H.R. 8217.

AMENDMENT 1850

Among other things, this proposal would repeal percentage depletion for oil and gas production. The coal industry strongly opposes this amendment, not because it impacts on our industry, but because the precedent would, I fear, set the pattern for future legislation that would result in the elimination of percentage depletion for all minerals, including coal.

At a time when the production of energy resources is at a premium, to eliminate any incentive to any industry should be unthinkable. We believe, in fact, that with respect to coal, the percentage depletion should be increased to 15 percent, and to that end, we strongly support and urge favorable consideration of S. 198, a bill introduced by Senator Hansen (R-Wyo.) and others to do just that.

Although there is a strong need from the standpoint of the nation's welfare to stimulate investment in coal production, the depletion allowance for coal is discriminatorily low. Specifically, oil shale, the nation's only other abundant energy fuel, has a depletion allowance of 15 percent.

Only through intense efforts will the nation be able to maintain an adequate supply of energy in the future, and at the same time maintain primary self-sufficiency in energy. Primary self-sufficiency in energy must be maintained if the United States is to regain its ability to act independently in international matters. Further, energy is such an enormous item of total dollar cost that any increase in imports would result in an unbearable drain on our balance of payments.

Coal is by far the greatest energy reserve available to the United States, and it can be used to make up for deficiencies in other sources. As noted above, coal cannot be produced without large investments because coal mining has become capital intensive. The necessary investments will be made only to the extent that incentives are sufficient to attract capital in the face of the risks. Increasing coal's depletion allowance would moderate risk. At stake is our ability to continue the social and economic progress which we have made over the past several decades and, more importantly perhaps, our ability to function in the world community as a stable and progressive force.

Energy, its supply and consumption, is no longer of parochial interest only to the energy industry. Rather, its importance has escalated and it must now occupy the immediate attention of those charged with the determination of national policy at the highest level.

It is in the best interests of the nation, as well as the coal industry, to not only reserve, but enlarge on the financial incentives related to the development and mining of coal. It would be short-sighted indeed to constrain the industry at this time by reducing the percentage depletion allowance. Indeed, it would also be very inequitable. Approximately 60 percent of the total commercially produced steam coal is sold under long-term contracts. These contracts were negotiated with the benefits of depletion as an integral part. While these contracts may provide for price escalation with respect to labor and materials, they have no provision for increased corporate income taxes which would result if the depletion allowance were reduced. Because of these restrictive contracts, many coal companies are currently operating at a deficit. Any additional burden could not be tolerated.

CONCLUSION

The United States is on the threshold of a severe energy crisis. That fact can no longer be talked away. Our oil supply is limited and our known natural gas reserves are running out. The promise of the atom is still years away.

Balancing this dilemma is the fact that we have approximately three trillion tons of coal reserves in the United States—sufficient to last for hundreds of years, even if used as synthetic oil or gas. In fact, fully 88 percent of our energy resource reserves is in the form of coal. And, sooner or later, we must turn to this reserve to preserve our national integrity, both from a balance of payments standpoint or as a necessity for national security.

However, faced with the problems of the coal industry, the financial community is reluctant to invest in new mines. The dollar incentive just does not exist when one considers the inherent risk. Much of this risk could be ameliorated through tax incentives. Rather than enacting legislation which would restrict new investments, this Committee and the Congress should be looking to new ways to encourage venture capital into the coal industry.

I urge you to do so.

WRITTEN STATEMENT OF THE RUBBER MANUFACTURERS ASSOCIATION, INC., BEFORE THE FINANCE COMMITTEE, U.S. SENATE HEARINGS ON TAX INCREASE PROPOSALS, JUNE 6 ET SEQ., 1974

SUMMARY OF CONTENTS

Domestic tax increases for corporations

The 7% investment tax credit, and accelerated depreciation rules should be continued. There is a strong need for these tax provisions to encourage the modernization of plant and equipment in the rubber manufacturing industry.

Foreign tax increases for corporations

Reasons for Establishing Plants Abroad.—The market for tires is growing faster outside the U.S. than it is at home. The only method by which U.S. tire manufacturers can effectively compete with foreign manufacturers is to build plants in or adjacent to foreign markets. The foreign facilities that have been established serve local markets and are not in competition with plants in the United States.

Positive contributions to the U.S. domestic economy and employment are being made by MNC's in the tire manufacturing industry under current laws.—Details are given regarding the positive contribution to the U.S. domestic economy now being made as a result of overseas investments by U.S. tire manufacturing companies. These positive contributions include: substantial favorable effects on the U.S. balance of payments and on domestic employment.

Harmful effects from changes in current provisions governing the taxation of foreign income.—Changes in the rules governing foreign tax credits and deferral of tax on undistributed income would seriously erode the competitive position of U.S. tire manufacturing companies abroad.

The RMA has approximately 180 member corporations involved in rubber manufacturing activities. Included in the Association are five major American tire manufacturing corporations which have plants and related facilities in foreign countries. These five companies are: The Firestone Tire & Rubber Company, The General Tire & Rubber Company, The B. F. Goodrich Company, The Goodyear Tire & Rubber Company, and Uniroyal, Inc. With respect to foreign tax issues this statement is submitted primarily on behalf of the five tire manufacturing companies with overseas facilities. With respect to domestic tax issues this statement is submitted on behalf of the entire RMA membership.

PROPOSED CHANGES IN DOMESTIC TAX RULES FOR U.S. CORPORATIONS

Among the tax change proposals noticed for this hearing are suggestions to eliminate the Asset Depreciation Range (ADR) system and, for all practical purposes, the 7% investment tax credit. We agree strongly with the statement submitted on June 10, 1974 to this Committee by the National Association of Manufacturers that these tax rules introduced in 1971 have been "notably successful in encouraging productive investment, employment and increased productivity," and that their retention is badly needed to encourage modernization of the U.S. industrial plant. We protest vigorously any repeal of these rules in a spur of the moment fashion without careful consideration of the consequences of repeal by Congress. The present hearing we regard as inadequate notice for our views to be prepared and presented in any detail. We would strongly hope that these and all other major changes in the U.S. corporate taxes will be deferred until more appropriate and thorough consideration can be given by this Committee and the Congress as a whole to the extremely important issues involved.

Proposed Changes in Foreign Tax Rules for U.S. Corporations

With respect to proposals to limit corporate use of the foreign tax credit generally, three central points which RMA wishes to present are:

1) the American tire manufacturing industry established foreign production facilities in order to service new and/or growing foreign markets which we could not service with domestic production through exports;

2) the industry, under the current U.S. tax laws, has managed not only to achieve this marketing goal, but has done so to the benefit of the United States economy and the operations of these companies;

3) repeal of the foreign tax credit and the deferral of tax on undistributed income would seriously jeopardize the present competitive position that these five tire manufacturers now maintain in the world today.

We would like to expand upon this marketing and economic program showing how its pursuit, under U.S. tax laws and treaties, has assisted not only the expansion of American based tire manufacturing companies in foreign countries but has played an extremely beneficial role to our domestic economy.

The rubber manufacturing industry in the United States was born in an atmosphere of international trade. For the first 100 years of its existence, it depended exclusively on imports of natural rubber. To insure adequate supplies of this vital raw material to satisfy domestic demands, American tire and rubber companies purchased rubber plantations in the rubber-producing areas of the world. It is only during the last quarter century that the industry has become increasingly, and predominantly, dependent on the use of domestically-produced synthetic rubber. At the same time, through an expansion of the industry's production facilities overseas its international involvement has not diminished. At present, the five multinational companies, have a total of 98 production facilities located in the free world outside of the United States.

We would like to explain the economic and marketing reasons for establishing these foreign facilities.

I. Reasons for Establishment of Foreign Plants

The market for tires is growing faster outside the U.S. than it is at home. Since 1950, the U.S. auto tire market increased 138% from 84 million units to 200 million units. The free-world market outside the U.S. grew 904% from 23 million units to 231 million units. (See Table "Growth of World Tire Market"—Appendix P. I.)

This disparity is expected to increase in the future. Not only Europe, but Latin America, and Africa-Asia will have a higher rate of growth than the U.S. American tire manufacturers have a choice of ignoring this rapidly growing market—and leaving it to foreign competitors—or of participating in it by the most feasible method.

For over 20 years, it has been clear that the only method by which the U.S. tire makers can effectively compete with foreign manufacturers is to build plants in, or adjacent to, these growing foreign markets. U.S. manufacturers would have preferred to export but the experience of the last 20 years in particular has shown this is unworkable and non-competitive. This is substantiated by the fact that exports during this period have averaged only 1.4% of U.S. tire shipments. (See Table "U.S. Exports as Percentage of U.S. Tire Shipments"—Appendix P. II).

It is also invalid to maintain that U.S. companies establish plants abroad to ship products back to the United States. Of the tire produced overseas, 99% remain abroad with the 1% coming into this country constituting odd sizes and types mostly used by imported foreign cars. Such tires represent such small production runs here that they would be uneconomical to produce in this country.

Specific factors in building plants abroad

There are sound reasons why tire plants are built abroad close to the markets they serve:

1. The sizes and types of tires used abroad are distinctly different from those used in the U.S.
2. The complexity of tire lines and inventories gives the marketing advantage to companies whose factories are close to the market.
3. Transportation is an important factor in the relative cost and price of tires.
4. Wage differentials between the U.S. and foreign countries make it uneconomical to ship from the U.S. abroad, but possible for foreign competitors to ship from abroad to the U.S.
5. Value added taxes abroad favor exports at the expense of imports, whereas U.S. income tax favors importers over exporters.
6. Exchange controls in some foreign countries preclude imports.
7. Under the Kennedy Round, tariff rates on tires were set lower in the U.S. than in all foreign countries.
8. Various non-tariff restrictions tend to favor local manufacture of certain products over imports.

Perhaps no one of these factors about would prevent exports of tires from the U.S., but, taken together, the economic and political considerations represent a virtually insurmountable barrier to the export of U.S. tires to most markets of the world. On the other hand, U.S. withdrawal from a foreign production base will be promptly filled by foreign manufacturers who have the competence, ability to increase their capacity and commitment to exploit every opportunity to the fullest. And in the last analysis, the competitiveness and growth potential of these five U.S. tire companies in this country will increasingly be eroded.

A more detailed explanation follows regarding the foreign marketing conditions which demonstrates why exports cannot serve such markets and why American companies build tire plants abroad.

1. Difference in sizes and types of tires

Almost all tires manufactured in the U.S. for the domestic market are 13", 14", and 15" diameter tires with large cross-sections to accommodate American-made cars. Most of the passenger tires used abroad are 12" and 13" sizes with small cross-sections to fit small European cars. American manufacturers find no market abroad for the types of tires built for the U.S. market. U.S.-owned plants abroad make entirely different types and sizes of tires from those made in the U.S. by the same companies.

2. Complexity of tire plants

A typical manufacturer's line of tires requires numerous different sizes and types that fit the large variety of original equipment and replacement tires needed. To supply such a foreign market from the U.S. puts a marketer at a disadvantage unless he has some offsetting savings in cost to make poor service acceptable.

3. Transportation costs

Relative to its value, a tire requires a considerable amount of shipping space. Tires worth $20 to $50 may take as much shipping space as T.V. sets worth $200 to $500. For this reason, transportation costs are a significant expense in the export of tires.

4. Labor cost differentials

Wage and fringe expenses of over $7 per hour in the U.S. are three times the average paid abroad. The use of automation on high volume U.S. types has made U.S. tires reasonably competitive with imports in the U.S. domestic market. But American manufacturers, with high labor costs to start with, have been unable to surmount the other export barriers described herein.

5. Border taxes

Common market countries now use the value added tax. This tax is not applied to exported tires. However, it is applied to imported tires. It, therefore, favors exports and hampers imports. In contrast, the U.S. relies primarily upon corporate income taxes. The American manufacturer must pay the U.S. government such taxes on the product he exports and then pay the value added tax abroad.

6. Exchange controls

Many less-developed countries have maintained strict control of foreign exchange. Special permission must be obtained to import items such as tires. If a local producer exists, the government is not likely to approve exchange for the import of tires.

7. Tariff dates

Under the Kennedy Round, tire tariffs were reduced in many countries. Although the U.S. has reduced tariff levels from 8.5% to 4.0%, the tariffs for other nations remain at levels three and four times that of the U.S. in spite of staged tariff reductions. (See Chart "Comparison of Tariff Levels Applicable to Tires"—Appendix P.III).

8. Nontariff restrictions

Many less-developed countries, particularly Asian, African and Latin-American countries maintain strict policies of protecting local manufacture by forbidding the import of any size or type of tire which could be made inside the country.

II. CONTRIBUTIONS TO THE DOMESTIC ECONOMY AND EMPLOYMENT BY MULTINATIONAL CORPORATIONS IN THE AMERICAN TIRE MANUFACTURING INDUSTRY UNDER CURRENT TAX LAWS

The RMA believes that, having chosen to compete in foreign markets by establishing production facilities abroad, the American tire manufacturing industry has made important positive contributions to the domestic economy and employment.

The significant domestic advantages derived from American tire manufacturers who built plants abroad are contained in an RMA study included in the recently released document *Multinational Corporations—A Compendium of Papers* prepared for the Senate Finance Subcommittee on International Trade. The RMA study entitled *The Role of Multinational Corporations in the American Tire Manufacturing Industry: A Statement By The Rubber Manufacturers Association*, contains a number of conclusions but we shall summarize the five having the greatest significance.

1. Balance of payaments

The present tax treatment of earnings and profits of controlled foreign corporations in the tire manufacturing industry has resulted in the repatriation of $929.3 million in individuals, royalties and other income from the 8-year period 1964–1971, (RMA Study, Table D) or an annual average of $116.1 million. This, coupled with exports to subsidiaries, affiliates, and associates of $1,250.7 million and $907.8 million exports to others has, given these five tire manufacturers a favorable balance of payments of $2,590,500,000.00 over the 8-year period.

The favorable balance of payments of $2.6 billion by these five U.S.-owned tire companies has kept the U.S. balance of payments problem from being worse than it is. This demonstrates that these five multinational corporations, far from contributing to the current monetary and currency crisis, have actually reduced its magnitude by bringing dollars back to this country.

2. Imports

The RMA Study (Table A) shows that the domestic replacement market is mainly served by U.S. production. While imports have grown from 1.4% of the replacement market in 1964 to 6% in 1971, only 6/10 of 1% of these replacement tires are from subsidiaries of domestic tire producers. The Study (Table B) further shows that only slightly more than 1% of all replacement tires produced subsidiaries of U.S. tire corporations were exported to the United States.

These figures reinforce the finding of domestic producers that competition within a given market requires production facilities in that market. Any loss of market share of withdrawal from a market would result in the market share being taken over by a foreign competitor because it could not be supplied by U.S. exports.

3. Domestic investment

The present tax system, by giving controlled foreign corporations a reasonable tax neutrality with their foreign competitors does not bear on, or conflict with U.S. investment in domestic manufacturing. Our Study (Table E and Chart 2) shows that there has been a steady annual increase in new manufacturing investment in plants and equipment both in the U.S. and abroad. Over the 8-year period a total of $2,550,100,000.00 has been invested in domestic manufacturing. This is 70% of the total manufacturing investment of $3,658,700,000.00 over this period. In every year of our Study, domestic investment has substantially exceeded foreign investment and is of course closely geared to the needs of our domestic market.

4. Domestic employment

In the tire manufacturing industry for the last eight years, there has been a marked stability in domestic production employment as a percentage of the worldwide production employment. (See Table F and Chart No. 3). The most recent figures show from 1964 to 1972 domestic production employment among the five American companies increased by 22,992, a 24% increase.

Our Study (Table G and H) shows that in a 7-year period 1964–1970 these five companies made a domestic investment of $2,271.8 million required to create 16,561 new production jobs or an average cost per new employee of $137,178. During the same period, they made a foreign investment of $892.3 million to create 15,446 new production jobs.

There is no doubt that the increase in domestic investment that has enabled the expansion of employment in these U.S. tire companies is a result of the contribution of earnings derived from their overseas operations.

5. Technology mobility

The accelerating rate of technological change which began during the 1950's and continues today has focused attention on the relationship between technology and employment and economic growth in the U.S. The role of the multinational corporation in transferring technology across national borders has come under particular scrutiny. It is contended by some that by transferring technology abroad multinational corporations are narrowing the technology gap between the U.S. and the rest of the world and, as a result, U.S. exports are reduced, imports encouraged, and jobs lost.

In the tire industry, the flow of technology across international borders has historically gone both ways, and U.S. domestic producers and domestic workers have benefitted accordingly. American tire and rubber manufacturers have been quick to adopt advanced foreign technology and further develop it in the U.S. research centers and on U.S. production lines. Some leading examples are:

(1) the discovery of styrene butadiene rubber (SBR) now the most widely used of the synthetic rubbers;

(2) the development of the all steel belt radial truck tire and the radial passenger tire incorporating steel belts;

(3) the use of metal studs in winter tires;

(4) the development of polyurethane, polyethylene and polypropylene.

It is fair to say that American tire firms engaged in international competition could not have achieved the above enumerated contributions to the domestic economy and would have lost ground in home markets had they borne substantially higher tax burdens than their foreign competitors. To prevent undue competitive imbalance, U.S. tax laws and tax treaties with other countries have been developed over the years to create conditions of "tax neutrality" for the earnings and profits of foreign subsidiaries of U.S. corporations.

III. SUPPORT OF CURRENT PROVISIONS GOVERNING THE TAXATION OF FOREIGN INCOME

Thus far we have explained: (1) Why American tire manufacturers chose to build plants abroad as the only effective means of competing in foreign markets; (2) some of the advantages accruing to the domestic economy under current tax laws, namely a strong favorable balance of payments, a minimal amount of imports from U.S.-owned foreign subsidiaries, a steady annual increase in domestic investment and employment, and a technology mobility favorable to the U.S. economy.

We will now direct our comments to some of the specific tax statutes that have enabled American industry to compete effectively but which, at the present time, are also under severe criticism.

1. *Foreign tax credit*

Present law provides that the U.S. will not tax again, beyond existing U.S. tax rates, income which has already been subjected to income tax by a foreign government. This provision was conceived as a measure to assure equity, i.e. to make certain that an American firm operating abroad paid exactly the same total tax rate as a business in this country.

Repeal of the foreign tax credit would not eliminate a special privilege, as some contend, but would impose a penalty. It would further constitute the abandonment of 32 reciprocal tax agreements with other countries.

Should the foreign tax credit be removed, the U.S. tax system would no longer be neutral but punitive as regards foreign investment. Any proposed change which places a higher tax burden on U.S. companies compared to their foreign competitors could not be called a step toward tax neutrality.

It is clear that elimination of the foreign tax credit would destroy the competitive position now held in foreign markets by the companies we represent today, with the potential of eventually closing down of many, if not all, foreign operations. For an excellent elaboration of the mathematics involved, see the witness statement before this Committee by Robert L. McNeill on behalf of the Emergency Committee For American Trade, June 6, 1974.

