TAX REFORM ACT OF 1975

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

H.R. 10612

AN ACT TO REFORM THE TAX LAWS OF THE UNITED STATES

MARCH 17, 18, 19, 22, 23, 24, 25, 26, 29, 30, 31, APRIL 1, 2, 5, 6, 7, 8, 9, and 13, 1976

PART 1

(MARCH 17, 18, 19, AND 22, 1976)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

69-460 WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $4.15

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM D. HATHAWAY, Maine
FLOYD K. HASKELL, Colorado

CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
BILL BROCK, Tennessee

MICHAEL STERN, *Staff Director*
DONALD V. MOOREHEAD, *Chief Minority Counsel*

CONTENTS

(Part 1)

ADMINISTRATION WITNESSES

PUBLIC WITNESSES

ADDITIONAL INFORMATION

Opening Statements of Members of Committee on Finance

Tables and Charts

Material Submitted for the Record

COMMUNICATIONS

TAX REFORM ACT OF 1976

WEDNESDAY, MARCH 17, 1976

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

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

Present: Senators Long, Talmadge, Ribicoff, Byrd, Jr., of Virginia, Nelson, Gravel, Bentsen, Curtis, Fannin, Hansen, and Dole.

OPENING STATEMENT OF THE CHAIRMAN

The CHAIRMAN. We begin the hearings today on the tax revision proposals and on the extension of the expiring tax cut provisions. These provisions have been incorporated in H.R. 10612.

The Finance Committee will be considering these provisions, and we will be trying to see the ways in which we think we can improve on the House suggestions.

[The committee press release announcing these hearings follows:]

[Press Release—February 5, 1976]

FINANCE COMMITTEE SCHEDULES HEARINGS ON TAX REVISION, EXTENSION OF EXPIRING TAX CUT PROVISIONS

The Honorable Russell B. Long (D., La.), Chairman of the Senate Committee on Finance announced today that the Committee would begin hearings in March on major tax revision proposals and extension of expiring tax cut provisions. The hearings will begin on Wednesday, March 17 at 10:00 A.M. in Room 2221, Dirksen Senate Office Building. The Honorable William E. Simon, Secretary of the Treasury, will be the lead-off witness on March 17 and will present the Administration's views on these subjects.

Senator Long noted that the following matters will be considered during the hearings:

1. *Extension of expiring provisions.*—The provision enacted in December, 1975 increasing the standard deduction, providing a tax credit for each taxpayer and dependent, providing an earned income credit, and reducing the corporate income tax rate on the first $50,000 of taxable income are scheduled to expire at the end of June, 1976. The temporary increase in investment tax credit enacted in March, 1975 is scheduled to expire at the end of December, 1976.

2. *House-passed tax revision proposals.*—H.R. 10612, currently pending in the Committee on Finance, contains numerous proposed changes in the income tax law.

3. *Other tax revision proposals.*—The hearings will also deal with other tax revision proposals which have not been included in H.R. 10612.

Energy tax matters.—The Chairman noted that the Finance Committee had already held hearings on energy tax proposals, including those contained in

H.R. 6860, pending in the Committee on Finance. Since those hearings, a bill has been enacted fixing the price of oil and action is expected on legislation relating to the deregulation of the price of interstate natural gas. In the light of changed circumstances, Senator Long invited persons interested in energy tax proposals to submit their views in writing for inclusion in the record of the upcoming hearings so that the Committee may have the benefit of these views when it continues its deliberations on energy tax matters. In particular, the Chairman expressed the hope that persons who have already testified in 1975 on energy tax matters will submit any modifications in their views for the record.

Requests to Testify.—The Chairman advised that witnesses desiring to testify during this hearing must submit their requests in writing to Michael Stern, Staff Director, Committee on Finance, 2227 Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, March 1, 1976. Witnesses will be notified as soon as possible after this cutoff date as to when they are scheduled to appear. Once the witness has been advised of the date of his appearance, it will not be possible for this date to be changed. If for some reason the witness is unable to appear on the date scheduled, he may file a written statement for the record of the hearing in lieu of a personal appearance. The hearings will be held in Room 2221, Dirksen Senate Office Building and will begin at 10:00 A.M. on each day.

Consolidated Testimony.—Senator Long also stated that the Committee urges all witnesses who have a common position or with the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views than it might otherwise obtain. The Chairman urged very strongly that all witnesses exert a maximum effort, taking into account the limited advance notice, to consolidate and coordinate their statements.

Legislative Reorganization Act.—Senator Long stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—The Chairman stated that the Committee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by Friday, April 23, 1976, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

The CHAIRMAN. Our leadoff witness at these hearings will be the Honorable William E. Simon, Secretary of the Treasury.

Senator CURTIS. To save the Secretary's time I will just hand my opening statement in for the record.

The CHAIRMAN. Thank you. Any further opening statements?

Senator FANNIN. I will have a statement. In deference to the Secretary's time, I will wait for his finishing before I make a statement.

The CHAIRMAN. Thank you very much.

[The statements of Senators Curtis, Fannin, Hansen, and Dole follow:]

Opening Statement of Senator Curtis

Mr. Chairman, as we commence these hearings on general tax revision, I welcome Secretary Simon before the Committee and look forward to his testimony on this important subject.

I would also like to make one brief observation that I hope will guide us through these hearings and later as we write our tax bill. Too often the debate on important issues of public policy—including taxes—generates much emotion and little analysis. Both our tax code and our economy are complex. Actions we take with respect to taxes often have a significant impact on inflation, employment, investment, and our economy in general. For this reason, we must ascertain all of the facts about the potential effects of proposed changes in the tax code and we must do so before we act. What is required is careful and reasoned analysis. Absent that, any tax bill will constitute "reform" in name only. I look forward to working with our chairman and my colleagues on the Committee in developing legislation that will in fact produce improvements, and not merely changes, in our tax code.