2. *Deferral of tax on undistributed income*

Another basic U.S. tax principle has been to tax income when realized so that funds are available to pay the tax. Repeal of the present deferral provision would mean that U.S. income tax would be due currently on all of a foreign controlled subsidiary's earnings whether or not the funds could be repatriated currently for use on paying the tax.

Experience has shown that it is not feasible to expect to be able to repatriate more than a portion of any given subsidiary's earnings. Frequently, there are currency controls, banking requirements, etc., which limit the amount of earnings that can be brought back any given year.

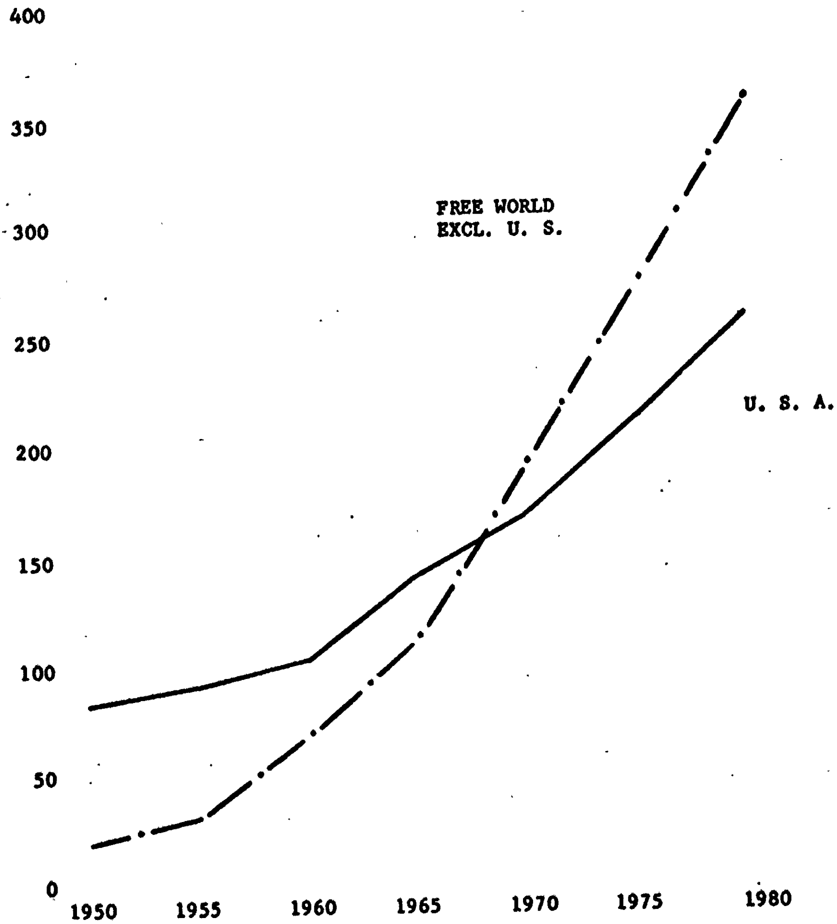
Furthermore, it must be recognized that if a controlled foreign subsidiary is successful and growing, it is necessary to maintain higher inventories, carry higher balances in accounts receivable, and generally provide more working capital in the operation of its business.

Even under ideal circumstances it would not be practical to attempt to repatriate enough additional funds to pay the proposed tax differential. Domestic capital already earmarked for other U.S. uses would have to be used for this purpose.

No other country has enacted such stringent methods and put them into effect currently. A Canadian proposal to tax undistributed income of foreign subsidiaries has already been delayed two years until 1975. Some Canadian Government officials already concede that the proposal may never become law because of the unfavorable potential results. It is well known that Congress rejected this same idea after long and careful studies in 1961 and 1962. We commend the testimony on this subject presented to this Committee on June 6, 1974 by the Emergency Committee For American Trade.

We are not routinely objecting to higher taxes. We do object to tax proposals that would eliminate the foreign tax credit and the deferral of tax on foreign source income because these changes would produce negative consequences for the United States of a very serious nature.

GROWTH OF
WORLD AUTO TIRE MARKETS
(Millions - Units)



Sources: RMA REPORTS
Various Foreign Trade Associations and Government Agencies

EXPORTS AS PERCENTAGE OF U.S. TIRE SHIPMENTS, TOTAL AUTOMOTIVE TIRES (PASSENGER AND TRUCK AND BUS COMBINED), 1950–71

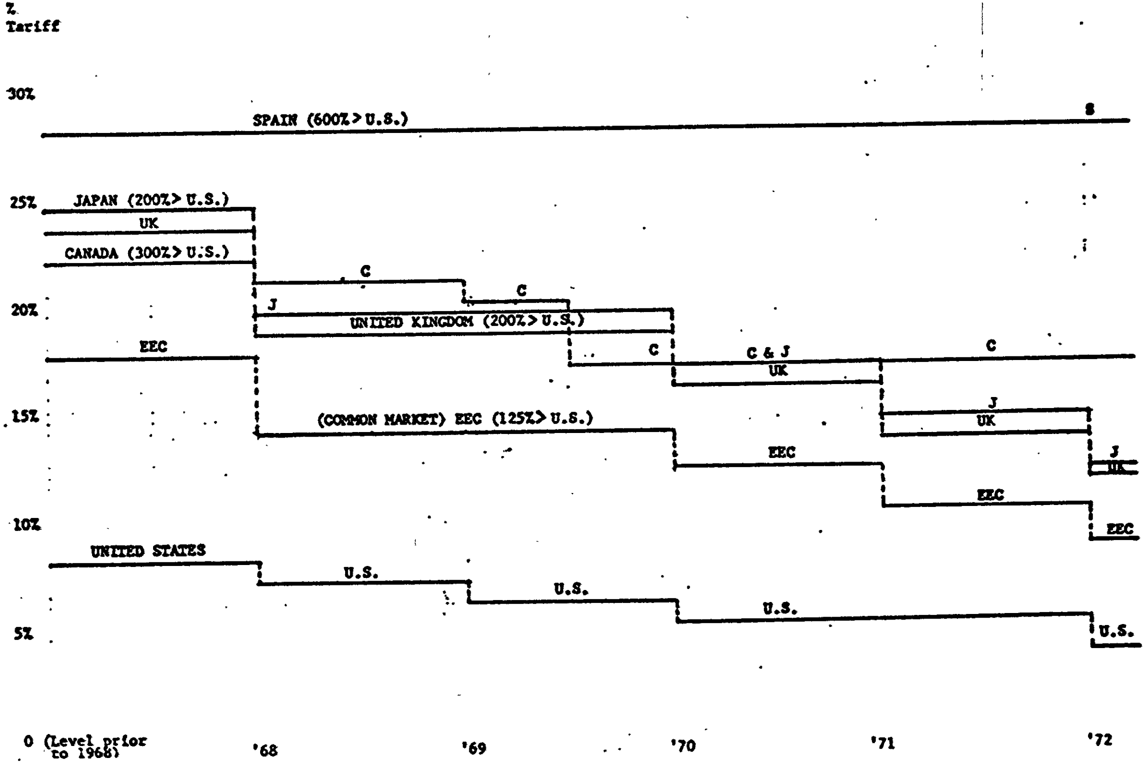
[Thousand units]

Year	Total	Exports	Exports as percentage of total
1950	99,587	1,430	1.4
1951	78,442	1,677	2.1
1952	85,346	1,520	1.7
1953	94,668	1,540	1.6
1954	90,241	1,754	1.9
1955	108,435	1,892	1.7
1956	99,251	1,773	1.7
1957	103,654	1,731	1.6
1958	98,924	1,350	1.3
1959	112,415	1,430	1.2
1960	119,598	1,710	1.4
1961	118,247	1,361	1.1
1962	132,584	1,549	1.1
1963	138,482	1,544	1.1
1964	150,401	2,073	1.3
1965	168,937	2,869	1.6
1966	173,621	2,433	1.4
1967	172,735	2,118	1.2
1968	198,905	3,199	1.6
1969	204,564	2,419	1.1
1970	194,303	1,899	.9
1971	214,201	1,954	.9

Source: RMA reports.

COMPARISON OF TARIFF LEVELS APPLICABLE TO TIRES

NEGOTIATED UNDER KENNEDY ROUND
(Also expressed % greater than U.S. Tariff in 1972)



NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION,
McLean, Va., June 14, 1974.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The purpose of this letter is to communicate the grave concern of the National Machine Tool Builders' Association and its member companies over two proposals to amend the debt ceiling bill, H.R. 14832. These proposals would repeal the Asset Depreciation Range System (ADR) and would eliminate the 7% investment credit for equipment costing more than $100,000 with gradual reduction in the amount of the credit for equipment in the range of $50,000 to $100,000. Both proposals are incorporated in Amendment No. 1434 introduced by Senators Haskell and Chiles.

We commend the Chairman for calling the hearings which were held last week and this week to receive testimony on the proposals to drastically alter the U.S. Tax Code. The testimony presented points up the extremely complex nature of the changes which would be made in the Code and the serious effect they would have on the economy of this country. Certainly any changes of this sort should not be made without adequate public hearings, staff consideration of public comments and objections, and markup sessions by the Senate Finance Committee.

We are particularly impressed with the testimony presented before your Committee on June 11 by Edwin S. Cohen, former Undersecretary of the Treasury. We urge the Committee to give special attention to that portion of Mr. Cohen's testimony dealing with the "Asset Depreciation Range System (ADR) and the investment Credit" which appears on pages 6–11 of his statement.

As Mr. Cohen indicates, adequate capital recovery allowances are absolutely essential to the economic well-being of the machine tool industry. The table attached to Mr. Cohen's statement clearly shows the "roller-coaster effect" on our industry of frequent changes by the government in its capital cost recovery policies. We believe that the proposed limitation on the ADR and the 7% investment credit, if adopted, now could have a devastating effect on this industry in particular.

Also, as Secretary Simon indicated in his testimony last week before your Committee such proposals, if adopted, could result in a chain reaction, holding modernization and expansion, in abeyance, with workers laid off. On the other hand, we firmly believe that if the investment credit and ADR are continued investment in new productive equipment will continue, resulting in much needed modernization of American industry and increase in the nation's productivity.

We respectfully request that this letter be made a part of the record of the recent hearings held by your Committee.

Sincerely yours,

JAMES A. GRAY,
Executive Vice President.

STATEMENT OF MACHINERY DEALERS NATIONAL ASSOCIATION ON CAPITAL INVESTMENT RECOVERY PROPOSALS

I. INTRODUCTION

The Machinery Dealers National Association (MDNA) is a national trade association composed of 350 companies who have joined together to promote the growth of the used machine tool industry. We are speaking on behalf of the 115,000 metal-working firms in the United States which employ fewer than 100 persons. These small businesses represent 87% of the firms in the metalworking industry and operate nearly one-half of the machine tools in use.

We urge that proposals before the Senate Finance Committee to reduce the capital investment recovery benefits presently available be rejected. Accordingly, we support the retention of the investment credit and the Asset Depreciation Range (ADR) system. Moreover, we urge that the amount of used property eligible for the investment credit be increased from $50,000, the present limit, to $150,000. We ask the Committee to recognize that we are living in a capital-scarce world in which the United States must compete with other countries for its share of capital investment. The inevitable result of the elimination of the present incentives for capital investment would be a flight of capital from the United States, a decrease in domestic productivity, and an increase in inflationary pressures in the United States.

II. INVESTMENT TAX CREDIT PROPOSAL

Amendment 1247, sponsored by Sen. Chiles and Sen. Haskell, would phase out the present seven percent investment tax credit for property with a cost basis of from $50,000 to $100,000, and immediately eliminate the credit for assets with a cost basis of over $100,000. It is estimated that passage of the proposal would result in an increase of $3.5 billion in income tax liability for 1974. MDNA urges the Senate Finance Committee to reject the proposed elimination of a major portion of the investment tax credit because it would undermine the continuity of the credit and violate the principles of tax equity.

The Continued Application of the Investment Tax Credit Promotes Modernization.—MDNA urges that the investment tax credit not be phased out, and that it be applied continuously. Our industry is a classic example of how the credit can promote modernization. Eighty-seven percent of the 132,000 metalworking plants in the United States employ fewer than 100 people. These small businesses frequently lack the necessary capital, or credit, to purchase new machinery and equipment. Our contact with these firms indicates that such companies responded dramatically to the enactment of the investment credit in 1962 and its reinstatement in 1967 and 1971. A chart reflecting the trend of used machine tool sales for the years 1969–1973 after the most recent reinstatement is attached as exhibit A.

A key aspect of the investment tax credit is its need for continuity. The investment tax credit can stimulate investment in capital assets over time only if investors can count on it. The proposed phase out of a major portion of the credit would undermine its efficiency for all investments, even those under $50,000, and serve as a yellow caution light to all who would otherwise invest in capital assets in the United States.

Tax Equity.—The principles of tax equity demand that taxpayers in the same financial position be treated in the same manner. The Chiles/Haskell proposal violates that principle. Our industry, which consists of a series of small businesses in the metalworking field, has high capital needs for the manufacture of its products, and would be harmed by a partial phase out of the investment tax credit. Small businesses which are *not* capital-intensive in nature, however, would not be hampered by the partial denial of the investment credit, and could continue to expand in any case. The fact that companies in the same financial position would be treated differently by the Code would violate tax equity and undermine the progressivity of our income tax system.

MDNA Proposal.—MDNA submits that the Chiles/Haskell proposal goes in precisely the opposite direction for the needs of small business firms in the metalworking field, a capital-intensive industry. Rather than phase out the credit for investments in the $50,000–$100,000 range, and eliminate it for investments over $100,000, the $50,000 limit on the amount of used property eligible for the investment credit should be expanded to $150,000. The expanded limit would permit companies that often must rely on used machinery to meet their modernization requirements within the limit of capital available. The inadequacy of the $50,000 limit for used property is due to a variety of factors including increasing inflation, the emergence of more highly sophisticated machinery on the used market, and the need to purchase many items of equipment in order to modernize a plant.

A recent survey of our membership indicated that a substantial and growing number of individual used machine tools in current inventory were valued in excess of $50,000 limit established in 1962. Based on the most recent Treasury data for purchases of used property and our knowledge of the used machinery market, we estimate that an increase in the limit from $50,000 to $150,000 would increase the percentage of property eligible for the credit by less than one percent. When contrasted with the $36.4 billion in property that presently qualifies for the credit, it can be seen that the cost of an expansion in the limit of used property eligible for the investment tax credit would be insignificant. The increase in the limit, however, could be very significant to small business, inducing it to modernize at once rather than piecemeal over a period of years.

In summary, MDNA totally rejects the thrust of the Chiles/Haskell proposal with respect to the investment tax credit. American needs to expand its capital investment incentives and not contract them. Moreover, the reutilization of machinery to increase productivity and promote modernization assists in conserving scarce resources, an important national objective in this period of shortages of many primary products. Accordingly, the used machinery market should obtain an expansion of the application of the investment tax credit from its present $50,000 limit to $150,000.

III. PROPOSALS TO LIMIT THE DEPRECIATION RANGE SYSTEM

The Class Life Asset Depreciation Range System (ADR) is based on broad industry classes of assets. Assets other than buildings and land have a range of years, called an asset depreciation range, that extends twenty percent above and below the class life (asset guideline period). The depreciation for such asset classes is calculated by using a depreciation period selected from the range for the class. A taxpayer using ADR does not have to justify his retirement and replacement policies to the Internal Revenue Service. A series of amendments have been offered to the Committee that would either repeal the ADR system outright, or lengthen the cost recovery periods permitted under the ADR system, thus decreasing depreciation deductions. Amendment 1247, offered by Senator Chiles and Senator Haskell, and amendment 1316, offered by Senator Nelson, would repeal ADR; amendment 1350, offered by Senator Kennedy, Senator Mondale, and others, would modify the ADR system by terminating the class life variance permitted for depreciation purposes. This would be achieved by repealing the twenty percent increase or decrease permitted in the range of class lives for depreciation purposes. MDNA strongly supports the ADR system and opposes proposals to repeal ADR or limit the effectiveness.

PROPOSAL TO REPEAL THE ASSET DEPRECIATION RANGE SYSTEM

The Asset Depreciation Range system should be retained without change to induce investments in machinery and equipment in the United States. The ADR system has worked to increase capital investment in two ways. First, the twenty percent shortening of lives permitted under the ADR system has lessened the taxation on the income earned from capital assets in the United States, thus inducing more capital investment. Secondly, a host of administrative advantages have provided certainty for the Government and the taxpayer. These advantages include the following:

(a) Under the ADR system a depreciation period selected for an asset cannot be changed by either the taxpayer or the IRS during the remaining period of use of the asset. This eliminates one of the largest areas of dispute the Government and the taxpayer—the continuous haggling over the "useful life" of particular assets or asset accounts.

(b) When the ADR system for assets is elected, the taxpayer must specify the salvage value taken into account in determining the annual depreciation amount. After the salvage value is specified, the Government may not alter it unless it can sustain an increase of more than ten percent of the cost of the asset over the taxpayer's amount. This eliminates another potential area of dispute between the Internal Revenue Service and the taxpayer.

(c) The question whether a given repair is a capital expenditure designed to prolong the life of an asset or a current expense item is a vexing one frequently incapable of satisfactory resolution. The ADR system reduces the problems that may arise in the repair-capital expenditure question to a mechanical computation in order to minimize IRS-taxpayer controversy. Under the percentage repair allowance rule, all expenditures for the repair, maintenance, rehabilitation or improvement of the "repair allowance property" within an asset guideline class that are not clearly capital expenditures are treated as currently deductible repairs to the extent they do not exceed the repair allowance.

PROPOSAL TO LENGTHEN COST RECOVERY PERIODS UNDER ADR

The question raised by the proposal to lengthen the cost recovery periods presently available under the ADR system is whether such periods give an unreasonably favorable range of possibilities for the taxpayer. Secretary of the Treasury William E. Simon addressed this issue before the Finance Committee on June 5, 1974, with convincing clarity. He noted that even now nearly forty percent of the depreciation base is accounted for on a "facts and circumstances" basis, which indicates that the ADR cost recovery periods are in fact in a reasonable middle range. As he noted, to now lengthen the periods would place many additional taxpayers in the facts and circumstances system, and return more of the public to the old system of continuous haggling with IRS over the "useful life" question. Moreover, Treasury data indicates that the amount by which cost recovery periods were shortened under ADR was less than half the amount originally expected.

In summary, MDNA finds the case against either repeal of ADR or lengthening of cost recovery periods under it unconvincing. We have used ADR along with the investment tax credit in expanding our industry. Its repeal or reduction would further cloud the possibilities for growth in our industry.

IV. SUMMARY

In summary, MDNA strongly supports the retention of the investment credit as a permanent feature of the tax law. We urge, however, that the present limitation on the value of used property eligible for the credit be increased from $50,000 to $150,000 in order to meet today's needs. Secondly. MDNA supports accelerated depreciation and the ADR system as a necessary supplement to the credit. Proposals to limit the investment credit and ADR cannot be supported in logic or from the empirical evidence available, and should be rejected by the Senate Finance Committee. America will need more incentives for capital investment in the years ahead, not less, if it is to continue as a leading industrial power.

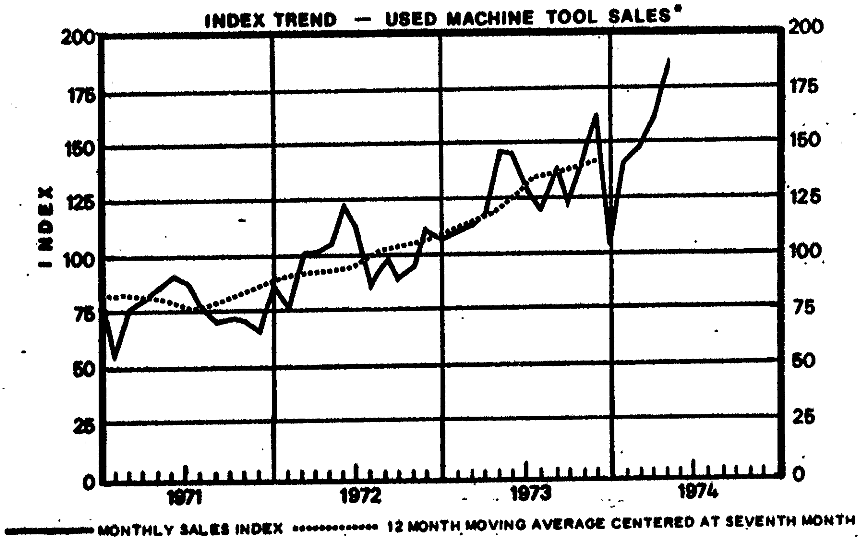
EXHIBIT A

MONTHLY MARKET TREND REPORT

MACHINERY DEALERS NATIONAL ASSOCIATION

USED MACHINE TOOL SALES

77 Participating Companies April 1974



AVERAGE MONTHLY SALES

PATTON, BOGGS & BLOW,
Washington, D.C., June 12, 1974.

STATEMENT OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE

(Submitted to the Senate Committee on Finance in Connection with Proposals Dealing with the Taxation of Foreign Source Income)

This statement is submitted on behalf of the Committee on State Taxation ("COST") by Patton, Boggs & Blow. The Council of State Chambers of Commerce, founded in 1932, is a federation of thirty-two autonomous state chambers of commerce organizations which has among its purposes to engage in objective analysis, study, and research and to make the results thereof available to its members, to appropriate governmental bodies, and to the public. COST, composed of approximately one hundred of the nation's largest corporations, is a working committee of the Council charged with the examination and analysis of taxation by the states of the income of companies doing business in interstate and foreign commerce.

COST files this statement today to advise members of the Senate Committee on Finance of the procedures currently being utilized by certain states to tax the income earned outside the United States by foreign subsidiaries of U.S. based companies and foreign based companies which have controlled subsidiaries doing business in the United States.

1. Background

In regard to the taxation of corporation incomes, the States generally take a different approach to the determination of the source of income than does the Federal Government. No States have provisions in their income tax laws comparable to the sourcing rules contained in Subchapter N of the Internal Revenue Code. The approach to determination of the source of income followed by all States levying a tax based on income is to classify income between business income which is apportionable and nonbusiness income which is allocable.

Although there is not complete uniformity, business income is generally apportioned by means of a three-factor formula giving effect to the relationship of the taxpayer's sales, property and payroll in a State to his overall sales, property and payroll. Allocable income is assigned to a State under varying rules, depending on the type of income. Under the most common practice, non-business income is allocated as follows: interest and dividends to the taxpayer's commercial domicile; rents and royalties to the State where the property from which income is derived is located; gains from sales of capital assets to the State in which the capital assets are located; and gains from the sale of intangible personal property to the taxpayer's commercial domicile.

Different interpretations by the States often result in the same item of income being allocated to one State as non-business income and apportioned to another State as business income, thus causing double taxation. This result occurs with respect to foreign source income as well as domestic income.

2. Treatment of foreign source income by States

Another important difference between State and Federal tax rules is the fact that no State, except Alaska, provides a mechanism for avoiding double taxation similar to the foreign tax credit provisions of the Internal Revenue Code. Moreover, some States do not even allow a deduction for foreign taxes paid. Beyond these distinctions between State tax rules and Federal rules, a few States aggravate further the tax burden with respect to foreign source income by invoking the unitary business concept for determining taxable income. Under this concept, income of a foreign subsidiary more than 50% owned by a U.S. taxpayer may be included in that taxpayer's income base to be apportioned to the State, whether or not repatriated.

The State of California has for some years used the unitary concept in determining the portion of a multicorporate group's income subject to the California tax. It extends the concept to foreign subsidiaries of a U.S. based company so long as the latter does business in the State, but notwithstanding the fact that the foreign subsidiary may have no business there. More recently it has even extended its reach to the income of foreign based companies having a controlled subsidiary doing business in California. This action by the State has reportedly produced complaints to the United States from several foreign countries. So far, Oregon has been the only other State which has followed the California practice of applying the unitary concept to multicorporate groups, but Michigan has expressed an intention to do so, and the unitary concept may become a growing practice among the States.

A striking contrast to the practice of California in its reach to tax foreign source income is that of the State of New York. It not only does not seek to tax the income of foreign affiliates of U.S. companies doing business in New York, but it also excludes from the U.S. company's tax base the dividends received from its foreign subsidiary. New York recognizes that it does not provide services or benefits to the foreign affiliate which would warrant a payment in return, and, consequently, it does not seek to tax the affiliate's earnings or its dividend payment when received by the U.S. company.

3. Rationale for California's Practice

It is asserted by California taxing authorities that they do not tax foreign income but merely combine the income of a "unitary" foreign corporation with the income of the affiliated U.S. corporation operating in California in order to measure the U.S. taxpayer's income apportionable to the State. The basis for this reasoning, sophistic as it is, can only be the belief that shifting of income is occurring between the U.S. company and the foreign affiliate, with the result being a reduction of the U.S. company's income apportionable to California.

But if there appeared to be such shifting of income through the accounting for intercompany transactions, it would be of interest to the U.S. Internal Revenue Service as well as California. Adjustments would be made under Sec. 482 of the Internal Revenue Code to place the transactions on an arm's length basis and thus restore to the U.S. company any income shifted to the foreign affiliate. Where such adjustments are made by IRS, they normally come to the attention of the States because most States, including California, require that all IRS adjustments be reported to them. Thereupon, the States can adjust the previously determined tax liability based on the IRS adjustments or they can make their own adjustments for arm's length purposes.

No doubt it has been recognized by California that it can benefit materially by bringing into a "unitary" group profitable foreign affiliates. This benefit occurs because of the generally lower plant and labor costs in most foreign countries and their effect on the property and payroll factors in the income apportionment formula. Because of these lower foreign costs, a larger share of the unitary income is apportioned to California than would be the case if plant and labor costs overseas were comparable to costs in California. This difference in U.S. and foreign costs, which often is substantial, voids the basis on which the U.S. courts, including the Supreme Court, have accepted the apportionment of income by formula as appropriate. This basis requires that the apportionment fairly reflect the income earned in the several States where the taxpayer does business.

4. Conclusion

A. There can be little, if any, justifiable basis for taxation by the States of any income from foreign sources. To the extent shifting of income may occur between a U.S. company and a foreign affiliate through less than arm's-length transactions, a State can make the same adjustments in the taxpayer's income that have been made by the Internal Revenue Service and reported by the taxpayer to the State.

B. It is evident that at least one State (California) has so extended its reach for the taxation of foreign source income that complaints have been filed with the U. S. Government by several nations. If other States should adopt California's practice, foreign countries would very likely retaliate. U.S. companies could be required to file combined reports with political subdivisions in whatever countries their foreign subsidiaries did business.

C. A solution to the problem would be a provision in the Internal Revenue Code which would exclude foreign source income from the reach of the States for income tax purposes. There is ample precedent for such action by the Congress. For example, under its constitutional authority to regulate commerce with foreign nations and among the States, the Congress in 1959 enacted Public Law 86-272 limiting the jurisdiction of States to tax income derived from interstate commerce. Another precedent appears in the Outer Continental Shelf Lands Act, Public Law 83-212, August 7, 1953. In that Act, the Congress expressly prohibited the application of State taxation laws to the Outer Continental Shelf.

Should additional information be desired, we will be happy to cooperate in any way.

AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES,
Washington, D.C.

STATEMENT OF AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES TO THE SENATE FINANCE COMMITTEE IN CONNECTION WITH CERTAIN PROPOSED CHANGES IN THE DEDUCTIBILITY OF ATTENDING CONVENTIONS

The American Society of Association Executives ("ASAE"), a trade association consisting of more than 5300 members, is concerned with certain of the House Ways and Means Committee's tentative decisions. In particular, we oppose the Ways and Means Committee's action of May 7, 1974 wherein it was tentatively agreed to limit the deductibility of expenses incurred in attending conventions, educational seminars and similar meetings held outside the United States. The proponents of such action apparently feel that such trips constitute disguised vacations. Obviously, we do not agree with having all U.S. taxpayers subsidize the vacations of some taxpayers. We do not, however, consider this to be a realistic view as it is applied to the vast majority of conventions and seminars. We submit that existing law provides the Internal Revenue Service with the necessary enforcement power to disallow those expenses which are not ordinary and necessary under Section 162 of the Code and which do not meet the criteria for foreign travel set forth in Section 274(c) of the Code. Indeed, on February 14, 1974, the Internal Revenue Service announced (TIR-1275) that Internal Revenue Agents had been instructed to scrutinize deductions for business trips, conventions and cruises to determine whether the trip or convention is "primarily personal in nature". Such an approach strikes at the real problem—personal versus business expenditures. The tentative Committee decision mandates Toronto as pleasure and Honolulu as business, a result which hardly comports with reality.

Moreover, the Ways and Means Committee decision introduces not only an additional section to the Code but also will foster litigation in order to determine the parameters of this new provision. One stated purpose (and most desirable results to be achieved in the area of taxation) is simplification of the Code. We believe the Ways and Means Committee's tentative decision on this subject not only flies in the face of simplification but, more importantly, deos not cure the alleged abuse, *viz*, attendance at conventions which are primarily personal, rather than business, in nature.

In discussion of this topic, it was noted that some countries, (e.g., Canada), restrict taxpayers from deducting the costs of attending conventions outside their country. While we do not subscribe to any such restrictions, we do agree that countries which espouse that position limit their citizens from traveling to the United States to attend a convention or an educational seminar. Accordingly, if the Senate Finance Committee feels that legislation is required in this area, we submit that allowance of the deduction for conventions and seminars abroad could be limited to those countries which permit its citizens to deduct the costs of attending a convention in the United States. Such a reciprocal policy would be completely consistent with U.S. trade policy and could well increase the number of foreign tourists visiting the U.S.

It should be noted that the Ways and Means Committee's action would impact most severely on those U.S. air carriers, i.e., Pan American and Trans World Airlines, which could carry U.S. residents to conventions held in foreign countries. At a time when such carriers are requesting direct Congressional subsidies in order to remain in service, it would seem that the Ways and Means Committee's decision should be reconsidered in order not to further contribute to the problems which U.S. air carriers now face.

We are prepared to provide whatever additional information you request.

Respectfully,

JAMES P. LOW, CAE.
Executive Vice President.

AIR TRANSPORT ASSOCIATION,
Washington, D.C., June 11, 1974.

Senator RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The Air Transport Association, which represents most scheduled airlines, appreciates the opportunity to comment on the tax increase measures proposed as amendments to H.R. 8217.

The attached statement details the airline position on three of the measures under consideration by your Committee:

1. The elimination of the more rapid depreciation of machines and equipment permitted under the Asset Depreciation Range System;
2. The phasing out of the 7 percent Investment Tax Credit for property costing more than $100,000, and;
3. The limitation in the use of the Foreign Tax Credit.

Adoption of these proposed measures would cause serious economic damage to our industry, with, we believe, adverse consequential effects on the public we serve. Your Committee's serious consideration of our position on these far reaching proposals is appreciated and we are hopeful that the Senate will see fit to reject these amendments to H.R. 8217.

Cordially,

S. G. TIPTON.

Attachment.

STATEMENT OF THE AIR TRANSPORT ASSOCIATION, BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE, JUNE 12, 1974

The Air Transport Association, which represents most of the U.S. scheduled airlines, opposes certain of the proposed amendments to H.R. 8217, under consideration by this Committee. Of particular concern to our industry are (a) the proposed elimination of the more rapid depreciation of machinery and equipment permitted under the Asset Depreciation Range (ADR) system; (b) the proposed phasing out of the seven percent investment tax credit for property costing more than $100,000; and (c) the proposed limitation in the use of the foreign tax credit.

Adoption of these proposed measures would cause serious economic damage to our industry, with, we believe, adverse consequential effects on the public we serve.

Airline industry earnings over the past several years have been inadequate by almost any standard, as shown in the following table:

[Dollar amounts in millions]

	Revenues	Earnings	Percent
1969	$8,800	$53.0	0.6
1970	9,300	(200.5)	(2.2)
1971	10,000	28.0	.3
1972	11,200	215.0	1.9
1973	12,400	223.0	1.8

Moreover, since September, 1973, the airline industry fuel costs have increased over 80%. For international operations alone, those costs have more than doubled. The ultimate impact of the "energy crisis", particularly in its long-term effect on airline costs, is as yet unknown. However, it is clear that fuel costs and other inflationary pressures will continue to plague the airline industry for the foreseeable future.

The unsatisfactory earnings performance, coupled with a constant demand for vast amounts of additional capital at high interest rates to purchase improved aircraft and ground equipment, has produced a capital structure about which serious concern has been expressed. At the present time the industry debt/equity ratio, based on a five quarter average, is nearly 2:1, and this does not include the debt represented by the growing amount of leased equipment now being operated by the airlines. Nor does it include an unknown volume of locally issued airport revenue bonds for which the airlines are guarantors.

All of this has had the result of placing the airlines in a very inflexible position by increasing the amounts of certain types of fixed charges. For example, the U. S. scheduled airline industry has annual obligations of over $350 million in interest payments and $200 million in aircraft lease payments. Yet, in order to continue to meet civilian air transport requirements, the airlines of America will need to make substantial additional capital expenditures in the years immediately ahead. Without retention of the investment tax credit and ADR, it will be difficult to make these capital expenditures in a manner that is consistent with the national interest in assuring that we continue to have fleets of modern, economically operated airliners.

Looking ahead for the next ten years, we foresee that demands for air transportation will continue to grow at a rate which will require substantial additional equipment to keep pace. Domestic passenger traffic can be expected to increase more than 150% between now and 1985; revenue passenger miles are expected to jump from 162 billion in 1973 to more than 400 billion in 1985; and the number of domestic passengers boarding domestic trunk and regional airlines should reach nearly 400 million, compared with 177 million domestic passengers in 1973.

Projected future capital requirements of the industry are estimated at about $2 billion by 1975. For the 1976–1980 period, it has been estimated that long-term capital requirements may reach $10 billion, indicating that even if there is an improved return on investment, the industry will face formidable financial challenges throughout the decade.

The new wide-bodied jets currently coming on line and planned for delivery in the future at a cost of millions of dollars represent an important step not only in handling the additional traffic growth but also in reducing the effects of aircraft on the environment, in terms of noise and smoke pollution. All of the new aircraft use advanced-technology engines which provide more power than those in older aircraft. These engines are virtually smoke-free and significantly quieter. Because they can carry so many more passengers than older jets, the new aircraft enable the airlines to absorb increases in traffic without corresponding increases in flight operations, thus contributing to economic productivity, to the reduction of aircraft-caused pollution, to the reduction of airport and airways congestion, and, above all, to fuel economy. Furthermore, many of the advances in engine technology are being adapted to narrow body aircraft, further resulting in improved environmental performance on the part of the industry.

It is in light of this outlook and our determination to meet national air transportation requirements that we strongly endorse retention of the investment tax credit and the ADR system.

INVESTMENT TAX CREDIT

Restoration of the investment tax credit in 1971 contributed substantially, in our view, to the general economic recovery which occurred in the early years of this decade. The investment tax credit simultaneously has moved the airlines forward toward goals of increasing productivity, meeting foreign competition, and encouraging new technological developments. We would risk all these by eliminating this credit.

The availability of the investment tax credit has contributed to airline productivity at a time of steeply rising operating costs. At the same time it has enabled the carriers to meet the requirements of substantially increased traffic growth and the challenges presented by the environment and the fuel shortage. Because new equipment effectively accomplishes these ends, capital investment in newer aircraft and engines must continue. The investment tax credit permits—and assists—this continued investment.

Moreover, the investment tax credit, as applied to the airline industry, aids in meeting foreign competition, and keeping dollars at home. As the U.S. airlines acquire the broad range of modern equipment necessary to remain competitive and to meet the demands of capacity and environment, those acquisitions will be made largely from U.S. suppliers, thereby assisting other American industries and safeguarding thousands of jobs.

Finally, the airlines of America have used the investment tax credit to keep transportation costs down and to dampen the effects of inflation. The airline industry has a history of passing on to the consuming public the benefits accrued from the investment tax credit and the savings resulting from increased productivity and new technology.

We view the retention of the investment tax credit as vital to the nation's continued healthy economic growth, and as necessary for the airline industry to continue to finance needed equipment acquisition at reasonable rates.

Because planning for the late 1970's must be undertaken now, we urge that action be taken to assure the continued availability to our industry of the investment tax credit. Such action will greatly assist in stabilizing and improving the industry's financial ability to make those acquisitions which are needed to continue serving the transportation needs of passengers and shippers.

CLASS LIFE DEPRECIATION RANGE SYSTEM (ADR)

In the Revenue Act of 1971, Congress recognized the critical need for a simplified depreciation system. In its consideration of that legislation, it carefully reviewed the existing treatment of depreciation by Treasury, most particularly the Asset Depreciation Range System ("ADR"), adopted by the Treasury early in 1971.

The Treasury ADR rules reflected a desire on the part of that department to achieve greater simplicity in the treatment of depreciation. Especially significant was the replacement of the complicated "reserve ratio test" with the new class life depreciation system.

Congress enacted a class life depreciation range system which combined the Treasury "ADR" and guideline lives, with class lives to be prescribed on the basis of anticipated industry norms. A taxpayer would be permitted to choose the use of this system, or, alternatively, to rely on its own facts and circumstances. If it chose the new system, the taxpayer would be permitted to employ lives within a 20% range above or below the established class life.

The objective of these and other provisions of the system adopted by Congress was to achieve substantial simplification and to provide more rapid capital recovery, similar to that available in other countries, in order for U.S. industries to remain competitive in international markets.