Opening Statement of Senator Paul Fannin

Mr. Chairman: The Finance Committee today begins 3½ weeks of hearings on H.R. 10612, the so-called Tax Reform Act of 1975 which was passed by the House on December 5 of last year. I agree with the Chairman that his legislation should be referred to as "tax revision" rather than "tax reform". In addition, the Committee has invited interested individuals to submit written testimony on energy related tax proposals, many of which have been considered previously by the Committee during its markup of H.R. 6860, the Energy Conservation and Conversion Act.

I commend the distinguished Chairman for scheduling these extensive hearings on the issues before us and for his decision to add an energy title to the bill which the Committee will report to the Senate Floor. As the Chairman and my colleagues know, I have devoted a majority of my efforts in recent years to the areas of energy legislation. Effective utilization of the nation's tax laws in the energy area is an additional tool in our movement towards energy independence.

My efforts during deliberation of the bill before us will include offering tax proposals which encourage the development and utilization of new sources of energy, in particular, solar and geothermal. Such efforts must be taken if we are to nurture the forward movement of these infant industries.

The scope of H.R. 10612 is enormous. Its 661 pages deal with several issues which clearly hold themselves out for much-needed revision. Present Internal Revenue Code provisions relating to individual taxpayer items such as child care deductions and retirement income credit are in need of careful examination and revision.

The Subcommittee on Administration of the Internal Revenue Code has held extensive hearings on the need for reform in simplifying the income tax return and to reform the administrative procedures of the Internal Revenue Service. The fact that large numbers of taxpayers are required to hire lawyers and accountants to prepare their tax returns is evidence of the need for simplification. Since such action would have little revenue effect, we should make efforts to move toward greater simplification.

Congress must provide changes in the Federal estate tax laws to make it easier for small farmers and small businessmen to bequeath their assets to future generations. We must assure that family businesses and family farms can be handed down from generation to generation without having to be sold to pay taxes. Such proposals which would permit the heirs of small estates to defer their initial estate tax payment for a longer period of time will be of great benefit in the small family businesses which traditionally have been essential to the spiritual as well as the economic wealth of our country.

A responsibility of Congress is to see that each taxpayer contributes financially to the operation of government.

Despite efforts in the 1969 Tax Reform Act to assure that all individuals share these burdens by imposing minimum tax provisions, complete success in this area has not been achieved. The Committee may find that further measures in the area of tax avoidance may be necessary. However, it is clear to me that the provisions in the House-passed bill in this area go beyond actual abuses. Enactment of the LAL provisions presently in H.R. 10612 would deal a devastating blow to the commercial real estate industry, farming, oil and gas production, motion picture production and other selected areas of the economy.

There is no need to isolate specific areas of investment for discriminatory tax treatment when less complicated and, yet, effective steps could be taken to discourage abuse of the tax laws. I look forward to working closely with the Chairman and my colleagues on the Committee to develop an alternative approach in this area of legislative concern.

Mr. Chairman, many of our colleagues, both in the House and in the Senate, have spoken out in favor of enacting tax measures which would expand the availability of capital to the nation's private sector. I am convinced that the Finance Committee must amend H.R. 10612 to include capital formation measures. Study after study has pointed to the nation's unprecedented need for new investment capability. In response to this need, I introduced S. 2909, the Investment Incentives Act, which is designed to encourage savings and investment throughout our economy by means of several tax mechanisms. Enactment of the provisions of S. 2909, or similar measures, would provide the private sector of our nation with the ability to meet our future economic and social needs.

Eighty-five per cent of employed Americans work in the private sector with the remaining fifteen per cent in government service. Our continuing unemployment problems will never be met by enacting inefficient and costly government jobs programs. The only permanent solution to our expanding employment needs is to strengthen the private sector so that it can provide new job opportunities, as well as increase productivity, improve our environment and working conditions and achieve energy independence.

All industries have been damaged by the lack of adequate investment capital. The utilities industry has been particularly hard hit by federal tax laws which provided only a four per cent investment tax credit for utilities in recent years when all others qualified for seven per cent. The Tax Reduction Act brought equity to the utilities by enacting a two-year ten per cent investment tax credit for all businesses. More must be done for the utilities which have had massive employee layoffs and cuts in planned capital improvement and expansion.

Legislation in this area cannot wait for future Congresses to act. Again, I commend the distinguished Chairman for scheduling four days of hearings on the issue of capital formation. These hearings should provide the Committee with a solid record from which to work when markup of the bill begins.

There is a myth which has been allowed to engulf our thinking here in Congress that U.S.-based multinational corporations are damaging the domestic economy by exporting jobs to foreign locations where they establish manufacturing operations and by exporting capital which could have a better domestic impact if invested in the United States. Nothing could be further from the truth.

I believe that the overseas operations of U.S. companies have significantly benefited the domestic economy by creating and maintaining U.S. jobs and by providing sources of capital which otherwise would not exist. The imposition of punitive taxation on such operations would be counterproductive to our own domestic economy and should be avoided. At a time when unemployment is at such high levels, it would be inappropriate for us to tax a segment of our business community which might be forced to close its foreign operation because of failure to compete with foreign companies and thereby force the unemployment of substantial numbers of backup personnel who would not otherwise need to be employed.

Most of the industrialized nations have long recognized the potential problem of double taxation of foreign income and either have instituted a foreign tax credit to solve it or have exempted all foreign source income from domestic taxation.

Until recently, the foreign tax credit was a totally neutral provision of the Internal Revenue Code which was available to all U.S. citizens and domestic corporations for income taxes paid to any foreign country with regard to any foreign source income. Recent changes as a result of the Tax Reduction Act of 1975 have fragmented foreign source income into different types for purposes of applying different limitations on the amounts and the uses of the credit with respect to oil-related income from foreign sources. Further fragmentation may well destroy the integrity of the credit, complicate the Code and damage the competitive ability of companies in foreign markets so that careful analysis should be made before any further changes are made in this area.