Because of the faster capital recovery provided by ADR, the airline industry is better able to acquire the necessary equipment and aircraft to meet the ever growing transportation needs of the United States. If the ADR system were to be repealed, it would impair the ability of the U.S. scheduled airline industry economically to finance the necessary additional equipment and to maintain financial stability.

FOREIGN TAX CREDIT

Present tax law permits a United States citizen to deduct foreign income taxes paid as a credit against his United States income tax liability, subject to certain express limitations—the "foreign tax credit".

The air transport industry believes that this provision of the Code has been useful in the travel industry's effort to remain competitive in an increasingly difficult international travel environment. Without special consideration of that industry's circumstances, many United States companies engaged in this business may well be subject to double taxation, and the competitive balance will be severely altered.

Unlike other U.S. business, U.S. international airlines and other U.S. owned travel related businesses must, by their nature, operate abroad. They are therefore subject to foreign taxation and, unavoidably, must pay substantial taxes to those jurisdictions in which they operate.

To enact limitations on the use of the foreign credit, especially at this time, would have devastating impact on the U. S. international air carriers, a number of which are experiencing serious financial problems. These companies, already severely damaged by the massive increases in prices of fuel in international markets, with extensive competition by foreign-owned and often government-subsidized carriers, are especially vulnerable now to any action by Congress which could adversely affect their financial performance. Limitations imposed on their freedom to use the foreign tax credit provisions of the Internal Revenue Code could effectively subject them to double or multiple taxation at the worst possible time—a time, ironically, when the Federal Government, in both Congress and the Executive Branch, is seeking ways to *improve* the economic condition of the U.S. international carriers.

Moreover, it must be remembered that a substantial portion of the revenues earned by United States international airlines, and in United States-owned travel-related enterprises, flows directly back to the United States. In the absence of United States participation in this market, such revenues will inevitably flow entirely abroad, and other countries will reap the economic benefits, with a resulting negative impact on the U. S. balance of payments.

The foreign tax credit provisions of the Internal Revenue Code are particularly appropriate for businesses engaged in providing international travel services. These service-related companies do not transfer to foreign countries, jobs which would otherwise exist in the United States. Insofar as they acquire for the United States a share of the existing international travel market, they do not compete with domestic businesses. They represent a necessary complement to the domestic travel business, and, through their active competition with foreign businesses, they contribute directly to the economic welfare of the United States.

The air transport industry strongly believes that the United States is entitled to its share of the international travel market, which will exist whether or not United States tax-paying corporations participate. This participation will not be feasible without an environment allowing economic travel-related investment abroad for American companies—and, particularly, without healthy U.S. international airlines. It is essential, to the public interest, we believe, that the present foreign tax credit provisions be retained, and that the Congress reject the limitations described above which have been proposed as amendments to H.R. 8217.

The air transport industry urges that the amendments to H.R. 8217, proposing to eliminate the Asset Depreciation Range System, phase out the investment tax credit, and limit the use of foreign tax credits, be rejected. The retention of these provisions of the Internal Revenue Code is, in our view, essential to the maintenance of a strong and financially viable national and international U.S. air transportation system. Further, we believe such action is both fully consistent with and necessary for the continuing objective of Congress to provide a tax structure equitable to all taxpayers, in a climate of sound economic growth.

UNION CARBIDE CORPORATION,
New York, N.Y., June 14, 1974.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building
Washington, D.C.

DEAR MR. CHAIRMAN: We appreciate the willingness of your Committee to schedule hearings and provide the opportunity for written comment with respect to a number of pending proposals for changes in the tax laws which may be offered as Senate amendments to a House-passed revenue measure, and would like to have these comments made a part of the record.

The tax proposals currently being discussed by some members of the Senate fall into two general classes—a significant general tax reduction for individuals and an off-setting tax increase applied to corporations and to those individuals who may be subject to the minimum tax. The shifts in tax liability could, under several of the proposals, amount to many billions of dollars a year.

What seems critical to us is that such proposals, while balanced in a revenue sense, are almost completely contrary to the economic needs of the nation at this time. Individual tax cuts will certainly tend to stimulate demand at a very time when demand exceeds supply for a very large number of raw materials and products. Such an increase in demand will further stoke the fires of inflation. The problem would be compounded by corporate tax increases which would significantly curtail the ability of industry to finance the expanded production it needs to meet the market demands.

In our own case, demand for a large number of Union Carbide's products which are essential to the economic well-being of the country currently outstrips our ability to supply them. To meet the growing demands for our products will require a considerable investment in new production capacity. This, in turn, will require that our earnings be adequate to finance these facilities. Proposals for the repeal of the investment tax credit, repeal of the Asset Depreciation Range System, repeal of depletion allowances and for increasing the minimum tax would directly increase the corporation's tax burden and curtail the funds available to it. The result would be a curtailment in plans for expansion or, in the alternate, price increases to cover the increased tax burden—and either result is highly inflationary and contrary to the public interest.

Other proposals, such as those proposing limits on foreign tax credits, or repeal of the DISC provisions, would also help to discourage the expansion of U.S. industry in indirect, but effective, ways and would also affect the long-term ability of American firms to compete in world markets.

Other witnesses, like those for the Manufacturing Chemists Association, the American Mining Congress, as well as Secretary of the Treasury Simon have provided the Committee with detailed information on these adverse effects of the proposed tax changes.

We believe the problems of inflation are gravely serious. They cannot be solved by tax changes like those under consideration that will simply have the effect of sending more dollars to chase after fewer goods.

Sincerely,

F. PERRY WILSON.

LYKES-YOUNGSTOWN CORPORATION, IMPACT OF THE MINIMUM TAX ON THE COMPANY

The Tax Reform Act of 1969 enacted the so-called "minimum tax". Briefly, the minimum tax imposes a 10 percent tax of certain items of tax preference, including the excess of percentage depletion over cost depletion, the excess of accelerated over straight line depreciation of real property and a portion of capital gain income. Regular income taxes otherwise payable are allowed as an offset in determining taxable preferences.

The impact of the minimum tax on Lykes-Youngstown Corporation for the years 1970 to 1973 illustrates that this provision of the Internal Revenue Code has been ill-conceived and should be repealed with respect to existing long-term business investments.

BACKGROUND

Lykes-Youngstown Corporation was formed in 1969 through the merger of Lykes Corporation (Lykes) and The Youngstown Sheet and Tube Company (Youngstown). Lykes operates one of the largest U.S. shipping companies, with cargo and passenger service from Gulf ports to Europe, Africa, South America, and the Orient. Youngstown is the eighth largest domestic integrated steel company, with plants in Ohio, Indiana, Texas and Oklahoma. In addition, it owns or participates in iron ore and coal mines in several states and Canada. Both companies have been in business since about 1900.

Income of the component companies declined in 1966 through 1973. As a result, Lykes-Youngstown Corporation ceased paying common dividends in January, 1971, and is currently six quarters in arrears (amounting to $20,528,000) on its preferred stock.

The Company has filed a consolidated Federal Income Return each year since the merger. Due to its low level of earnings, the Company has not, on balance, paid any regular Federal Income Tax for the years 1970 to 1973. Refunds for 1970 and 1971 exceeded the taxes paid in 1972 and 1973. However, during the same four year period, the Company has incurred a total minimum tax liability of $4,800,000. Of this amount, 68 percent has resulted from percentage depletion, 20.5 percent from capital gain transactions, and 11.5 percent from the excess of accelerated over straight depreciation of real property.

At December 31, 1973, the Company had unused investment tax credits approximating $18,000,000.

PERCENTAGE DEPLETION

The iron ore and coal mining operations of Youngstown are entitled to statutory depletion in accordance with Section 613 of the Internal Revenue Code. The Company has been subject to this provision from the inception of the percentage depletion law. Its present mines were developed with the expectation of receiving percentage depletion as provided by law. In particular, a substantial portion of Youngstown's percentage depletion arises from its ownership interest in Erie Mining Company. Erie mines taconite ore in the State of Minnesota and produces iron ore pellets which are shipped to Youngstown's steel plants in Ohio and Indiana. This mining venture, involving the investment of over $400,000,000, of which Youngstown owns 35 percent, was developed during the 1950's with the encouragement of the Federal Government. In 1951, the Defense Production Administration established a goal of fifteen million (15,000,000) gross tons per year of taconite production in the United States. The development of Erie was part of that objective. In addition, Erie was granted a Certificate of Necessity covering 75 percent of its facility.

Thus, in accordance with national objectives, Youngstown has invested vast sums in mineral production with the expectation of receiving the allowable statutory depletion. The operation of the minimum tax provisions has resulted in reduced depletion allowances. In years when the Company incurred tax losses it received an effective 12 percent allowance on iron ore versus the 15 percent statutory rate. Likewise, percentage depletion on coal was effectively reduced from 10 percent to 8 percent.

EXCESS OF ACCELERATED DEPRECIATION ON REAL PROPERTY

Between 1955 and 1969 Youngstown invested $125,000,000 in new steel mill buildings and other improvements to real property. These properties were depreciated on the sum of the years digits method in accordance with the provisions enacted into law in 1954. There have been no significant dispositions of this property, nor has the Company realized any significant capital gains thereon.

The effect of the minimum tax has been to reduce the total depreciation recovery on real property. Since the minimum tax does not produce depreciable tax basis for the assets, the Company effectively is denied full cost recovery for Federal Income Tax purposes.

DIFFERENTIAL BETWEEN CAPITAL GAIN TAX RATE AND REGULAR TAX RATE

The minimum tax provisions treat the differential between the 30 percent capital gains rate and 48 percent regular tax rate as a preference item. Thus, for corporations, 18/48 of capital gain income is considered subject to the minimum tax.

During the years 1970 to 1973, the Company disposed of its investments in three companies at substantial capital gains. In addition, the Company received annual royalties from iron ore and coal properties which qualify for capital gain treatment under Section 631 of the Internal Revenue Code. The minimum tax has effectively taxed these transactions at nearly 33 percent rather than the 30 percent statutory rate.

ARGUMENTS AGAINST APPLICATION OF MINIMUM TAX TO LYKES-YOUNGSTOWN CORPORATION

1. Youngstown has over the years invested very substantial sums in iron ore and coal mines to serve its requirements in the manufacture of iron and steel. These investments were made in anticipation of the statutory depletion rates. However, the minimum tax provisions have effectively eliminated 20 percent of the statutory depletion and increased the cost of producing its basic raw materials accordingly.

2. Likewise, the Company invested substantial money in new steel mills between 1955 and 1969 when the tax law provided for accelerated depreciation. Again, the minimum tax imposes a penalty on the Company's anticipated return on investment. The minimum tax therefore is unfair in that it reduces tax incentives offered in prior years, which were relied upon by the Company.

3. There is no indication that accelerated depreciation of steel mill buildings has in any way been a tax "loophole". They are depreciated over long lives and very seldom disposed of in a manner that would produce capital gain income. In fact, Section 1250 has effectively removed the possibility of any significant capital gain treatment for buildings depreciated on an accelerated method.

4. The capital gains transactions which became subject to the minimum tax involved long-term business investments. One company had been held 35 years and another 32 years. Likewise, royalty income arose from long-term investments in mineral property. It is maintained these transactions are outside the area intended by Congress to be taxed by the minimum tax.

5. The minimum tax is grossly unfair in that it taxes only the companies with tax losses or low taxable income. Its impact is thus principally on the new businesses or the existing business with a low level of earnings. Thus, its application is inconsistent with the theory of the taxation of income.

In practice, the minimum tax is not so much a tax on preference income as it is a tax on the lack of income. It is difficult to comprehend what economic purpose this accomplishes, unless the goal is to discourage new companies and penalize those with little or no earnings.

6. The interrelation of the minimum tax and the investment tax credit is also poorly conceived. Obviously, the company with a low level of income will have difficulty utilizing the investment tax credit, since the credit can only be applied against tax liability. The minimum tax compounds the problem in two ways. First, the balance of the tax liability which offsets the items of tax preference in the determination of the minimum tax is after deduction of the investment credit, or generally 50 percent of the tax liability before the credit.

The reduced tax liability thus produces a greater minimum tax. Secondly, the minimum tax liability itself cannot be used to absorb investment credits otherwise available. The result is that business investments which produce investment credit are being penalized by increased tax liability. While offering tax reduction on the one hand through the investment credit it is taken back on the other by means of the minimum tax.

The effect of the minimum tax on the business of Lykes-Youngstown Corporation clearly indicates the tax has been poorly conceived with respect to long-term business investments of corporations and its effects are arbitrary and inequitable.

SUGGESTED REMEDIAL LEGISLATION

1. The equitable remedy to this provision of the tax law is repeal of its application to long-term transactions which are related to the taxpayer's trade or

business. Distinction should be drawn between transactions that serve a viable economic purpose and those that are entered into primarily for tax avoidance purposes.

2. To the extent it is determined that corporations are making improper use of existing tax incentives, it is suggested the incentives be separately studied and adjusted in view of the current evaluation of their need. Such changes should be of a prospective nature recognizing the taxpayer's reliance on prior law.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION ON PROPOSED TAX INCREASE AMENDMENTS TO H.R. 8217

The American Bankers Association appreciates the opportunity to submit comments on certain proposed amendments to H.R. 8217, concerning tax increases, which are being considered by the Senate Finance Committee.

MINIMUM TAX

Amendments No. 1324 and 1350 would provide for an increase in the minimum tax preferences. Under these proposals, the minimum tax would be increased by (1) reducing the current exemption of the first $30,000 of items of tax preference (i.e., "tax preference income") to $10,000 and (2) eliminating the deduction currently permitted for other Federal taxes paid.

The reduction of the $30,000 exemption to $10,000 would obviously result in a larger number of taxpayers being made subject to the minimum tax. Because of the reduced exemption, many taxpayers would pay a minimum tax for the first time. Others would pay a larger amount of minimum tax. In general, it would appear that the reduced exemption would tend to impose an increased tax burden on *smaller* taxpayers. The exemption per se does not significantly affect taxpayers with items of tax preference substantially in excess of the amount of the exemption.

The proposal to eliminate the deduction for other Federal taxes paid would increase the minimum tax—and the overall tax burden—for taxpayers *who are already paying significant or large amounts of Federal income tax*. Conversely, the elimination of the taxes paid deduction would have no revenue effect on persons who pay no income tax at all. One of the objectives of enacting the minimum tax provisions of the Tax Reform Act of 1969 was to impose a tax on individuals with large incomes who pay little or no income tax. The elimination of the taxes paid deduction does not aid this objective. It is to be noted that in 1969 the original intent was to apply the minimum tax to *individuals* who avoid the payment of Federal income taxes through the use of investment schemes or tax preference provisions of the Internal Revenue Code. As originally conceived, the minimum tax was not intended to apply to corporations.

We take this opportunity to bring to the Committee's attention the fact that § 57(a)(7) and proposed Treasury Regulation § 1.57-1(g), under which bad debt reserves of financial institutions are treated as a tax preference item, imposed an inequitable tax burden on banks which take deductions for bad debt losses under the reserve method. This inequity results from the fact that a bank which uses the specific charge-off method of deducting bad debts under § 166(a) is not subject to the minimum tax because bad debt deductions under § 166(a) are not a tax preference item, whereas in the case of a bank which uses the reserve method under § 585, the portion of the deduction for a bad debt reserve addition which is attributable to loan losses charged off and restored to the reserve is subject to the minimum tax. This may be illustrated by the following example:

Bank A which uses the specific charge-off method made a loan of $10 million to the Penn Central Transportation Company. In 1971, Bank A was directed to charge off this bad debt loss by the Comptroller of the Currency. Bank A would be entitled to a tax deduction of $10 million for the 1971 taxable year on that loss *without* being subject to the 10 percent minimum tax.

Bank B which uses the reserve method under § 585 also made a $10 million loan to Penn Central and was directed by the Comptroller of the Currency to charge off that loss for the same taxable year. Bank B's bad debt charge-off for the Penn Central loss may well be subject to the 10 percent minimum tax under the provisions of § 57(a)(7) and the proposed regulations issued thereunder.

A bank on the reserve method of bad debt accounting for tax purposes whose bad debt deduction merely restores loan losses to the reserve is taking the same deduction for bad debt charge-offs that is taken by taxpayers who use the specific charge-off method under § 166(a) of the Code.

We respectively request the Committee to consider an amendment to § 57(a)(7) of the Internal Revenue Code which will *expressly* provide that the minimum tax will not apply to deductions for bad debt reserve additions which result from loan losses charged against and restored to the bad debt reserve. As in the case of bad debt charge-offs under § 166(a), the deduction for charge-offs of net bad debts under § 585 should not give rise to an item of tax preference. The minimum tax should not restrict the bad debt loss portion of a § 585 deduction.

This result is supported by the legislative history of § 585 from which it is to be concluded that banks are to be allowed to deduct their actual bad debt losses during the year without being subject to the minimum tax under § 57(a)(7). The Conference Report at page 310 states:

"Moreover, [banks] will be allowed in any event to deduct their bad debt losses during the year."

The General Explanation of the Tax Reform Act of 1969, prepared by the Joint Committee on Internal Revenue Taxation, at page 139 states:

"At a minimum, banks whose level of eligible loans does not decrease are allowed to deduct their actual bad debt losses during the year."

Thus, it may be concluded from the legislative history of § 585 that the Congress, in enacting the Tax Reform Act of 1969, did not intend to penalize the portion of a deduction for a bad debt reserve addition which is attributable to actual bad debt losses incurred during the taxable year, by subjecting such portion to the minimum tax.

FOREIGN SOURCE INCOME

Two proposals, Nos. 1319 and 1323, would make certain changes in the existing tax treatment of foreign source income. Amendment No. 1319 would require a U.S. taxpayer who uses the per-country limitation for computing the foreign tax credit to make certain adjustments to recapture the tax benefit resulting from previously claimed losses. Amendment No. 1323 would make the income of a controlled foreign corporation subject to U.S. tax on a current basis, rather than only when such income is distributed to the U.S. parent, as under present law.

As we stated in our testimony before the House Ways and Means Committee on March 5, 1973, we strongly endorse the continuation of the existing provisions of the Internal Revenue Code relating to the foreign tax credit. Under our present tax system, the United States' direct foreign investment policies have generated and increased exports and employment in the U.S. As a result of past outlays, the dollar inflow from such foreign investment has far exceeded the dollar outflow for investment abroad.

By reducing the effective rate of return on foreign investments for many American businesses, these proposals would hinder the ability of many American businesses to compete in foreign markets. This could result in a decerease in U.S. exports and an increase in unemployment, a highly undesirable situation.

INVESTMENT TAX CREDIT AND ADR

Proposed amendment No. 1247 provides for a phaseout of the investment tax credit for property having a cost basis of $50,000 to $100,000 and an immediate elimination of the investment tax credit for assets with a cost basis of over $100,000. Further, proposed amendments 1247, 1316, and 1350 provide for the repeal of the asset depreciation range system (ADR).

These and other proposals to eliminate or change the investment tax credit and the asset depreciation range system (ADR) have created serious concern throughout American industry. The continuation of the 7 percent investment tax credit and ADR are essential to support our national needs for increased productivity and more plant and equipment.

As we started in testimony before the House Ways and Means Committee on March 5, 1973, to operate effectively, the investment tax credit must be a permanent feature of the tax laws. The investment tax credit and the ADR system have sound economic rationale. They improve our economic health and create jobs and enable us to become more competitive in world markets. *The investment tax credit reduces the relative need for external corporate financing which tends to reduce the pressure on credit markets generated by anticipated expansion in* *capital spending.* This function of the investment tax credit is particularly important in today's climate of increasing pressures on credit markets and high interest rates.

We support the statements made by Treasury Secretary Simon before the Senate Finance Committee, Wednesday, June 5, 1974, in which he opposed the elimination of the investment credit and the ADR system. It is to be emphasized that both the ADR and the investment tax credit provide a climate for investment and increased productivity. These incentives have a counter-inflationary thrust and their continuation is clearly in the public interest.

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC. ON TAX INCREASE MEASURES PROPOSED AS AMENDMENTS TO H.R. 8217 FOR INCLUSION IN THE RECORD OF HEARINGS BEFORE THE FINANCE COMMITTEE OF THE U.S. SENATE

The membership of the National Foreign Trade Council, which was founded in 1914, comprises a broad cross section of United States companies engaged in all major fields of international trade and investment, including manufacturers, exporters, importers, bankers, insurance underwriters and companies engaged in rail, sea and air transportation.

In connection with the tax increase measures currently under consideration by the Senate, the Council thoroughly agrees with the statement in the Finance Committee's Press Release of May 31, 1974, that these proposed measures should receive extensive consideration by the appropriate tax writing Committees of both the Senate and the House.

Of the several tax increase measures you are now considering, particularly those set forth in the May 31st Press Release as well as those dealt with by Administration witnesses, our documentation deals essentially with the following:

1. Limitation on the use of the foreign tax credit.
2. Current taxation of undistributed foreign earnings.
3. Repeal or modification of the Domestic International Sales Corporation (DISC) provisions.
4. Repeal of the percentage depletion allowances for oil, gas and mineral production.

If in the course of these hearings your Committee takes under consideration other measures which would affect or modify the present system for the U.S. taxation of foreign source income, the Council respectfully requests that it be permitted to submit additional documentation relating thereto.

1. Limitation on the use of the foreign tax credit

The Council is gravely concerned about the apparent misunderstandings surrounding the operation of the foreign tax credit that seemingly still prevail.

One of the underlying principles of the U.S. tax system is that residents are taxed on their incomes regardless of whether the source is domestic or foreign. The objectives are broadly twofold, namely, to achieve equity by applying equal U.S. income taxes to U.S. taxpayers having the same amount of income irrespective of the country in which that income is derived, and to achieve tax neutrality as between investments at home and abroad.

The application of this principle to the foreign source income of U.S. citizens is complicated by the exercise of the primary tax jurisdiction over such income by host countries. Other countries, as does the United States, exercise their fundamental and prior right to tax all income generated within their borders regardless of owner nationality. Thus, when the United States asserts tax jurisdiction over foreign-generated income, international accommodation among countries is required to prevent the pyramiding of different layers of taxation on the same income base. Such pyramiding, commonly known as double taxation, would destroy the neutrality of our tax system. Recognizing that a host nation has the primary right and a prior claim to tax such income, nations have adopted one of two systems to deal with the problem of avoiding double taxation. One system is to exempt from home country tax all foreign source income realized by their nationals.

The other system employed by the United States, as well as a number of industrialized countries, is to apply generally the same tax structure to the worldwide income of its citizens but to allow a credit for foreign income taxes on income earned abroad to the extent of the home country tax on such foreign income. The allowance of the foreign tax credit by the United States, in effect, assures that a U.S. resident will pay the higher of the U.S. or the foreign tax on his income from abroad and is consistent with the goal of tax neutrality.

It is most distressing that many published statements imply that the foreign tax credit can be applied against the U.S. tax on income derived solely from domestic sources. We emphasize most strongly that because of limitations prescribed by the Internal Revenue Code, the foreign tax credit can never be applied against the U.S. tax on domestic source income.

In continuing to firmly oppose repeal of the foreign tax credit or any significant change in the present system of U.S. taxation of foreign source income the Council stresses the following:

(a) Repeal of the foreign tax credit would negate the long standing U.S. policy of promoting tax neutrality between foreign and domestic income, which policy has been sustained periodically over the years after Congressional review.

(b) Any limitation on the allowable foreign tax credit now permitted by law would violate the established policy of avoiding double taxation.

(c) Any proposals which would deny a foreign tax credit to the extent permitted under present law would penalize U.S. foreign investment. We therefore oppose any proposals which would reduce the credit for foreign taxes paid by some arbitrary percentage such as 5 or 10 percent; which would limit such foreign tax credit to 110 percent of the U.S. tax rate; or which would treat the foreign tax credit itself as an item of tax preference income subject to the minimum tax on tax preference items. We re-emphasize that any such proposals or any form of a minimum tax on foreign earnings would be punitive and in contravention of policies to preserve tax neutrality and to avoid double taxation.

2. Proposed current taxation of undistributed foreign earnings

We are also concerned that some quarters may not fully appreciate the far-reaching negative consequences which would result if U.S. shareholders were to be currently taxed on the earnings of their foreign affiliates before such earnings are distributed. Any such proposal must therefore be carefully considered in its proper perspective.

It is a misconception to suggest that U.S. law contains a special provision for deferring the taxation of earnings of foreign affiliates. In fact nothing could be further from the truth. The general rule in the United States is that shareholders are taxed on earnings of corporations only when they receive those earnings, regardless of whether the corporations are U.S. corporations or foreign corporations. This general rule is as applicable elsewhere in the world as it is in the United States. Any departure by the United States from this recognized international tax principle would clearly adversely affect the ability of U.S. business to retain or enhance its competitive position in the international market place.

If the United States were to attempt to tax the undistributed earnings of foreign corporations owned by Americans, it is likely that foreign governments would be as offended by this incursion into their jurisdictions as they have been by similar actions in the past. It is even more likely that foreign governments would retaliate, for instance, by levying a special dividend withholding tax on such unremitted earnings of U.S.-owned corporations. The taxation of undistributed earnings of such corporations could thus be self-defeating because the foreign government, through the levy of such a special dividend withholding tax, would pick up revenues which would otherwise enure to the United States. Of course, U.S. companies would suffer competitively in either event because their foreign-owned competitors would face no such special tax.

Any attempt to tax such undistributed earnings would reduce the resources necessary for U.S. worldwide businesses to remain competitive. If the foreign affiliate were required to distribute earnings currently in order to pay the accelerated U.S. tax, it obviously would not be able to keep pace with foreign-owned competition in business expansion. If the U.S. company should elect to pay the tax without repatriating foreign earnings, its ability to expand or modernize domestic facilities would be impaired, or it would be necessary to reduce dividends to shareholders. Whatever course is taken would have an adverse effect on security markets and investors, including pension trusts and educational institutions.

3. Repeal or modification of the Domestic International Sales Corp. provisions (DISC)

The Council opposes repeal of those provisions of the Internal Revenue Code relating to Domestic International Sales Corporations (DISC). The Council further opposes restricting the products which may be exported through the

DISC. On this latter point we agree that the U.S. export of materials in short supply should not be encouraged but emphasize that the President has authority under present law to designate those items in short supply wich would not qualify for the benefits of DISC.

The task of increasing exports and maintaining a favorable trade balance lies primarily with private business. However, business efforts should be supported by government policies and programs which demonstrate that export expansion is a continuing objective of our government. The DISC clearly manifests this objective. The concept of DISC is that it should also serve to facilitate domestic plant expansion and increase research and promotion activities and in turn our country's capacity to export and meet competition abroad of foreign producers who enjoy export incentive benefits provided by their governments.

Consequently the Council continues to adhere to its view that further experience is required, with an opportunity for U.S. business to more fully utilize the DISC, before its full contributions can be appraised. The Council further maintains that it would be unwise to consider repeal or modification of the DISC, if at all, before negotiations are undertaken under appropriate trade legislation, particularly with respect to the reduction or removal of non-tariff barriers.

4. Repeal of percentage depletion allowance

The National Foreign Trade Council urges that no precipitous action be taken with respect to elimination of the percentage depletion allowance for oil, gas and minerals without carefully weighing any potential adverse economic effect on U.S. businesses and consumers who depend upon these industries for vital sources of raw materials and energy. Such adverse economic effects could be an increase in the cost of such raw materials and energy as well as the inability to meet domestic requirements and the adverse effect on the competitive position of U.S. business in world markets.

CONCLUSION

The concerns underlying the foregoing documentation of the Council's position are the grave adverse economic consequences that would result if any of the proposed tax increase measures were to be adopted.

The bases of our concerns stem from the basic factual premise that the U.S. economy overall is strengthened by the continued expansion of international trade and investment. To maintain and gain access to markets abroad—to maitain the ability of the United States to compete in international trade—has increasingly required international investment by U.S. firms. Consequently the legislative basis for U.S. foreign economic policy, including specifically our policy regarding the taxation of foreign source income, must take fully into account the interdependence of our own and other economies of the world. It must equally take into account the mutually supporting relationships between international investment and international trade.

The double taxation that would result from any restriction of the foreign tax credit and any current taxation on undistributed earnings of foreign subsidiaries would place U.S. corporations at so severe a competitive disadvantage with respect to foreign corporations that there would inevitably be a reduction of U.S. investment abroad—and to some extent even the liquidation of existing foreign investments.

Any significant reduction or the liquidation of U.S. foreign direct investments would negate the positive impact which such investments have on the U.S. balance of trade both through direct exports to affiliates and other exports to the local market place; would reduce the positive contributions which such foreign direct investments make to the U.S. balance of payments through the repatriation of dividends, fees and royalties; and would decrease the U.S. employment which derives from U.S. foreign direct investments.

ARLINGTON, VA., *June 14, 1974.*

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: This statement, prepared on behalf of Geothermal Resources International, Inc., of 4676 Admiralty Way, Marina del Rey, California 90291, is submitted for inclusion in the record of hearings held by the Committee on Finance during the past few days on the subject of adjustments in the laws pertaining to Federal taxation.

Geothermal Resources International, Inc., is an independent company engaged partly in airplane and ship leasing and partly in acquiring and developing properties for the production of geothermal energy. Through planned exploration and development activities on leased public and private lands, the Company hopes to contribute importantly toward supplying domestic energy needs from geothermal resources, while at the same time respecting and complying with all applicable environmental quality requirements of the Federal, State and local governments. The Company's capabilities in this regard have been enhanced through its participation in the development of geothermal energy at The Geysers in California and its pending acquisition from the United States Department of the Interior of geothermal leases covering certain Federal lands in California and other States.

As the Committee knows, the United States has experienced a great increase in the demands for all of the conventional sources of energy. Supplies of energy from the conventional sources have not kept pace with demands. As stated recently by Senator Frank Church, Chairman of the Senate Subcommittee on Water and Power Resources, "greater attention must be given to the unconventional energy sources which have been largely ignored in the past." Senator Church went on to say: "Geothermal energy, the energy of the earth's natural heat, is among the most promising of these unconventional sources."

The following are among the findings and recommendations printed in a report of Senator Church's Subcommittee submitted in December, 1973, under the title "The Potential for Energy Production from Geothermal Resources":

"A. FINDINGS . . .

"2. The geothermal resources of the United States hold a potential for the production of substantial amounts of energy in the form of heat and electric power. They hold special promise for making a significant contribution to regional power supplies.

"3. Potential geothermal technologies offer the possibility of providing environmentally attractive energy production techniques . . .

"6. Geothermal resources occur in a variety of types and situations which pose widely different types of technological problems.

a. Dry-steam geothermal systems have been developed successfully but their total potential is believed to be limited.

b. Wet-steam geothermal systems have been harnessed for useful appliactions, but the ultimate utility of the resource depends upon development of methods to develop energy from low-temperature brines and the successful resolution of engineering and environmental problems.

c. Hot dry-rock systems may offer the greatest power potential over the long run, but significant research and development work (including drilling technology and advanced binary cycle heat exchange work) will be required to develop this resource.

d. Geopressured brines are believed to have potential for energy development, but exploration and research on this form of geothermal resource are especially limited.

"7. There is considerable interest on the part of private industry in developing geothermal energy. However, the lack of a Federal leasing program, financing impediments, and the risk involved in advanced technologies are inhibiting development . . .

"12. There is a need for more Federal assistance in exploration, research, development, and demonstration of geothermal technology and for financial assistance to non-Federal developments.

"B. RECOMMENDATIONS . . .

"3. Exploration activity for geothermal energy resources should be greatly accelerated . . .

"5. In order to facilitate private development of geothermal resources, a financial assistance program should be initiated to overcome some of the uncertainties associated with the new technology development."

Support for the Subcommittee's assessments of the possibilities for rapid and sustained growth in domestic geothermal energy production is available from a number of sources. For instance, during the Subcommittee's hearing conducted on July 13, 1973, the Federal Government's National Geothermal Energy Research Program was defined by a NASA representative as having the purpose "to develop the full technology base to stimulate the installation by private industry of tens of thousands of megawatts generating capacity by the middle of the next decade." NASA indicated its support for the idea that the exploitation of geothermal sources of energy could be an important element in the overall strategy of alleviating the Nation's energy shortage. And the Atomic Energy Commission indicated its optimism about the ultimate contribution that geothermal energy can make to the Nation's power and heat requirements.

It is well known that geothermal energy production of the future holds an important place in the Government's program known as "Project Independence."

In summary, the Subcommittee on Water and Power Resources, after careful study, found, among other things, that Federal assistance toward private-industry exploration for, and development of, domestic geothermal resources should be expanded; and the Subcommittee recommended a program of financial assistance for this purpose.

It therefore appears to be particularly strange that in the recent past, and at the present time, some Members of Congress are advocating revisions of the Federal Tax Code which would severely harm the financial outlook for private geothermal resources exploration and development, without, at the same time, offering any simultaneously proposed legislation which would provide needed encouragement and financial assistance to this new energy industry.

Geothermal Resources International, Inc., became concerned over this matter first when bills were introduced in the House of Representatives which would eliminate percentage depletion for "oil and gas wells". However this concern did not arise in time for GRI to contribute toward the Committee on Ways and Means in its extensive hearings during the Spring of 1973 under the topic of "General Tax Reform".

A reading of the more than 7,000 pages of testimony from Administration and public witnesses before the Committee on Ways and Means during its 1973 hearings will indicate that none of the witnesses who appeared purported to represent firms engaged in current or potential geothermal energy production. Practically nothing of substance concerning geothermal energy was developed during the hearings. Certainly nothing was developed which would have explained to the Committee the present situation concerning the tax treatment of production from geothermal wells within the Internal Revenue Code. The fact is that there has been, and still is, a great deal of misunderstanding among Members of Congress on this subject.

Geothermal Resources International, Inc. acted during the Ways and Means Committee's "mark-up" sessions on oil and gas energy taxation legislation to help clear up such misunderstanding. In March of 1974, information on behalf of the Company was transmitted to Congressman Ullman and certain other Members of the Committee that the Committee's staff, in preparing a Committee Print of the legislation, had included a provision which obviously implied inattention to the fact that wells producing "geothermal steam" have been held by the courts to be included within the term "gas wells" under section 613(b)(1)(A) of the Internal Revenue Code for purposes of providing for percentage depletion. This fact follows from the decision of the United States Circuit Court of Appeals for the Ninth Circuit in *Reich et al.* v. *Commissioner of Internal Revenue*, 454 F. 2d 1157 (1972). In that decision, it was held that geothermal steam, as found at The Geysers in California, was a "gas" under the meaning of the Code provisions for percentage depletion deductions.

The recommendation made to Members of the Committee at the time, as a means of correcting the Committee Print, was to make a suitable provision which would amend section 613(b)(1)(A) so as to insert, as a separate or independent item under the 22 percentage rate, geothermal steam and associated resources. This latter term, which is a term of art employed by the Congress in 1970 in defining the subject matter included within the Geothermal Steam Act (84 Stat. 1566), was proposed to be defined in accordance with subparagraphs (i), (ii), and (iii) of section 2 of that Act so as to cover hot water, hot brine, heat and other associated energy forms of geothermal resources, both those that are indigenous in nature and those that are produced by artifically inducing water, gas or other fluids into geothermal formations, as well as vapor-dominated forms of geothermal energy that might come under the term "steam." The essential purpose of this recommendation was to avoid any inadvertent phase-out of percentage depletion for geothermal energy which might take place otherwise along with the Committee's proposal to phase out percentage depletion for oil and unregulated natural gas.

The net response to GRI's recommendations to Congressman Ullman and certain other Committee Members was an expressed exception of geothermal energy from the proposed phase-out for oil and unregulated natural gas wells. This exception is included in the Committee's reported bill, H.R. 14462. The Committee's Report, at pages 44–45, explains the Committee's actions in part as follows:

In two recent court decisions, it was held that geothermal steam produced from a "vapor dominated" hydrothermal system known as the "Geysers" in California is a "gas" within the meaning of section 613(b)(1)(A). Therefore, percentage depletion has been allowed at the 22 percent rate on gross income derived from the production of steam. . . .

In providing that the percentage depletion allowance deduction should be phased out on unregulated natural gas, your committee intended to eliminate the percentage depletion allowance deduction with respect to natural gas which is a hydrocarbon and which is burned as a fuel. It did not intend in any way to affect the present status of geothermal steam. Your committee recognizes that geothermal energy is a valuable resource, but the issues it raises are different from the issues presented by natural gas. As a result, your committee believe that the issues peculiar to geothermal steam should be considered at a later time. . . .

As stated in the Committee's Report, the exception which the Committee has provided will operate so that the phase-out of percentage depletion for oil and unregulated natural gas will not apply to geothermal steam no matter how the status of geothermal deposits is determined in the future by the courts. However, as the Committee's Report may be read to infer, if geothermal steam (or, it might be added, any other form of geothermal energy obtainable from a well) is held in the future not to be a "gas," then the depletion deduction at the 22 percent rate would not apply under the existing language of section 613(b)(1)(A). This potential uncertainty, particularly as to the so-called hot-water form of geothermal energy, has continued to be of concern to GRI both before and after the Ways and Means Committee's recent action.

Of most particular concern at the present time, from the standpoint of GRI and undoubtedly the standpoint of other independents in the field of geothermal energy, is Amendment No. 1326 to H.R. 8217, a tax bill which has been favorably reported by the Senate Committee on Finance.