The creation of a Domestic International Sales Corporation (DISC), in 1971 was welcomed by the business community as a belated recognition by the Federal government of the vast array of direct subsidies, quotas, and other devices used by foreign governments to restrict imports. Since 1971, U.S. exports have increased tremendously. While some of this impact can be attributed to dollar devaluations, much of it is due to the DISC program which has provided thousands of American companies with enough additional cash flow incentive to finance the creation or expansion of foreign markets. For many companies which did not have any export business, DISC has opened altogether new doors. This is particularly true of small businesses which previously did not seriously investigate export business. DISC has stimulated employment and economic activity both by exporters and by their supply and support industries.

It is difficult to assess the chilling effect that any curtailment of the DISC program would have, but it surely would reduce the ability of many companies to continue their expansion of export markets. I urge that no change be made to further restrict the application of DISC until we have had time to thoroughly evaluate its effect on these businesses abroad.

I am especially concerned with the provision of H.R. 10612 which proposed to repeal Section 911 of the Code. As you know, that Section permits the annual exclusion of up to $25,000 of income earned for services performed while living and residing abroad. My constituent mail has been heavy urging opposition to the repeal of Section 911. The incentive of Section 911 is still needed to persuade U.S. citizens to work abroad. In developed countries, living expenses are very high, and the living conditions often are very difficult. U.S. companies must often provide either by allowance or directly, for the municipal-type services of education, transportation, health, and public safety.

The repeal of Section 911 would only add to the cost of present allowances by forcing employers to increase wages to cover the taxes. I oppose such a repeal since this increased cost would damage the competitive position of U.S. businesses vis-a-vis foreign competitors, whose own countries generally do not tax income earned abroad.

Mr. Chairman, an immediate responsibility of this Committee is to make a recommendation to the Full Senate with respect to the extension of the existing tax cuts. It is, therefore, an appropriate time to remind this Committee of its commitment to reduce Federal spending. As you are well aware inflation is the most potentially destructive, the most dangerous problem we face. If we are to provide further tax cuts, we must provide for a dollar for dollar reduction in the level of spending.

We owe those on fixed incomes, the elderly, the retired, that they not face a ruinous future. We owe the coming generation that they receive from our hands a country of promise and expanded possibilities, not a land in which all solid values have melted away in the fires of inflation.

Opening Statement of Senator Hansen

Mr. Chairman, I want to thank you for holding these hearings to enable the Finance Committee to gain a perspective on H.R. 10612, the House passed tax revision bill. I am also grateful that our hearings will include individuals and groups who advocate provisions not included in the House bill.

Hopefully, upon the completion of the next 3½ weeks of hearings we will be in a position to exercise an informed judgment on the provisions of the House bill and the subject of tax reform.

Mr. Chairman, while I recognize that the House, particularly the House Ways and Means Committee, spent a considerable amount of time drafting the 661 page Act they sent us, quite frankly I find there are various provisions in the House passed bill which I believe do not promote a proper tax policy and are not in the best interest of the nation. Additionally, I believe that certain much needed tax reforms are not included in the House passed bill.

Mr. Chairman, before I address what I believe should be some of the priorities of tax reform, allow me first to address several mythical concepts which often not only inhibit meaningful tax reform but if believed, tend further to bias our tax system. These myths were recently addressed during hearings before the Financial Market Subcommittee of this Committee by former Deputy Treasury Secretary, Charls E. Walker.

The first myth is that wealthy taxpayers escape income taxes while middle and lower class individuals get stuck. The fact is that Federal income tax rates are progressive; the more money you make the higher your tax burden. Effective Federal income tax rates range from zero for non-taxpayers to 10% in the lowest bracket up to 33% to 40% in the top brackets. I believe that most taxpayers agree that this progressive rate is fair and fundamentally sound.

While there are instances where an individual may escape or pay a disproportionately low tax rate. Treasury figures indicate that such instances are extremely rare, and then often represent only a particular year when the individual experienced large economic losses.

I do believe the Committee should consider those instances where an individual abuses the tax system to escape paying tax. However, I have reservations about the approach taken by the House on this subject.

The second myth of taxation is that corporations can be taxed without hurting individual taxpayers. The fact is that individuals pay taxes not corporations. Corporations are merely legal arrangements for doing business and the taxes levied on them are either passed forward to customers or backwards to owners. If the taxes are passed forward, the cost-of-living for everyone increases. If the taxes are passed backward, profits and the attractiveness of that business fall. Falling profits will eventually force the corporation out of business or greatly impede the expansion and growth of the enterprise. Either consequence is crucial to jobs, growth and inflation control.

The third myth is that there are millions of "tax loopholes." The fact is that the great majority of these so called tax loopholes go to the "typical taxpayer."—Especially such things as the deductibility of interest on mortgages, state and local property and income taxes, charitable contributions and employer contributions to employee pension plans. Of the $90 plus billion in so-called tax preferences more than $70 billion accrue to individuals, not corporations, and largely to low and middle income taxpayers at that.

Mr. Chairman, I am hopeful the Finance Committee will not be moved by these myths that have so often prefaced any discussion of tax reform. With the recognition that these often discussed topics are myths, I am confident the Committee will be in a position to exercise an informed judgment and recommend a tax package that will truly deserve to be considered reform.

With a recognition of these myths in mind allow me to turn to a provision in the House bill that, I believe, represents major over reaction to a minor problem.

The House passed bill would introduce to our tax code a concept call Limitation on Artificial Losses (LAL). This provision would prohibit the use of losses, from certain specified investments to be used to offset income derived from other sources. The purpose of this provision is to prevent the use of so called "artificial" deductions to shelter other unrelated income from tax. While I think we can all agree that we want to prohibit the misuse of our tax laws, I do not believe that the LAL provision included in the House bill provides the best way to deal with this problem.