Amendment No. 1326, known as the Ribicoff-Magnuson-Jackson Amendment, has been described by its sponsors and co-sponsors as a measure to eliminate, retroactively as of January 1, 1974, all percentage depletion deductions for oil and unregulated natural gas. However a reading of the language of the Amendment indicates, quite obviously, that the Amendment would eliminate at the same time the percentage depletion allowance for geothermal steam. There are very strong indications that the author or authors of Amendment No. 1326 were not aware of this potential side-effect involving geothermal energy production, any more than were some of the Members and staff of the Ways and Means Committee aware of the geothermal side-effect of the Committee Print referred to above before it was brought to their attention.

Immediately upon learning of the contents of Amendment No. 1326, I wrote to its sponsors and certain of its co-sponsors and conferred with members of their staffs and members of the staff of the Committee on Finance. On behalf of Geothermal Resources International, Inc., and in line with the suggestions which had earlier been made to Members of the Ways and Means Committee, I urged the sponsors to revise their Amendment so as to except geothermal energy from the elimination of percentage depletion for oil and unregulated natural gas production. The revision which I suggested to them for this purpose would follow the device of amending section 613 (b)(1)(A) so as to insert, as an item to be treated at the 22 percent rate, geothermal wells defined as wells producing "geothermal steam and associated resources" as that term is defined in section 2(c)(i), (ii), and (iii) of the Geothermal Steam Act of 1970. The reasons for suggesting this particular means of rectifying the Amendment are the same as those which gave rise to the similar suggestion which was made on behalf of GRI to Members of the Ways and Means Committee.

My belief is that the successful efforts of Congressman Ullman, Congressman Pettis, and other Members of the Committee on Ways and Means in amending the pending House bill so as to exclude geothermal energy from the proposed three-year phase-out of percentage depletion for oil and unregulated natural gas, have been greatly appreciated by the officers of Geothermal Resources International, Inc. However I am sure that the officers of this Company and those of other companies which are present or potential producers of geothermal energy would very much favor the positive insertion of a comprehensive geothermal energy item in section 613(b)(1)(A) along the lines that have been suggested on behalf of the Company.

By defining geothermal energy wells in accordance with the definition of geothermal steam and associated resources, which is found in the Geothermal Steam Act of 1970, percentage depletion allowances could be uniformly and comprehensively applied to all depleting forms of geothermal energy sources. Independents such as Geothermal Resources International, Inc., would continue to be encouraged by the Government to proceed with exploration for, and development of, geothermal energy resources. The Government's "Project Independence" would be furthered along its way.

The cooperation of the Members of the Committee on Finance toward this end will be greatly appreciated.

Sincerely,

KARL S. LANDSTROM,
Special Counsel, Geothermal Resources International, Inc.

STATEMENT OF GEORGE A. STRICHMAN, COLT INDUSTRIES, INC., NEW YORK, N.Y.

Mr. Chairman, I am George A. Strichman, Chairman of the Board of Colt Industries Inc., and Chairman of the *Ad Hoc Committee For An Effective Investment Tax Credit*. This statement is made on behalf of the membership of the Ad Hoc Committee—a voluntary organization of 161 corporate members covering a broad spectrum of the nation's economic activity. A current list of officers and members is attached.

The Ad Hoc Committee was formed in 1971 to advocate the restoration of the then-repealed Investment Tax Credit, to support a statutory foundation for the Asset Depreciation Range (ADR) system, and to otherwise promote tax policy providing more efficient cost recovery of capital investments in plant and equipment.

At that time there was overwhelming economic evidence that an imbalanced U.S. tax structure was sapping our economy of the ability to replace obsolete plant and equipment, to make technological improvements and to maintain parity in productivity with other industrialized nations. In view of the growing disparity between capital investment needs and the ability of the economy to respond, we suggested at that time that the Investment Tax Credit should be reinstated at a fixed 10 percent rate. There was a compelling need to catch up and keep up if we were to avoid predicted shortages of materials and commodities; and our studies indicated that a 10 percent credit and greatly improved depreciation provisions were among the minimum requirements to bring U.S. plant and equipment up to levels sufficient to curtail inflationary pressures and to provide employment opportunities for a growing labor force.

NEED FOR BALANCE IN TAX POLICY

The 1971 action of Congress in enacting the 7 percent Investment Tax Credit and ADR did help to moderate some of the anti-capital investment bias of the 1969 Tax Reform Act. It did not go far enough.

Yet now we are threatened with a new round of tax changes which again would penalize savings and long-term investment. At the same time new tax benefits are proposed which are aimed at increasing consumption demand. The advocates of tax reduction for low and middle income persons couple their proposals with demands for increased taxes in the capital investment sector, thus inhibiting forces which can increase supply and employment while providing more funds for increasing consumption expenditures.

If we are really concerned about halting runaway inflation . . . if we are really concerned about providing new and better jobs . . . and if we are really concerned about keeping the U.S. economy competitive in world trade, then we cannot disregard our need for a well balanced tax system. We are already suffering the consequences of inadequate savings and capital formation in past years. Many raw materials are in short supply. Scarcity of critical commodities plague every sector of our economy. The capital markets are in a shambles—

making it difficult, and sometimes impossible, for industry to finance adequate capacity additions. The result is an unhealthy mixture of inflated prices and persistent unemployment in some manufacturing sectors.

SUMMARY OF RECOMMENDATIONS

For these reasons and for reasons cited elsewhere in our statement, we make the following recommendations to your Committee and to the Congress:

1. We urge the rejection of the ill-timed and counter-productive proposals to limit the application of the Investment Tax Credit to investments below a specific dollar value. Such action would virtually destroy the incentive value of the credit, and would be as harmful to the small business sector as to other sectors of the economy.
2. We urge retention of the Asset Depreciation Range system. Its repeal or any upward revision of the class life guidelines would force many taxpayers back into a system of depreciation which, by its very nature, fostered an adversary relationship between the taxpayer and the IRS. ADR reduces the extra heavy tax burden in real investment.
3. Today's economic conditions warrant an increase in the Investment Tax Credit to 10 percent or higher. ADR should be revised to allow a 40 percent range from guideline lives rather than the present 20 percent, and its provisions should be extended to certain assets now excluded.

PROBLEMS OF INFLATION AND CAPITAL REQUIREMENTS

One of the arguments we heard during Congressional consideration of the 1971 Revenue Act was that increased investment was not needed because we had an excess of productive capacity. I doubt that anyone would suggest that we have much excess manufacturing capacity today.

The lesson that needs to be learned is that we should not tinker with the capital investment side of the tax ledger every time there is a shift in the nation's economic fortunes. It takes a long time to plan and build a modern steel mill or a manufacturing plant. One that is needed today must have been started five years earlier. One that will be needed in 1980 must be in the advanced planning stage today. Therefore, those provisions in our tax laws which affect management decisions on new facilities should not be turned on and off like a spigot. If we want growth and economic stability, then we should make these provisions adequate for the long term, and leave them in effect.

A discussion of some elements of the existing imbalance between tax incentives for capital investment and those favoring consumption are included in the attached paper by Dr. Norman Ture. His analysis was prepared for the Ad Hoc Committee. It contains very revealing statistics on future investment needs, the effects of inflation on true cost recovery, and the present overtaxation of corporate income resulting from inadequate cost recovery to cope with inflated replacement costs.

Dr. Ture points out, among other things, the seriously adulterating effect which inflation has had upon the investment incentive enacted in 1971.

> According to the Department of Commerce's Bureau of Economic Analysis, each dollar of today's capital recovery allowances based on the original cost of the existing stock of production facilities is worth only 83 cents in terms of the current cost of those facilities.[1] In other words, in terms of the dollars at which the present stock of machinery and equipment was purchased, each dollar of current depreciation allowance is worth 17 cents less. To keep pace with the inflation, for every dollar of historical cost depreciation, $1.20 should be allowed as a deduction for tax purposes.

We believe all the evidence supports the contention that enactment of new penalties on capital formation and investment in plant and equipment would be foolhardy and shortsighted. The consequences could be devastating—for our food supply, our energy needs, raw material development and for the efficient production of the vast range of consumer products essential for our way of life.

Among the very disturbing factors which weigh heavily on our economy today—and which need to be considered in the development of effective economic policy are:

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[1] Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, May 1974, pp. 19-21.

The ratio of debt to physical assets of many corporations is precariously high.

Also the debt-to-earnings ratio of many businesses has stretched borrowing to or beyond the limits of prudence.

Much of the capital expended over the past several years has gone into pollution control rather than into equipment for increased capacity. Reasonable requirements for abatement are essential, but their effects on the ability of industry to meet new production demands must be considered.

Inflation has also had its effects on the gain in capacity to be realized from each dollar invested. Unfortunately, much of the increase in capital investment since 1971 has been needed merely to stay even with higher costs.

The complexity of modern facilities and new processes has also resulted in large increases in capital requirements. One example of the gap between book value and replacement cost is in the steel industry where it would now take about $78 billion to replace plant and equipment with present book value of $14 billion.

The conclusions to be drawn from these factors are two-fold: first, there is the overwhelming need to continue and to improve such reasonable cost recovery provisions as the Investment Tax Credit and the Asset Depreciation Range (ADR) system.

Secondly, a comparison of these existing cost recovery provisions with those provided by other industrialized nations demonstrates clearly that investment in U.S. plant and equipment continues to be treated much less favorably, notwithstanding the enactment in 1971 of the Investment Tax Credit and ADR. The effects in terms of international parity and stability of the dollar are profound. This, combined with the present inflation-feeding lag in domestic productivity, lead to the conclusion that government policies should be shifted to further emphasis on new investment.

CONCLUSION

Therefore, we strongly recommend against the adoption of any of the several pending amendments which would impose further impediments to full economic recovery, and we suggest that realistic studies be made to assess how the future capital investment needs of the nation can best be met. In the meantime, we believe that current conditions warrant greatly improved provisions for capital cost recovery, and we hope that this Committee will pursue that objective.

Certainly this is not the time to add tax penalties on the long-term investment we need to expand the productive capacity, output and employment essential to a return to the stable growth of our economy.

Thank you.

[Attachment A]

OFFICERS AND MEMBERS OF THE AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT

OFFICERS

Chairman, George A. Strichman, Chairman of the Board, Colt Industries, Inc.

Vice Chairman (Aerospace), James W. Ethington, Vice Chairman of the Board and Chief Financial Officer, Sundstrand Corporation.

Vice Chairman (Chemicals), James F. Towey, Chairman of the Board and Chief Executive Officer, Olin Corporation.

Vice Chairman (Farm Machinery & Foods), Donald P. Kelly, President and Chief Operating Officer, Esmark, Inc.

Vice Chairman (Machinery), D. Wayne Hallstein, President, Ingersoll-Rand Corporation.

Vice Chairman (Oil and Minerals), John C. Duncan, President and Chief Executive Officer, St. Joe Minerals Corporation.

Vice Chairman (Paper), J. P. Monge, Chairman of the Finance Committee, International Paper Company.

Vice Chairman (Retail), Ralph Lazarus, Chairman and Chief Executive Officer, Federated Department Stores, Inc.

Vice Chairman (Transportation), H. T. Watkins, Chairman and Chief Executive Officer, The Chesapeake and Ohio Railway Company.

Vice Chairman (Utilities), Edward R. Eberle, President and Chief Executive Officer, Public Service Electric and Gas Company.

A-T-O Inc.
Air Products and Chemicals Inc.
Akzona, Inc.
Albany International Corp.
Alberto-Culver Company
Allis-Chalmers Corporation
Amerace Corporation
American Metal Climax, Inc.
Arvin Industries, Inc.
Ashland Oil, Inc.
Avnet, Inc.
Beatrice Foods Company.
Belden Corp.
Bemis Company, Inc.
Booth Newspapers, Inc.
Brown Group, Inc.
Brunswick Corporation.
The Budd Company.
Bunker-Ramo Corporation.
Burlington Industries, Inc.
Burroughs Corporation.
CCI Corporation.
CF Industries, Inc.
The Carborundum Company.
Carlisle Corporation.
Carpenter Technology Corporation.
Carrier Corporation.
Castle & Cooke, Inc.
Ceco Corporation.
Cessna Aircraft Company.
Champion International Corp.
The Chesapeake and Ohio Railway Company.
Chicago Bridge & Iron Company.
The Citizens and Southern National Bank.
City Products Corporation.
Clow Corporation.
Colt Industries, Inc.
Commercial Shearing, Inc.
Consolidated Foods Corporation.
Consumers Power Company.
Continental Telephone Corp.
Cooper Tire & Rubber Company.
Crouse-Hinds Company.
Cyclops Corporation.
Dana Corporation.
Dean Foods Company.
Deere & Company.
De Laval Turbine Inc.
The Detroit Bank & Trust Company.
Diamond Shamrock Corporation.
R. R. Donnelly & Sons Company.
ESB Incorporated.
Eaton Corporation.
The Echlin Mfg. Co.
Economics Laboratory, Inc.
Electronic Memories & Magnetics Corp.
Emerson Electric Co.
Emery Industries, Inc.
Esmark, Inc.
Evans Products Company.
Ex-Cell-O Corporation.
Federal-Mogul.
Federal Paper Board Company, Inc.

Federated Department Stores, Inc.
First National Bank of Chicago.
The Flying Tiger Corporation.
Fruehauf Corp.
Fuqua Industries, Inc.
Gannett Co., Inc.
Gardner-Denver Company.
General Cinema Corporation.
General Dynamics Corporation.
General Telephone & Electronics Corp.
The General Tire & Rubber Company.
Giddings & Lewis, Inc.
Globe-Union, Inc.
Gould, Inc.
Greyhound Leasing and Financial Corporation.
Harris-Intertype Corporation.
Harsco Corporation.
Hoover Ball & Bearing Company.
Houdaille Industries, Inc.
Howmet Corporation.
Ideal Basic Industries, Inc.
Ingersoll-Rand Company.
International Paper Company.
Jewel Companies, Inc.
Josten's, Inc.
Joy Manufacturing Company.
Kansas Beef Industries, Inc.
Katy Industries, Inc.
Kennecott Copper Corporation.
Kraftco Corporation.
The LTV Corporation.
Lance, Inc.
Leaseway Transportation Corp.
Libbey-Owens-Ford Co.
Longview Fibre Company.
Lucky Stores, Inc.
Macmillan, Inc.
Manufacturers National Bank of Detroit.
Martin Marietta Corporation.
Masonite Corporation.
Michigan National Corp.
Midland-Ross Corporation.
Milton Bradley Company.
Mobil Oil Corporation.
Modine Manufacturing Company.
Monsanto Company.
NL Industries.
NVF Company.
National Gypsum Company.
National Presto Industries, Inc.
Newmont Mining Corporation.
Norris Industries, Inc.
Olin Corporation.
Outboard Marine Corporation.
Oxford Industries, Inc.
PPG Industries, Inc.
Parker Hannifin Corporation.
Phelps Dodge Corporation.
Philip Morris, Incorporated.
Portec, Inc.
Potlatch Corp.
Public Service Electric and Gas Company.
Raytheon Company.
Reed Tool Company.
Reliance Electric Company.

Rockwell Inernational Corp.
Rohm and Haas Company.
Rohr Industries, Inc.
Roper Corporation.
Rubbermaid, Inc.
St. Joe Minerals Corporation.
St. Regis Paper Company.
The Signal Companies, Inc.
Southwest Forest Industries.
Square D Company.
Stanadyne, Inc.
Standard International Corporation.
Sterling Drug Inc.
Sundstrand Corporation.
TRW, Inc.
Tecumseh Products Company.
Texas Industries, Inc.
Texas Instruments, Inc.
Todd Shipyards Corporation.
Union Trust Company of the District of Columbia.
U. S. National Bank of Oregon.
Universal Leaf Tobacco Co.
Valley National Bank of Arizona.
Van Dorn Company.
Vulcan Materials Company.
Wallace Murray Corporation.
The Warner & Swasey Company.
Wean United, Inc.
Wheelabrator-Frye, Inc.
Whirlpool Corporation.
The Williams Companies.
Winn-Dixie Stores, Inc.
Zayre Corp.

[Attachment B]

SUPPLEMENTAL STATEMENT BY NORMAN B. TURE, OF NORMAN B. TURE, INC., WASHINGTON, D.C.

The record of the U.S. economy over the past several years affords some crystal clear lessons which the nation can ignore only at its peril. The basic lesson we must learn is that we can't finance explosions in public sector demands by rapid increases in the money stock while failing to provide for an equal increase in our production capability. The consequence of doing so is the inflation which now grips the economy. Can there be any question that if the nation had saved and invested a significantly larger share of its total income during the past several years that we would not now be facing bottlenecks, shortages, and soaring prices in one industry after another? And can there be any question that if we had not so rapidly increased the money supply—at 8.7 percent a year, on the average, from 1969 through 1978—the increase in aggregate demand would not have so greatly exceeded the increase in our production capacity? We must learn that unless we're prepared to accept a marked and sustained deceleration in the growth of our demands, we'd better make substantially more ample provision for the growth in our ability to produce the goods and services to meet those demands. In a word, we need to save and invest a larger share of our income to provide for faster growth in our production potential.

A collateral lesson on which our history is clear is that public policies which focus only on the present and immediate future are likely to store up major problems for the longer term. In the 1970–71 recession, proposals to moderate the punitive impact of the Tax Reform Act of 1969 on saving and investment were frequently countered by the shortsighted assertion that the economy had no need for faster expansion of its production capacity, that we had excess capacity as it is. Just a short while later, the excess capacity has vanished and we confront inadequate capacity in one industry after another. Had we not reenacted the Investment Tax Credit and the Asset Depreciation Range (ADR) depreciation provisions, we'd be facing the present aggregate demands with 4 to 7 percent less production capacity than we actually have; inflationary strains, severe as they actually are at present and prospectively would be substantially greater.

By the same token, it would be foolhardy and shortsighted in the extreme if the Congress were now to reduce taxes to promote faster increases in consumption demands while increasing the tax burdens on saving and investment. The bills and amendments the Committee is considering in these hearings, by increasing the minimum tax, by repealing ADR, by reducing or eliminating the investment tax credit, and by other changes which would increase the tax load on saving and capital would retard the growth in the nation's production potential and leave us more exposed than at present to the storms of inflation. Repeal of the investment credit and ADR would cost the nation more than $85 billion in sorely needed gross additions of modern, technically advanced new capital facilities over the next two or three years. Surely we should ask whether we want to deprive ourselves of this additional production capability, whether we want to risk a 1976 or 1977 with even more serious capacity limitations, relative to our total demands, than we now must face.

In the light of the inflation the economy has suffered in the last several years, the current proposals to increase the tax load on saving and capital formation are diametrically opposite to the requirements of good public policy. Tax provisions such as the ADR and the Investment Tax Credit are not the loopholes which the proponents of the so-called tax "reforms" would have you believe. They are not even properly characterized as incentives. In fact, they represent at best very modest abatements of an extraordinary tax bias against private saving and investment.[1] Their effectiveness in this respect has been grossly diminished by inflation. According to the Department of Commerce's Bureau of Economic Analysis, each dollar of today's capital recovery allowances based on the original cost of the existing stock of production facilities is worth only 83 cents in terms of the current cost of those facilities.[2] In other words, in terms of the dollars at which the present stock of machinery and equipment was purchased, each dollar of current depreciation allowance is worth 17 cents less. To keep pace with the inflation, for every dollar of historical cost depreciation, $1.20 should be allowed as a deduction for tax purposes.

Because of the inflation, the income tax is levied not just on the profits currently generated by use of depreciable property but on a substantial amount of the recovery of the cost of that capital. Inflation accentuates grossly the fundamental tax bias against saving; it is turning the income tax more and more into a capital levy. For the first quarter of this year, for example, capital consumption allowances are understated by not less than $28.8 billion. This means that more than $28 billion of business capital costs are being subjected to tax as if they were net profits.

All of us have heard a lot of loose talk in recent months about bloated corporate profits. Corporate profits are indeed "bloated"; as reported, they are substantially overstated—by more than 22 percent—by reason of the understatement of capital recovery allowances.[3] Repeal of ADR and elimination of the Investment Tax Credit would add to this overstatement of profits for tax purposes and would increase the amount of tax on these overstated profits by an estimated $5.3 billion (at 1978 income levels).

The adverse impact of the current inflation on the capacity of U.S. business to generate the funds—in real terms—needed to maintain, let alone expand, the existing stock of machinery, equipment, and other capital is one of the most serious problems facing the economy today. To repeal the ADR and Investment Tax Credit provisions would aggravate this problem enormously. The certain consequences would be a severe cutback in capital formation; the resulting reduction in production potential both in the near future and for the long term would immeasurably weaken the nation's capacity to cope with inflationary pressures.

Inflation has, in addition, a more subtle, but nevertheless powerful, adverse effect on saving and investment. It raises the cost of saving and the cost of

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[1] For a detailed discussion, see the NAM study, *Tax Policy, Capital Formation, and Productivity*, prepared by Norman B. Ture, and the same author's "Tax Treatment of Savings and Capital Recovery," The George Washington Law Review, Vol. 42, No. 3, March 1974, pp. 501–515.

[2] Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, May 1974, pp. 19–21.

[3] Ibid.

capital relative to the cost of consumption. We hear continuously about inflation's erosion of the real income of households. While this is perfectly true, it does not tell the whole story. The expectation of continuing inflation, i.e., the anticipation that prices will be significantly higher next week, next month, or next year than they are today, also sets up a strong incentive for people to increase their current purchases of commodities and goods they can put into their household inventories. As a consequence, it increases the proportion of their current disposable income they want to use for such consumption spending. As a corollary, this means that they demand a greater return per dollar of saving in order to forego the greater current consumption outlays. And this means, in turn, that the cost of capital to business goes up. We have seen this in the rise in the level of bond yields and interest rates and in the precipitous fall in price-earnings ratios.

Inflation, thus, erodes business' capacity to maintain and expand production capacity because (1) it results in understatement of capital cost recovery and overstatement of profits, hence exposes business capital rather than only business income to the income tax, and (2) it raises the cost of external financing of capital outlays as well. In the face of these inflation-caused barriers to capital formation, how can further increases in the tax on capital possibly be considered tax reform? How can such tax increases possibly be viewed as good public policy aimed at strengthening the economy, expanding its production bases, enhancing its ability to withstand inflationary strains?

Let us not make the mistake some would have committed a few short years ago of ignoring our long-term demands for capital. If the business sector is to expand at least as rapidly and if the pace of advance of labor's productivity and real wage rate in the next 12 years is to at least equal that of the past 25 years, we must undertake gross capital formation of at least $3.7 trillion between now and 1985. This is an extremely conservative estimate, assuming that the cost of production facilities increases at only 3 percent a year and making no allowance for the capital requirements to meet environmental protection goals. If we add $15 billion a year for the latter, we face the need to finance a total of $4 trillion of capital formation in the next 12 years.

Even this figure errs on the conservative side. When we take account of the projected increases in the costs of acquiring the energy sources needed to fuel and power our production and to meet our household demands, we must add several billion more per year to the aggregate capital formation business will be required to finance between now and 1985. If government budget policies are not brought under far better control in the next twelve years than in the postwar years to date, we also have to count on financing an additional $100 billion or more in deficits through 1985.

Total requirements for private sector saving over the next twelve years, thus, will be significantly above $4 trillion. But at the average ratio of private sector saving to GNP of the last, say, 18 years, this saving is likely to fall at least $200 billion and possibly as much as $400 billion or more short of the requirements described above.

In the light of these conservative estimates, it should be overwhelmingly clear that the first priority for Federal tax policy must be to relieve—not accentuate—the present tax burden on private saving. There is a large inventory of tax changes, some of which can be promptly enacted and some of which are longer term, which would contribute materially to reducing the present tax drain from private saving. In the former category, urgent consideration should be given to (a) increasing the present Investment Tax Credit to 15 percent and (b) to expanding the ADR range from the present 20 percent to 40 percent.

Increasing the Investment Tax Credit would quickly add to private sector saving and investment in technically advanced production capacity. Over three years time, capital outlays over and above the amount we are otherwise likely to realize would aggregate $30 billion, as a result of increasing the Investment Tax Credit to 15 percent. If ADR is increased to 40 percent, the increase in capital outlays might well total $76 billion over three years. And if both of these changes are made, the additional saving and investment would be about $107 billion more than otherwise now through 1976.

Looking farther ahead to 1985, increasing the Investment Tax Credit now would augment private saving and capital formation by a total of $180 billion; twelve years from now, our stock of equipment would be 5.5 to 6 percent larger than it otherwise would be. Expanding the ADR to 40 percent would add $266 billion to capital outlays and would enlarge the total business sector stock of capital by 5 percent. Combined, these tax changes would increase gross investment by $400 billion over the amount we might otherwise realize during the next twelve years and afford us an 8 percent greater production capability in 1985 than would otherwise be available.

Constructive tax policy which seeks to enhance the well being of all Americans must not increase the tax load on those, whether rich or poor, who want to save more while reducing taxes on those who want to save less. A constructive tax policy will weigh the curb on the growth of production capability which would result from the punitive measures now being pushed against the spurious gains in equity which these additional tax burdens on saving allegedly would provide. A constructive tax policy will reduce the present tax biases against saving and capital in pursuit of the gains in production capability, in productivity, in real output, and in real wage rates which are the only means by which we can sustain the growth in our demands without excessive inflation.

Statement of Albert Sussman, Executive Vice President, International Council of Shopping Centers

Mr. Chairman and Members of the Committee: Economically the shopping center industry, born shortly after World War II, is in more serious difficulty than it has ever been. Costs are up, profits are down, risks are greater than ever, and an alarming number of new shopping centers are financially marginal.

In this environment, the possibility that the Senate may vote to enact increases in the minimum tax on tax preferences constitutes a serious threat to the health and stability of our industry.

The proposed amendments to H.R. 8217 dealing with the minimum tax, if adopted, would have the effect of:

1. Reducing the return on investment with one swoop of the hand and then requiring more equity capital for new shopping center construction with the other.
2. This condition would in turn increase the risk of business failure which could be overcome only by obtaining higher rents from tenants.
3. Higher rents would inevitably result in higher prices to consumers at a time when prices are already at record levels.

These inflationary pressures and uncertainties in our segment of the economy are now forcing many shopping center developers to cancel or postpone development needed to serve consumers. Any measure which would aggravate this condition would be harmful to the retail economy, to the developers of shopping centers, and to the consuming public which is the ultimate beneficiary of carefully planned, soundly designed, and scientifically integrated shopping centers.

The International Council of Shopping Centers is a business association of more than 5,000 members. About 60 percent of our members develop and/or own shopping centers. About 15 percent are retail companies, the major share of whose stores are operated in shopping centers. Most of our developer-owner members own from two to four shopping centers each, and collectively represent a major share of the estimated 16,000 shopping centers in the United States. Most of our retail members have been locating 95 to 100 percent of their new stores in shopping centers.

New shopping center construction requires total annual investment of over $6.6 billion per year for buildings, stores, fixtures, and equipment. It is estimated that shopping centers provide regular employment for more than 5,000,000 sales and store personnel and that several hundred thousand more are engaged in the construction end of the business. The rippling effect on employment in related businesses, among them display, advertising, maintenance and cleaning, legal as well as others, is considerable. We have a significant influence on the total economy. Retail sales in shopping centers now total over $125,000,000,000 a year, or close to 30 percent of all retail sales in the country.

This industry is now plagued by inflationary costs that have developers in a tight and binding squeeze.

1. Construction costs are increasing at the rate of one to two percent a month.
2. Interest rates are the highest in history and loan money is hard to find.
3. New housing construction has sharply receded in the last two years, seriously diminishing the future need for new shopping centers.

4. Federal and state environmental regulations, covering air, water, noise and solid waste disposal, are increasing both in time and cost of construction.

The total effect of these factors is having an adverse impact on shopping center development. The increases in costs are staggering.

The total cost of developing new regional shopping centers is currently close to $50 per square foot including land, buildings, and professional fees.

Construction costs are 15 percent higher than they were last year, 28 percent higher than two years ago, and 38 percent higher than they were three years ago, according to a report prepared by Dodge Building Cost Services which is attached to this statement as Exhibit 1. In the 10-year period from 1964 to 1974, construction costs rose 122 percent.

Interest rates on construction loans usually run about two or three points above the prime rate. Today, as we all know, they are higher than ever.

In addition, development budgets currently must include generous provisions for fees, time delays and other costs to cover essential, desirable but, nevertheless expensive, environmental protective features. Many states now require environmental impact statements from developers of large shopping centers. Water disposal and repurification systems, drainage ponds and other environmental control devices, both current and pending, are increasing construction in costs and time schedules at inflationary rates.

Just the annual mortgage charges on $50 of development costs come to $5 or $6 a square foot. Add local property taxes, maintenance insurance, advertising, promotion, and management costs and it becomes necessary for a developer to charge rents of more than $9 a square foot just to break even. That is $9 a square foot of rent, without making any allowance for vacancies or federal taxes, nor producing any profit or excess cash flow.

At rentals computed at an average rate of six percent of gross sales, the typical tenant must produce sales volumes of at least $150 per square foot of leasable area to be able to pay his landlord. Yet at this rental, the landlord himself cannot realize a profit, allow a vacancy or afford to pay federal taxes.

While some merchants sell more than $150 of merchandise per square foot of space they occupy, the national average is about $75 a foot.

Typically, rentals in women's apparel stores had increased to $4.49 a square foot during the years 1971–1973. Average rents for men's apparel stores during the same period were $4.42.

Rents of $9 or more would represent an increase of about 100 percent for these types of merchants. To pay such rents, retailers would reluctantly but necessarily be compelled to increase their prices to customers.

The United States Department of Commerce has estimated that between 1971 and 1980 the number of households in the United States will increase from 64.4 million to 76.1 million. This growth will create a need and demand for new retail facilities and services which shopping centers demonstrably could fill more efficiently and conveniently than any other type of retail distribution system.

If it becomes unprofitable, more risky and unwise to develop the shopping centers that are needed to maintain balanced and smooth working distribution facilities, what will the Congress have accomplished?

Perhaps the industry will become dominated by giant corporations who for the most part may be exempt from the proposed changes to the minimum tax. Perhaps it will mean that developers and investors will seek other forms of business and other types of investment.

It will surely mean less services to the American public at higher prices and at less convenient locations.

We do not believe that this is what the Senate intends or wants. We therefore urge you and this Committee, Mr. Chairman, to discourage any amendment to the minimum tax which would affect real estate investment in general and shopping centers in particular.

In appearing before this Committee, we do not plead for any special privilege or singular consideration. In 1969, officers of the International Council of Shopping Centers testified before this Committee and recommended the adoption of a minimum tax because we believed then and still believe now, that it is the obligation for every American to pay a rightful share of taxes—business and individual. We submit that the minimum tax, as it now stands, requires those who derive their income from real estate to pay a higher proportion of taxes than those who receive their income from tax preference sources. (See Exhibit 2 attached hereto.) The tax should not be made more punitive for those who now pay it, while others who should rightfully be paying it, are exempt.

We appreciate the privilege of presenting our views to this Committee and we will be pleased to provide any additional information at any date the Committee may require.

EXHIBIT 1—SPECIAL REPORT ON THE INCREASED CONSTRUCTION COSTS OF SHOPPING CENTERS FROM 1964 TO 1974

(Prepared by: John H. Farley, Senior Editor, Dodge Building Cost Services)

The following report reflects the rise in construction costs from 1964 to 1974. These costs are based on the specifications that follow and reflect construction costs on a National Average. These National Average figures are published semi-annually in the Dodge Building Cost Publications—*United States Construction Costs*. These National Average figures reflect material prices and labor rates in 182 cities across the nation.

The specifications given and the size of the structure represent National Average for shopping centers. We have taken no representative of shopping centers on a National Average a mall type shopping center of 550,000 square feet. The prices shown reflect building and mall construction only and exclude land costs.

Building: Shopping Center.

Construction: Concrete Frame.

Quality: Average.

Structure: Reinforced concrete foundation, footings walls and slabs. Structural framing: reinforced concrete columns, beams, suspended slabs and roof structure. Built-up roof and insulation. Exterior walls: masonry panels of precast concrete, prefinished aggregate, limestone or brick. Resilient flooring general sales areas, ceramic tiled toilets, terrazzo or marble in entries, exposed concrete in service areas, vinyl asbestos tile or carpet in offices. Good quality suspended accoustical ceilings. Vinyl or fabric wall coverings.

Plumbing: Many public and employee rest rooms, average quality toilet fixtures. Water coolers, utility and service sinks. Standpipe and complete sprinkler system.

HVAC: Complete system, boiler-gas or oil fired low pressure steam, hot water or forced air.

Electrical: Fluorescent lighting fixtures integrated or surface mounted to suspended ceilings. Incandescent lights for exit, service and utility areas. Display spot fixtures complete intercom system throughout. Power wiring.

EXHIBIT 2—IMPACT OF THE MINIMUM TAX, INCLUDING THE PROPOSED AMENDMENTS, ON THE SHOPPING CENTER INDUSTRY

We sincerely believe that the proposed amendments to H.R. 8217 which would increase the present minimum tax on tax preference items will seriously escalate the many economic problems that our industry is now facing. Moreover our economic problems notwithstanding, we question whether the minimum tax operates equitably throughout the economy. We suspect it is undeservedly slanted against real estate and, accordingly, any increase in its impact will magnify this inequity.

Many of the items designated as tax preferences probably affect only a handful of taxpayers. However, as enacted in 1969, three tax preference items which have general application throughout the economy—accelerated depreciation, capital gains, and investment interest—primarily affect real state ownership. Probably, the only other preference items which might be of general concern to taxpayers are percentage depletion and qualified stock options. Moreover, for the taxable year beginning in 1972, the tax preference item described as "excess investment interest" is subject to a limitation on deductibility rather than the minimum tax, and we have been advised by our members that its impact on real estate ownership has become even more severe.

We understand that there are various proposed amendments to H.R. 8217 which would increase the impact of the minimum tax. Thus, it has been suggested that the present minimum tax rate of 10 percent be increased, even to the extent of one-half of one's regular tax rate. Other proposals would eliminate part or all of the sums—$30,000.00 plus the taxpayer's regular tax—presently available as deductions in determining the amount upon which the minimum tax is calculated. Finally, we understand that consideration is being given to including construction period deductions as a tax preference item.

Eliminating the regular tax as a deduction in determining the amount upon which the minimum tax is calculated, would convert the minimum tax to an excise tax on preference items. We believe that such action would be contrary to the fundamental intent of the minimum tax as enacted in 1969—i.e., assurance that all taxpayers pay at least some tax on their economic income. We appreciate that the minimum tax has not operated as intended by Congress. However, this is largely due to the failure to categorize as tax preference items all forms of economic income which are not subject to tax. This failure in the basic framework of the minimum tax will not be cured by converting it into an excise-type tax. Rather, it will merely subject those who are already paying tax to much higher tax burden.

Reducing or eliminating the $30,000 deduction may not severely affect most taxpayers insofar as the minimum tax is concerned. Nevertheless, it must be appreciated that any tampering with $30,000 deduction may severely undermine the 50 percent maximum tax rate on earned income. Presently, each dollar of tax preferences in excess of $30,000 removes a dollar of one's earned income from the 50 percent maximum rate. A decrease in the $30,000 deduction will subject more of one's earned income to a tax rate which exceeds 50 percent. Many of our members are shopping center executives whose earned income would be taxed at a rate exceeding 50 percent if it was not for the maximum tax rate ceiling.

At first blush, a modest increase in the present minimum tax rate of ten percent may not appear to have a serious impact on most taxpayers. However, it must be understood that the minimum tax operates as a penalty tax in that one is denied an adjustment to the tax basis of the underlying property, even though he paid a tax on a preference item. The adverse consequence of this oversight in the operation of the minimum tax will become much more apparent if the ten percent rate is increased. In any event, we respectfully submit that the minimum tax should be amended so as to provide for a basis adjustment in every instance in which one is subjected to the tax.

Clearly, the proposal which would treat as preference items, interest, taxes, and carrying charges incurred by a real estate developer during the construction period will cause the minimum tax to be even more heavily weighted against real estate. It will compound the inequity which this industry now suffers by reason of the uneven application of the minimum tax throughout the economy.

Furthermore, within the real estate industry, it will discriminate against the developer who must borrow funds because his financial resources are limited. A developer of modest means will have to raise rents to stay in business since his development costs will be substantially higher if he is subjected to a minimum tax on his construction period deductions. On the other hand, a huge financial institution or affluent investor with unlimited sources of funds may be able to develop real estate without borrowing and thereby avoid the additional after-tax cost of borrowing resulting from the proposal which would treat construction interest as a tax preference. The affluent may not have to raise rents to the same extent as the independent developer. On the other hand, the independent shopping center developer of modest means may be forced out of business since he will not be able to compete with those of greater wealth.

Statement of the U.S. League of Savings Associations

The U.S. League of Savings Associations[1] appreciates this opportunity to present its views on the Minimum Income Tax.

It is our understanding that Senators Gaylord Nelson, Edward Kennedy, and perhaps others propose to amend Section 56 of the Internal Revenue Code—the Minimum Tax for Tax Preferences—by eliminating the offset for other

[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,600 savings and loan associations, representing over 98% of the assets of the savings and loan business. League membership includes all types of associations—Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: George B. Preston, President, West Palm Beach, Florida; Lloyd S. Bowles, Vice President, Dallas, Texas; Tom B. Scott, Jr., Legislative Chairman, Jackson, Mississippi; and Norman Strunk, Executive Vice President, Chicago, Illinois. League headquarters are at 111 East Wacker Drive, Chicago, Illinois (60601); and the Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. (20006); Telephone: 785–9150.