The LAL provisions add 33 pages to the tax code, a document already greatly overburdened. More importantly, LAL is at odds with the expressed goal of tax simplicity, LAL adds unprecedented complexities to our tax laws. Clearly, only the accountants and lawyers will gain by the enactment of LAL.

Mr. Chairman, I look forward to working with you and the other Members of this Committee in an effort to develop an alternative to this concept.

Mr. Chairman, next allow me to turn briefly to a topic not addressed by the House passed bill.

The tax proposals relating to gift and estate taxation have remained basically unchanged since 1932; the exemptions were last changed in 1942. Current law provides for an estate tax exemption of $60,000. However, since 1942 inflation has substantially reduced the value of the $60,000 exemption. In fact, Treasury figures indicate it would require an exemption of $210,000 to equal the current buying power of $60,000 in 1942.

The situation has become so severe that the heirs of an individual who died owning a small business or farm are often forced to sell the business or farm merely to pay the estate taxes. To remedy this problem and assure that all individuals can provide for their heirs, I strongly believe that this Committee should include in any general tax bill a provision for estate tax reform.

I recognize that there are many estate tax proposals pending before this Committee, and most, if not all, the members of this Committee, myself included, are sponsoring or co-sponsoring estate tax proposals.

The proposal I believe deserves close Committee consideration would raise the present estate tax exemptions from $60,000 to $20,000, raise the marital deduction from 50% of the gross estate to $100,000 plus 50% of the gross estate, and value farmland and open space, for estate tax purposes at its current use or production value rather than its higher market value. These provisions would provide much needed relief to millions of individuals engaged in small business, farming and ranching, and assist all Americans to pass a fair and equitable amount to their heirs and loved ones.

Mr. Chairman, the second major concept I believe should be included in any tax reform package is capital formation.

For a number of years this nation has pursued a tax policy that emphasizes excessive consumption at the expense of encouraging savings and investments. This emphasis on consumption has created the Nation's current high inflation and unemployment. Any new tax policy must shift the tilt away from exclusively stimulating consumption toward furthering the saving and investments required to meet the Nation's capital requirements.

The close relationship between capital investment and economic growth and productivity is well known and documented. Since 1960, the United States has had the lowest level of capital investment among the major countries of the world.

Significantly, among these major industrialized nations, only the United Kingdom has shown a rate of productivity growth slower than that of the United States. The rate of growth in Japan is triple that of the U.S., the rates in Germany, France and Canada are substantially higher than ours. All of these Nations give more favorable tax treatment to capital investment than do we.

During the decade of the 1960's, the United States tied for seventeenth position in a list of 20 industrial Nations belonging to the Organization for Economic Cooperation and Development (OECD) as to the average annual growth rate of real output. (see table 1). Additionally, total U.S. fixed investment as a percent of national output during the period 1960–1973 was 17.5%; this figure ranks last among a group of eleven major industrial nations. (see table 2) Moreover, the United States ranks last in a list of seven major industrial nations as to the average annual rate of growth of manufacturing output per manhour and gains in gross domestic product per employed person from 1960–1973. (see table 3)

It is important to note the goal of our tax policy must be not only to correct the capital imbalance of the past decade but to meet the extensive capital requirements of the next ten years.

Recent studies indicated that the United States will require an incredible $4.5 trillion in new capital funds during the next 10 years. This is three times the $1.5 trillion of the past decade. The Bureau of Economic Analysis of the Department of Commerce has concluded that private fixed investment must increase from the 10.4% of gross national product that characterized the 1965–1974 period to 12% of GNP between now and 1980, if we are to have the capital necessary to promote full employment, control pollution, and maximize development of our domestic energy resources. If full employment, pollution control, and maximum use of our energy resources are the goals of the American people, as I believe they are, Congress must develop a tax policy to achieve there objectives.

The most promising and feasible means of promoting this goal is to shift the tilt in the tax system away from excessively stimulating consumption toward fostering savings and investment.

If the Congress does not enact tax provisions to encourage greater savings and investment, the nation will be unable to amass the $4.5 trillion necessary to realize our economic goals for the next decade. The consequence of inaction will be greater unemployment, higher inflation and general economic instability.

Mr. Chairman there are a number of capital formulation proposals pending before this Committee, some of which I am cosponsoring. I am hopeful these hearings will produce other proposals, refinements of existing proposals, and greater insights into this entire area. With this background the Committee will be in a position to formulate the tax program the nation needs and the people deserve.

TABLE 1.—*Average annual rate of change in real growth for member nations of OECD, 1960–70*

	(Percent)
Japan	11.1
Greece	7.6
Portugal	6.3
Yugoslavia	6.7
France	5.8
Italy	5.6
Canada	5.2
Finland	5.2
Australia	5.1
Netherlands	5.1
Norway	5.0
Belgium	4.9
Denmark	4.9
West Germany	4.8
Austria	4.8
Iceland	4.3
Ireland	4.0
United States	4.0
Luxembourg	3.3
United Kingdom	2.8

Source: Organization for Economic Development and Cooperation.

TABLE 2.—INVESTMENT AS PERCENT OF REAL NATIONAL OUTPUT 1960–73[1]

	Total fixed[2]	Nonresidential fixed
Japan	35.0	29.0
West Germany	25.8	20.0
France	24.5	18.2
Canada	21.8	17.4
Italy	20.5	14.4
United Kingdom	18.5	15.2
United States	17.5	13.6
11 OECD countries	24.7	19.4

[1] OECD concepts of investment and national product. The OECD concept includes nondefense government outlays for machinery and equipment in the private investment total which required special adjustment in the U.S. national accounts for comparability. National output is defined in this study as "gross domestic product," rather than the more familiar measure of gross national product, to conform with OECD definitions.

[2] Including residential.