Federal taxes paid, and by lowering the $30,000 exemption to $10,000. (See, for example, Nelson amendment #1324 to H.R. 8217.) Such proposals would have an unexpected and serious impact on our member associations which provide the financing for our nation's housing markets. The U.S. League therefore urges the Committee and the Senate to reject such changes in the Minimum Income Tax formula as applied to savings associations.

Savings and loans and mutual savings banks allocate portions of their income to a bad debt reserve, one of the tax preference categories subject to the Minimum Income Tax. This preferred tax treatment is in recognition of their role as specialized lenders providing, almost exclusively, long-term mortgage credit for American home buyers.

Dr. Kenneth Thygerson of our staff estimates that the proposals of Senators Nelson and Kennedy would raise the tax liability of savings and loans by $56 million. This amounts to an increase of 10.2% in the effective tax rate of savings associations based on an estimated $549 million in taxes paid in 1972, the latest year for which figures are available. Dr. Thygerson's material is attached.[3]

As Dr. Thygerson demonstrates, the reduction in the $30,000 exemption to $10,000 is particularly serious for smaller S&L's. In his example of an association with $100,000 of taxable income, the change in the exemption increases taxes by 21%.

The elimination of the offset for other Federal taxes of the proposal falls unevenly and severely on those S&Ls which pay higher taxes. These associations often "set the market" throughout the country; thus, the actual impact of such a change may be magnified still further.

And, of course, a $56 million increase in the taxes paid by all savings associations would seriously hamper mortgage credit. If it may be assumed that these funds would be drawn from S&L reserves (required by statute at a 5% level), then the housing market would be deprived of a substantially greater amount, perhaps as much as $1 billion.

The Committee will recall that the 1969 Tax Reform Act already provides for annual increases (over a ten-year period) in the tax rate for savings associations—through decreases in their permissible bad debt deductions. Some commentators have suggested that the additional liability resulting from the Minimum Tax of the 1969 Act was certainly unanticipated, and perhaps unintended.

A further tax burden at this time would have a very serious effect on thrift institutions. Savings and loan associations and mutual savings banks bore the brunt last fall of the third credit crunch in seven years. That crunch was renewed again in March, April and May of this year when market interest rates soared to unprecedented levels. Savings flow data for these thrift institutions indicate a net loss of over $1 billion in the month of April. We are once again in a critical period for housing finance since early figures indicate that virtually no new net savings were attracted to our institutions during the month of May. The persistence of high rates on competing investments makes the outlook for June and July gloomy indeed.

We estimate that our institutions at mid-1974 will earn an average of 7.27% on the mortgage loan portfolios which comprise 85% of their assets. Money costs (without the costs of Federal Home Loan Bank credit) at mid-year will be 6.12%. This spread between portfolio yield and money costs is at an historic low, and there is every expectation that it will narrow still further in coming months. This margin of slightly more than 1% leaves very little room for increased expenses, and certainly would be seriously eroded by a $56 million or more increase in our tax bill.

There very well may be inequities in the Minimum Tax system as now structured—particularly for some wealthy individual taxpayers. But the occasional abuses of our tax laws by individuals should not be allowed to jeopardize our home finance system. Perhaps the formula as applied to individuals should be distinguished from the formula as applied to corporations. In any event, we urge the Committee to refrain from imposing a new and crippling tax burden on savings associations—institutions which perform a public service that Congress has specifically recognized as deserving of specialized tax treatment.

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[3] In addition to the Nelson/Kennedy proposal, a number of alternative Minimum Tax changes have been suggested on the House side. Dr. Thygerson estimates that the amendment advocated last fall by Representative Reuss and Vanik, for example, would mean a whopping $189 million increase in the tax liability of savings associations.

MEMORANDUM

Re Proposed Change in Preference Tax #4 "Nelson/Kennedy Formula"

(Prepared by Dr. Kenneth Thygerson, Economist, U.S. League of Savings Associations)

The following represents an analysis of the proposed changes in the minimum preference tax on savings and loan associations.

The analysis assumes the following change in the present form of savings and loan taxation: (1) the elimination of the Federal tax exclusion, and (2) a reduction in the regular exemption from $30,000 to $10,000.

1. Exhibit 1 shows the effect of these changes on an association with $100,000 in pre-tax income.

The exhibit indicates an increase of 21.0% in the effective tax rate for this association.

2. Exhibit 2 shows the results of an analysis of the effect of the proposed tax changes on our management conference group of 2,164 associations. The exhibit also shows the effect of the tax increase by size of institution, specified in terms of pre-tax income.

The exhibit shows the greatest impact, percentage-wise, would be on the small association. This is because the reduction of the regular exemption eliminates the small association's major protection against the minimum preference tax.

3. Finally, we worked out the impact on the business as a whole. During 1972, our sample institutions paid $357,267,000 in taxes. Under the new formula, they would pay a $393,565,327 in taxes, an increase of $36,298,227.

4. Since our reporting group of 2,164 institutions is only 65% of the total business, we can estimate that assuming that the associations not covered in the analysis pay the same rate as those in the sample, the total tax liability would be $549,642,000 under the current tax formula and would increase $605,485,627 under

EXHIBIT 1

ESTIMATE OF TOTAL TAX PAID UNDER EXISTING AND PROPOSED FORMULAS

	Existing formula	Formula no Federal exclusion
Taxable income (before bad debt deduction)	$100,000	$100,000
Less: Bad debt deduction (49 percent)	49,000	49,000
Total	51,000	51,000
Basic tax (0.22 of 1st $25,000) (0.48 of that over $25,000)	17,980	17,980
Minimum tax for tax preferences:		
Tax preference item: (bad debt deduction)	49,000	49,000
Less:		
Regular exemption	30,000	10,000
Federal tax exclusion	17,980	
Amount on which minimum tax is based	1,020	39,000
Minimom tax for tax preferences (10 percent)	102	3,900
Total tax rate	18,082	21,880
Effective tax rate (percent)	18.1	21.9
Percent increase in taxes		21.0

EXHIBIT 2

CHANGES IN TAXES PAID BY SIZE OF CLASS OF ASSOCIATION (SAMPLE REPRESENTING 65 PERCENT OF SAVINGS ASSOCIATIONS)

[Assume a 10 percent preference tax, $30,000 regular exemption and no Federal tax exclusion]

	Percentage increase in taxes paid	New effective tax rate (percent)	Old effective tax rate (percent)	Number of associations
Associations with less than $50,000 in pretax income	17.15	12.57	10.73	190
Associations with $50,000 to $100,000 in pretax income	22.59	18.47	15.10	250
Associations with $100,000 to $500,000 in pretax income	12.87	25.35	22.46	1,038
Associations with over $500,000 in pretax income	9.55	27.57	25.17	686
All associations	10.16	27.04	24.94	2,164

AMERICAN TELEPHONE & TELEGRAPH CO.,
New York, N.Y., June 7, 1974.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing with reference to the announcement that your Committee will hold hearings on certain pending tax increase recommendations that have been proposed as amendments to H.R. 8217.

The Bell System views with particular concern proposals to eliminate rapid depreciation of machinery and equipment permitted under the Asset Depreciation Range (ADR) System and to phase out the Investment Tax Credit. We strongly urge that such proposals not be adopted by your Committee.

Provisions such as ADR and the investment credit, as clearly indicated in their legislative history, were intended to induce investment in American industry. Such provisions are as necessary today as when they were enacted, because an increase in industrial capacity is needed if there is to be further growth in both jobs and real output—especially if that growth is to be obtained without inflation. The ADR and investment credit provisions both provide important incentives for that expansion and are an important means by which industry accomplishes it. To eliminate or reduce them would impose enormous additional demands for capital on the Nation's money markets, with accompanying upward pressure on interest rates. For all of these reasons, the ADR and investment credit provisions should be retained in the law. They are needed in all sectors of industry, regulated as well as unregulated.

Regarding your questions about incidence of the tax increase proposals you are considering, we believe that the greater part of the increased tax burden ultimately would fall on consumers through the price mechanism. Under present circumstances, however, the process throughout which those tax changes would affect the economy is far more important. This is because repeal of ADR and the investment credit provisions would remove a stimulus for increasing industrial capacity, but would do nothing to restrain consumption, whereas controlling inflation requires just the reverse.

Respectfully yours,

R. N. FLINT.

[Telegram]

Senator RUSSELL LONG,
Chairman, Senate Committee on Finance:

The Associated General Contractors of America calls to the attention of the Committee on Finance the fact that construction, the nation's largest industry, is already caught in a squeeze between rapidly advancing wage settlements and material prices on the one hand and long-term contract commitments at fixed prices on the other. Shortage of mortgage money and interim financing has hurt all types of construction. Enactment of the tax increase measures now proposed as amendments to HR 8217 would be disastrous to this industry.

With 1974 wage settlements running at more than an eight percent increase over the 1973 settlements, and with material prices increasing even faster, general contractors would be unable to meet large tax increases. Since profits on contract construction have been averaging less than two percent before taxes, any substantial tax increase would have an effect which is far more onerous than in other higher profit industries.

The construction industry is characterized by small business firms, closely held and thinly capitalized. While the capital requirements of contractors are rising to cover the higher costs of doing business, elimination of the Asset Depreciation Range system and phase-out of the seven percent investment order would seriously impair their working capital and production capacity. Repeal of the percentage depletion allowance for oil and gas would discourage the construction of facilities necessary to alleviate severe oil and gas shortages. Limitation of the use of the foreign tax credit would be adverse to American business abroad and to our country's achieving a favorable balance of trade.

Enactment of these tax proposals would contribute to numerous business failures and widespread unemployment in the construction industry. The Associated General Contractors of America strongly oppose these tax increase measures as contrary to the public interest.

JAMES M. SPROUSE,
Executive Director.

STATE OF LOUISIANA,
DEPARTMENT OF REVENUE,
Baton Rouge, May 30, 1974.

Hon. RUSSELL B. LONG,
U.S. Senate,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The State of Louisiana is opposed in principle to H.R. 14462, the Oil and Gas Energy Act of 1974. If, however, the approach of H.R. 14462 is followed, we have prepared and enclose two proposed amendments which would greatly alleviate the impact of the windfall profits tax on Louisiana production of crude oil.

As you know, effective January 1, 1974, the State of Louisiana changed the method of computing its severance tax on oil from a flat charge per barrel, based on the gravity of the oil removed, to a tax equal to 12½ per cent of the value of the oil removed. Because of higher oil prices, the effect of this change has been to substantially increase the severance tax paid by Louisiana producers.

As currently drafted, the amount of windfall profits subject to tax by H.R. 14462 is geared to the Costof Living Council ceiling price as of December 1, 1973, or the base price as it is called in H.R. 14462. Such date does not reflect the $1.00 per barrel increase which COLC approved on December 19, 1973, nor does it include increased State severance taxes enacted December 4, 1973, made effective January 1, 1974. Thus, the impact of the December 1, 1973 date is particularly onerous on Louisiana producers since they could be forced to pay a windfall profits tax on the amount of Louisiana severance tax paid—hardly a fair result.

Proposal No. 1 would re-define the removal price to take into account State severance taxes paid at the time the oil is removed from the ground. This approach would at least relieve Louisiana producers from the prospect of paying a windfall profits tax on State severance taxes paid.

Proposal No. 2, while not curing the problem of a tax on a tax, would certainly soften the impact of the change in Louisiana severance tax. The 1.00 per barrel increase allowed by COLC on December 19, 1973 would, in most instances, cover the increase in Louisiana severance tax.

Both proposals would have the support of Louisiana producers, although their problems with H.R. 14462 are clearly more broad based.

If you would like additional information or supporting memorandum on our proposals, we would be most happy to supply it.

Sincerely,

JOSEPH N. TRAIGLE,
Collector of Revenue.

Enclosure.

PROPOSAL #1

AMENDMENT TO H.R. 14462

On Page 8, line 25, strike the period and insert the following: "reduced by any state taxes on crude oil producers for removal of oil in force prior to the date of enactment of this Act."

PROPOSAL #2

AMENDMENT TO H.R. 14462

On Page 10, lines 1 through 6 are deleted and the following is inserted in lieu thereof:

"(c) BASE PRICE.—For purposes of this chapter, the term base price means the ceiling price determined in the manner provided in regulations section 150,353 prescribed by the Cost of Living Council as such regulations were in effect on January 1, 1974, for domestic crude oil of the same grade and location."

STATEMENT OF THE NATIONAL REALTY COMMITTEE, INC., WITH RESPECT TO THE MINIMUM TAX

The recent proposed Senate rider to H.R. 8217, cosponsored by Senators Kennedy, Mondale, Bayh, Clark, Hartke, Humphrey and Muskie, would among other things, drastically change the Minimum Tax on Tax Preferences, by: (1) eliminating the existing deduction for regular federal income taxes paid and (ii) reducing the current $30,000 exemption. It would also impose this tax at graduated rates.

The National Realty Committee respectfully but strongly opposes any changes in the Minimum Tax on Tax Preferences, such as those presently proposed, which would have the effect of increasing long-term capital gains tax rates and which would further exacerbate existing inequities in the Minimum Tax.

The existing deduction for regular federal taxes paid, as intended, makes the Minimum Tax a "back-up" or *alternative* tax, imposed on an individual who would otherwise pay little or no regular federal income taxes by reason of his ability to claim the benefit of an inordinate aggregate amount of "tax preference items".[1] Elimination of this deduction would completely transform the Minimum Tax, and make it an *additional* direct (excise) tax on all "tax preference items", regardless of the amount of regular income taxes which the individual had already paid.[2]

The arguments in favor of this elimination completely disregard or misunderstand the purpose of the Minimum Tax. It is asserted, with little regard for economic realities, that the actual payment of substantial federal income taxes by an individual, in full compliance with our system of taxation, is a tax avoidance device used to "shelter" that individual from the Minimum Tax on Tax Preferences. The Minimum Tax was intended to apply *only* when the regular tax system failed to perform its assigned task; neither the 1968 Treasury Staff proposals for a minimum tax, nor the Treasury's proposals in 1969 for a Limit on Tax Preferences, nor the current minimum tax law, would apply when the taxpayer had a relatively small proportion of "tax preferences" in relation to his total income.[3]

Since the largest impact of the Minimum Tax is on long-term capital gains,[4] the basic effect of this proposal would be a dramatic increase in the effective rate of tax imposed on such gains.[5]

A substantial increase in the effective rate of capital gains tax involves serious questions of social and economic policy.[6] These should be the subject of separate study and debate, independent of many of the considerations involved with respect to the application of a Minimum Tax on tax preference items generally. Piecemeal action by the Senate with respect to capital gains rates, independent of the comprehensive tax reform effort now under way in the House of Representatives, would be premature, without consideration of many of the important issues involved, and perhaps detrimental to the overall effort for comprehensive reform.

The current minimum tax, and the proposal before the Senate, both intentionally ignore the fact that, except for capital gains, virtually all of the items designated as "tax preferences" are not items of income, but are only current deductions, and, as such, are not a means of tax avoidance, but create at most a tax deferral.[7] In 1969, Congress decided to treat all items of tax preference in effect as if they were items of income, for the sake of simplicity. At that time, the Senate Finance Committee noted that:

"Certain items subject to the 5-percent minimum tax, such as accelerated depreciation, involve tax deferral and not permanent escape from taxation. The committee is aware that in these instances some case could be made for providing adjustments to basis to avoid double taxation. For example, the fact that accelerated depreciation in excess of straight-line depreciation is subject to a 5-percent minimum tax might be advanced as grounds for some increase in the basis of the property involved. However, the committee concluded that as a practical matter, it would be best not to provide for basis adjustments under a 5-percent tax since such adjustments would complicate the minimum tax."[8]

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[1] Remarks of then Assistant Secretary of the Treasury for Tax Policy Edwin S. Cohen, April 29, 1972, before Federal Tax Institute of New England, Boston, Massachusetts, reprinted in 85 BNA Daily Executive Report J-1 (May 1, 1972) (hereinafter, "Asst. Sec. Cohen—Boston Remarks"); Remarks of then Under-Secretary of the Treasury Edwin S. Cohen, November 29, 1972, before Tax Forum, U.S. Chamber of Commerce, Washington, D.C., reprinted in 289 BNA Daily Executive Report J-1 (December 11, 1972) (hereinafter, "Under-Sec. Cohen—Washington Remarks"); Stanley S. Surrey (Assistant Secretary of the Treasury for Tax Policy from 1961–69), *Pathways To Tax Reform* (Harvard University Press, 1973) (hereinafter, "Surrey, *Tax Reform*") at 275–6.

[2] Surrey, *Tax Reform* 275; Under-Sec. Cohen—Washington Remarks. See also, Asst. Sec. Cohen—Boston Remarks.

[3] Asst. Sec. Cohen—Boston Remarks; Surrey, *Tax Reform* 275.

[4] Under-Sec. Cohen—Washington Remarks.

[5] *Ibid.*

[6] Asst. Sec. Cohen—Boston Remarks.

[7] Surrey, *Tax Reform* 277–78.

[8] Senate Committee on Finance, Tax Reform Act of 1969 [H.R. 13270] S. Rep. No. 552, 91st Cong., 1st Sess. 117 (1969).

If the Minimum Tax were to be increased and expanded as now suggested, however, equity would mandate enactment of such corrective provisions.[9]

The Minimum Tax presently fails to take into account the *added* normal tax paid under present law by an individual possessing "items of tax preference" by reason of the reduction of the amount of his income eligible for the "maximum tax on earned income" due to the presence of such items.[10] The proposal intensifies the effects of this failure.

The proposal assumes that all items designated as "tax preferences" are "loopholes". It ignores the fact that each of these "preferences" was enacted by Congress in order to achieve certain specific goals;[11] imposition of the proposed penalty tax on the utilization of these items would either curtail or eliminate their use.[12] It is respectfully suggested that, to the extent that any tax preference item is no longer justifiable, the better approach would be to curtail or eliminate it directly, after due deliberation, rather than to permit its use subject to imposition of an excise tax.[13] Direct amendment of the provisions creating the various tax preference items constitutes a much simpler, more equitable, and more intelligent method of reflecting a change in congressional purpose, and avoids the complexity and increased administrative burden which would result from application of a more complicated Minimum Tax to a substantially increased number of tax returns.[14]

The National Realty Committee therefore strongly urges that any amendment to the Minimum Tax by the Senate be postponed until the current sessions in the House Ways and Means Committee have been completed, and that any such amendments be correlated and made consistent with the resulting future pattern of the tax law in general, and the method of taxing long-term capital gains, in particular.

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[9] Surrey, *Tax Reform* 278, 406 n. 72.
[10] Surrey, *Tax Reform* 405 n. 68.
[11] Under-Sec. Cohen—Washington Remarks. See also, Asst. Sec. Cohen—Boston Remarks.
[12] *Id.*
[13] *Id.*
[14] *Id.* Any proposal which would so broaden the applicability of the Minimum Tax would impose a substantially greater compliance burden on approximately 100,000 additional taxpayers. Under-Secretary Cohen—Washington Remarks.

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