Source: U.S. Department of the Treasury.

TABLE 3.—PRODUCTIVITY GROWTH, 1960-73

[Average annual rate]

	Gross domestic product per employed person	Manufacturing output man-hour
United States	2.1	3.3
Japan	9.2	10.5
West Germany	5.4	5.8
France	5.2	6.0
Canada	2.4	4.3
Italy	5.7	6.4
United Kingdom	2.8	4.0
11 OECD nations	[1] 5.2	6.1

[1] Average for 6 OECD countries listed.

Source: Department of the Treasury.

OPENING STATEMENT OF SENATOR BOB DOLE

Mr. Chairman, the month-long series of hearings we are commencing today is of major importance to every American taxpayer. In 1976, we have the opportunity to formulate meaningful tax revisions which will improve the Internal Revenue Code and lessen the public perception that the tax system is prejudiced against middle-income Americans.

As always, it is our task to balance the competing interests by fashioning tax legislation which is equitable to all segments of the American economy—from low-income wage earners to large industrial corporations. With assistance from the administration, I am confident we can achieve this objective.

In particular, I look forward to hearing the views of many witnesses on alternatives to the "limitation on artificial losses" provisions of the House bill. While I am sympathetic to the goals which the LAL concept seeks to address, I fear that it may only serve to discourage legitimate investment in vital sectors of the economy, such as farming, ranching, and domestic oil exploration.

Also, we must seek a swift consensus on meaningful reform of the inequitable estate tax. I have introduced legislation—as has nearly every other member of the committee—to revise the antiquated exemption level in the estate tax in order to preserve small farms and businesses in America. While the estate tax problem is not addressed in the House bill, I believe we should not hesitate to include estate tax relief in our tax revision package.

We must also restore the public's confidence in the basic integrity of the Internal Revenue Service. In this connection, I have introduced tax return confidentiality legislation which will ensure the basic privacy of every American's income tax return. Hopefully, tax return privacy provisions can be incorporated in this tax revision bill.

I look forward to hearing the views of Secretary Simon on these important matters, and I look forward to working with my colleagues on the committee in the important task we are undertaking today.

The CHAIRMAN. Mr. Secretary, we are happy to welcome you this morning.

You may proceed in any way you desire.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY, ACCOMPANIED BY CHARLES M. WALKER, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY; WILLIAM M. GOLDSTEIN, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY; VICTOR ZONANA, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY; AND HARVEY GALPER, ASSOCIATE DIRECTOR, OFFICE OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY

Secretary SIMON. Thank you, Mr. Chairman.

I am pleased to be here this morning as you begin your deliberations on major tax revisions and the extension of expiring tax cut provisions. You have before you an extremely challenging agenda.

This morning I will discuss H.R. 10612—the House-passed tax reform bill. While many of the provisions of H.R. 10612 incorporate proposals initiated by the Administration in 1973, more work remains to be done.

I probably have the lengthiest testimony that I have ever prepared, and I would just like to highlight and summarize some of the more important aspects. I will not deal with many of the technical changes. I will discuss the present proposals to cut individual and business taxes and to reduce the rate of growth in Federal spending.

I will also present proposals to encourage capital formation. These proposals include integration of the corporate and personal income taxes, a job creation incentive proposal, the six-point utilities tax program, a proposal to reduce the tax on capital gains, which also alleviates the burden of taxation on inflationary gains, by the mechanism of a sliding scale, and a proposal to eliminate the withholding system on foreign investments. In addition, I will discuss general and specific estate tax revisions, as well as the relationship of the administration's energy policy and tax policy.

OVERALL OBJECTIVES OF THE ADMINISTRATION'S TAX POLICY

The overall objectives of the administration's tax policy are very simple and fundamental. First and foremost, our tax system must be fair. Its fairness and integrity rest upon three premises: equity, simplicity, and efficiency. A tax system not built on this foundation erodes both the confidence of taxpayers and the incentive required for economic progress and well-being.

Second, our tax policy must complement and supplement our basic economic goal of achieving a growing, vigorous, and noninflationary economy. We achieve this by removing the tax barriers which impede our growth and prevent the most efficient use of our economic resources.

Third, our tax policy must contribute to a sound energy policy. Here, again, I must emphasize that allowing market incentives to operate would be the most efficient and effective means of achieving energy independence. As long as we are unwilling to rely on the market, we should retain the tax incentives we now have in place and by no means erect further impediments by increasing the tax burden on oil and gas investments.

ADMINISTRATION PROPOSALS

The administration has already proposed the following measures: Permanent personal and business income tax reductions coupled with corresponding reductions in the size of the Federal budget; a plan to integrate corporate and personal income taxes and thereby eliminate the perverse effects of the current double tax on equity investments; a six-point utilities tax program to stimulate construction of additional facilities by electric utilities, to reduce imports of foreign oil, and to insure adequate electric generating capacity in the years ahead; a proposal to repeal the undesirable and inefficient present withholding system on portfolio dividends and interest earned by foreign investors on U.S. securities.

The administration has also taken new initiatives to maintain and improve the health and vigor of the economy. These proposals are: A job creation incentive program which provides for accelerated depreciation of new plant facilities and equipment in areas which experienced unemployment of 7 percent or more in 1975; a tax incentive to encourage broadened stock ownership by low- and middle-income working Americans by allowing deferral of taxes on certain funds invested in common stocks; estate tax relief which will alleviate the effect of inflation by increasing the estate tax exemption from $60,000 to $150,000; estate tax relief for farmers and owners of small businesses to make it easier to continue the family ownership of a small farm or business after the owner's death; a proposal to encourage capital formation and the efficient allocation of investment resources by the introduction of a sliding scale of capital gains which will, in addition, alleviate the burden of taxation on inflationary gains.

ADMINISTRATION ENERGY PROPOSALS

The administration is also committed to an energy policy that will achieve our goal of energy self-sufficiency.

In January 1975 the President proposed measures to conserve energy, increase domestic production, and provide for strategic reserves. Although the Energy Policy and Conservation Act contemplates eventual decontrol of oil prices, its immediate effect is to roll back the average price of oil. Prices of natural gas are still controlled in interstate markets. As long as we refuse to remove these Government-imposed controls and thereby prevent free market incentives from increasing domestic energy supplies, we will continue our dependence on foreign imports and our vulnerability to political blackmail. For these reasons we are opposed to the provisions of H.R. 10612 which would erect further impediments by increasing the tax burden on investments in oil and gas.

ADMINISTRATION TAX REFORM PROPOSALS

With respect to tax reform, the administration's goals are to: Improve the equity of our tax system at all income levels. This principle goes beyond the concept of vertical equity or progressivity which holds that those with higher incomes should pay a larger share. It extends to the more basic idea that the tax system of a democratic society must be fair to all taxpayers and must be widely recognized as such; simplify many of the tax provisions of the Code which seriously affect the taxpayer's ability to cope with the preparation of his income tax return; make improvements in the ways in which our tax law is administered.

In 1973 the administration made a number of tax reform proposals. In the nearly 3 years that have elapsed much has been done by the House Ways and Means Committee. H.R. 10612 incorporates to varying degrees many of our 1973 proposals. We are, therefore, renewing the following proposals:

LAL [Limitation on Artificial Losses] to deal effectively with the problems associated with tax shelters by a solution which reaches their most common features—the mismatching of income and expenses;

MTI [Minimum Taxable Income] which, in combination with LAL, deals with the problem of taxpayers with high economic income who pay little or no Federal income tax;

A simplification package designed to alleviate the intolerable reporting burden imposed upon the average taxpayer.

We also have a number of specific recommendations on various aspects of the House bill and I shall, therefore, devote a substantial portion of my time to H.R. 10612.

ADMINISTRATION'S ECONOMIC POLICIES

The administration's economic policies, as outlined by the President in his State of the Union Message, are designed to keep the economy on an upward path toward two central long-term objectives: Increasing steadily the number of real, rewarding, permanent jobs; and sustained noninflationary economic growth.

But the most immediate concern, of course, has been to support the recovery of the economy from the most severe recession in the post-World War II period in a manner which will achieve full employment as rapidly as possible without rekindling inflationary pressures and expectations. Achievement of this objective will not only provide jobs for all who wish to work but, equally important, will reestablish the basic economic conditions necessary to sustain strong and continuous real economic growth which can provide permanent employment gains and a rising standard of living for all Americans.

I am pleased to be able to report substantial progress in the recovery of the U.S. economy. We are all familiar with all the statistics coming out daily, including those that came out yesterday on unemployment in industrial production and housing, among others.

There is still an important role for the tax policy for the short term. Thus, as discussed in more detail later, the administration has proposed special temporary tax incentives to encourage construction of new facilities and purchases of equipment in areas in which unemployment exceeds 7 percent. The objective of this program is twofold. First, it will provide immediate relief to the unemployment problem of the construction industry, one of the most depressed industries in our economy. Second, the incentives will be provided in areas of high unemployment where new jobs are most needed.

Our policies for the long term must be to create an economic environment which encourages individuals to save and businesses to invest, and thereby restore the dynamism of our economy. The Administration has long and continuously emphasized the need for a higher rate of capital formation, and I shall have more to say on this topic in a moment. At this point I simply note that we cannot expect businessmen to assume the risks of business expansion unless the Federal Government does its share to provide a stable climate in which sound business decisions can be made. This means stable prices, ready access to financial markets, and the certainty that the Federal Government will not make increasing tax claims on the returns flowing from these investments.

In my written statement I go on to describe our recommendations.

DANGERS OF INADEQUATE CAPITAL SAVING AND INVESTMENT

The dangers that can arise from inadequate capital investment over a period of years are best illustrated by the 1973 production bottleneck. In that year industries that process such materials as steel, paper, fertilizers, chemicals, cement, nonferrous metals, and textiles were operating at the limits of their physical capacity. But they still were not producing enough goods and services to meet the demands of other industries.

Another consequence of inadequate saving and investment is that annual gains in productivity—that is, total output per worker—have significantly slowed during the post-World War II period, as shown in the figures in my written statement, the growth rate of productivity has ranged from 2.44 percent in 1950–54 to 1.33 percent in 1970–75.

The diminishing of U.S. productivity gains takes on added significance when compared with the experience of our major trading partners. Over the past 15 years Japan, West Germany, and other countries have all experienced more rapid rates of productivity growth than the United States; and taken together, their rate of productivity growth is more than double ours.

The rate of capital formation is a major determinant of the growth of productivity. Therefore, an increased rate of capital formation is required to maintain the competitive positioning of U.S. business in world markets.

Wage increases need not lead to higher per unit costs of production as long as output per worker, or productivity, rises sufficiently. This can happen if we provide workers with more and better equipment; that is, if we maintain high rates of capital formation.

However, as I have noted on other occasions, our investment performance has not been satisfactory. All studies on this subject conclude that if we are to realize our economic goals, we must commit an even higher portion of our income to national saving and investment. Results of these studies imply a need for an increase in the rate of private savings from 15 percent to 16 percent of GNP.

The sources of demand for capital should be carefully identified.

First: There are enormous investment demands generated just in maintaining a growing labor force properly equipped with capital.

Second: Capital is needed to achieve specific public policy objectives. In the energy field alone estimated investment needs for the next decade total $1 trillion.

Third: And most important, is the economic necessity to increase our production efficiency to raise the real standard of living enjoyed by Americans.

The tax proposals which I have already mentioned and will discuss in considerably more detail are directed towards stimulating more saving and investment to meet our long-term capital needs. Along with the reduction in the growth of Federal spending, these proposals should help tilt slightly the overall allocation of our total income in favor of investment.

CORPORATE INCOME TAX

There are a number of related problems concerning capital formation which our tax policies address.

The existing tax system—the combination of income, estate and gift and State and local property and income taxes—imposes a heavy burden on capital. Obviously if we wish to increase saving and investment, a lessening of this tax burden is the logical place to begin.

We should be concerned as well about the tax system's effect on efficient allocation of investment among competing uses. We should, therefore, work to remove those features of the tax system which cause the flow of savings to be channeled away from more productive investment and into less productive investment. The most important such distortion in the existing tax system is the two-tiered tax upon corporate income.

Inventories and depreciation are two major elements which substantially overstate profits in periods of inflation.

The overstatement and overtaxation of operating profits caused by inflation is a problem for all business which represents yet another barrier to our goal of stimulating a higher rate of capital formation. Our recommendations to reduce business taxes should be considered in this context.

One of the factors which can inhibit the future growth of needed capital formation is the financial condition of American corporations. Analysis of debt-equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade.

The implication of these fundamental shifts in the patterns of financing is that the structure of corporate balance sheets is much more brittle and less liquid than it was ten years ago. Obviously there is no single level where the corporate financial structure suddenly becomes too illiquid and inflexible, but at the same time an ever higher burden of debt commitments relative both to financial assets and to income is a matter for some concern.

Coverage ratios have dropped sharply over the past decade and operating breakeven points have risen. This makes companies less able to withstand even modest sized recessions. Accordingly, the potential for bankruptcy has greatly increased across the entire spectrum of U.S. business. This potential, in and of itself, will discourage future investment as lenders become more reluctant to make long-term commitments and companies become less willing to take on fixed payments of interest and repayment of debt obligations.

The increasing aversion to risk taking in the lending and investing process must be arrested.

INTEGRATION OF CORPORATE AND PERSONAL INCOME TAXES

Toward those ends the administration is proposing to integrate corporate and personal income taxes. This proposal would eliminate the double taxation of corporate earnings which results from first taxing corporate incomes and then taxing individuals who receive dividends. I strongly believe that this proposal—which has already been adopted in most of the other major industrialized countries—would make a significant contribution toward meeting our capital needs of the future. Moreover, it is the only major tax proposal of which I am aware that comes to grips with the growing imbalance between corporate debt and equity.

ADMINISTRATION'S ENERGY POLICY

No subject is more basic to the future of our economic prosperity than energy. Unfortunately, we have been without a comprehensive energy policy for too long.

The President is committed to ensuring an energy policy that will achieve our goals. In January 1975, he submitted a set of measures to conserve energy, increase domestic production and provide for strategic reserves. The Energy Policy and Conservation Act contains important steps in the right direction, but the penalty for ultimately ending oil decontrol is first to roll back the average oil price. This action, coupled with the action taken by Congress to effectively repeal 70 percent of the depletion allowance for oil and gas, cannot help but have a retarding effect on exploration and development.

The President is committed to bringing about decontrol as rapidly as possible, and we must make sure that the 40-month period for decontrol is not extended.

Prices of our natural gas are still prohibited from rising to their market level in interstate markets, and shortages will continually plague us unless price is allowed to rise.

As long as we refuse to remove these government-imposed controls, and thereby prevent free market incentives from increasing domestic energy supplies, we will continue our dependence on foreign imports and our vulnerability to political blackmail. For these reasons we are opposed to the provision of H.R. 10612 which would erect further impediments by increasing the tax burden on investments in oil and gas.

TAX SIMPLICITY AND FAIRNESS

The third major issue before you concerns the ways to enhance the fairness and simplicity of the tax system.

Many people today feel that taxes are being imposed upon them without their consent, that too many of their fellow taxpayers are escaping their responsibility through dozens of loopholes, and that the code itself has become a Byzantine labyrinth of legal doubletalk.

In 1973 the administration originated the LAL—limitation on artificial losses—proposal which limits the benefits of those tax incentives—often called tax shelters. We are pleased that the House bill generally follows our proposal and we continue to support the broad objectives toward which LAL is directed.

Further, to deal with the problem of high income taxpayers who do not pay their fair share of tax, the administration is renewing in modified form its 1973 MIT—minimum taxable income—proposal. MTI—minimum taxable income—is an alternative tax which will subject taxpayers to progressive income tax rates. Our MTI proposal is consistent with the objectives of equity, simplicity and efficiency which can best be served by appropriate broadening of the base for the income tax, moving toward a more inclusive concept, and ultimate leading to a lower structure of rates for all.

Having set the context for our approach to the issues before this committee, let me turn now to some of the specifics. I shall take up first the main elements of the administration's tax proposals, discuss the relationship of energy policy and tax policy, and close with a discussion of tax reform, focusing specifically on H.R. 10612.

PROPOSED DOLLAR-FOR-DOLLAR REDUCTION IN FEDERAL TAXES AND EXPENDITURES

Last October President Ford proposed that permanent large tax reductions be made possible for American taxpayers by Congress joining with him to limit the rate of growth of Federal expenditures. Specifically, the President proposed a $28 billion tax cut linked to the adoption by the Congress of a spending ceiling of $395 billion for fiscal 1977. That spending ceiling, and the budget presented to the Congress this January, represent a reduction of about $28 billion from the projected levels of spending that would have applied.

The proposed dollar-for-dollar reduction in Federal taxes and Federal expenditures has two fundamental objectives. The first is to restore fiscal discipline in the consideration of tax and expenditure measures; the second is to return more decisionmaking discretion to individuals and families to determine how they will allocate their incomes and personal resources.

Our recent fiscal history demonstrates that the failure to link tax cuts with expenditure cuts, and expenditure increases with tax increases, has resulted in substituting the capricious tax of inflation for the more equitable, but politically difficult, legislated tax increase.

Thus, a principal goal of the President's program is to restore the Federal budget to balance. Reducing the projected fiscal 1977 deficit to $43 billion will make possible a balanced budget by fiscal 1979. We are, of course, extremely pleased that your committee, in its budget recommendations for fiscal 1977, has substantially agreed with the President's target for that year's deficit.

RETURNING DECISIONMAKING DISCRETION TO INDIVIDUALS

The second objective of the President's program is to return more decisionmaking discretion to individuals and families to determine how they will allocate their incomes and personal financial resources.

The growth of Federal expenditures has brought with it increasing government dominance in basic decisions respecting the use of our Nation's resources and a corresponding diminution in the role of private decisionmaking.

Our choice then is clear. We can regain control over Federal spending, stop the trend toward the Federal Government's direction of the use of an ever-increasing portion of our national wealth, and restore a greater share in decisionmaking to individuals and families through large permanent tax cuts. Or, we can continue down the road of the past which leads toward even larger budgets, continuous deficits, and increasing domination of government over our economic affairs.

PROPOSED INDIVIDUAL TAX REDUCTIONS

With respect to individual tax reductions, the administration's proposals are designed to achieve two important goals. The first goal is to simplify the existing tax structure by providing a single standard deduction as a substitute for the present low-income allowance and maximum standard deduction. The second goal is to begin the difficult, but most vital, task of realining the tax rate structure to relieve the middle-income taxpayer from onerous tax burden imposed as a result of industriousness and thrift. Tables 14–21 [1] provide further information on the individual tax cuts.

PROPOSED PERMANENT INCREASES IN THE INVESTMENT

With respect to business tax cuts, the Tax Reduction Act of 1975 increased the nominal rate of the investment credit to 10 percent from 7—4 percent in the case of utilities—for the years 1975 and 1976. The President's proposal would make the increase permanent.

PROPOSED REDUCTION OF CORPORATE TAXES

In addition to this modification of the corporation tax schedule, the President proposes to reduce the top rate 2 points so that the maximum applicable tax rate would be 46 percent. Until we, working with the committees of Congress, can effect integration of the corporation and personal income taxes, this modest relief of the extra burden of tax should cause beneficial increases in the rate of capital formation.

JOB CREATION INCENTIVES

As I mentioned earlier, this administration is committed to two fundamental economic policies: sustained noninflationary economic growth and jobs for all who seek work.

The proposed tax cuts, coupled with the corresponding reduction in the growth of Federal spending which I have just described, go a long way toward achieving our goal over the long run. But tax cuts alone are not enough. There is a pressing need for more immediate measures to alleviate the unemployment problem that is particularly severe in certain segments of our industry and in certain

[1] See. pp. 115–122.

areas of our Nation. What we need and must do is to create a favorable climate for private industry to create more jobs.

The administration has proposed just such a job-creation incentive. Introduced in the House as H.R. 11854, the proposal will permit rapid depreciation for businesses which construct new plants or expand existing facilities in areas where the unemployment rate exceeds 7 percent, or purchase equipment for use in these new or expanded facilities.

The administration's proposal has the following advantages:

First, the stimulation of plant construction and expansion and equipment purchases will lead to the creation of new and permanent jobs, in the private sector, in areas where they are needed most.

Second, we expect the proposed tax incentive will provide substantial impetus for business to embark upon projects now deferred and to undertake new projects which otherwise might not get started.

Third, the administration proposal will provide immediate benefit to the construction industry, one of the most depressed in the economy.

PROPOSED BROADENED STOCK OWNERSHIP PLAN

I would like to turn now to the subject of broadened stock ownership in the United States. The following are the principal features of the proposal:

First, contributions would be deductible from taxable income, with participation being restricted to individuals in the low- and middle-income ranges and limited to the maximum amount eligible for deduction. In addition, there would be a phaseout of the amount deductible at the higher income levels. For example, a taxpayer might be allowed to deduct $1,500 a year or, if less, 15 percent of his compensation, subject to a phaseout in the case of compensation between $20,000 and $40,000.

Second, income earned by a Broadened Stock Ownership Plan (BSOP) would be exempt from income taxation until withdrawn from the plan. Upon withdrawal, a participant would be subject to a current tax at capital gain rates, to provide participants with the benefits normally associated with the accumulation of capital values. However, there would be a holding period requirement. Thus, funds held in a BSOP would have to remain invested for at least seven years. Premature withdrawals would be subject to a penalty tax in order to discourage early withdrawals.

Third, the contributions made to a BSOP would have to be invested in common stocks, the selection of which would be entirely up to the participant. He could, for example, select individual stocks or mutual funds.

PROPOSED ELECTRIC UTILITIES TAX PROGRAM

The electric utilities tax program is another important part of the administration's program. It not only will serve as a stimulus to construction of additional facilities by electric utilities, but will also provide a means to minimize imports of foreign oil and to insure adequate electric generating capacity in the several years ahead. The program is highly important to the national economy.

The proposal I presented last July 8 before the House Ways and Means Committee, and before your committee on December 9, represents the recommendations of the President's Labor-Management Committee, and the President has endorsed them. The need for this legislation has not lessened since I last urged its adoption. The reasons are:

1. Financing difficulties have prevented the construction, or completion, of badly needed nuclear and coal-fired plants.
2. The need to minimize our dependence on foreign oil demands adoption of means to increase electric generating facilities fueled otherwise than by petroleum products.
3. The energy shortage must be met. Insufficient electric power will inhibit construction of new manufacturing and commercial facilities. This cannot be allowed to happen.

I would now like to turn to the specifics of the six-point proposal.

First, the proposal would increase the investment tax credit permanently to 12 percent for all electric utility property except generating facilities fueled by petroleum.

Second, the proposal would give electric utilities full, immediate investment tax credits on construction progress payments for construction of property that takes two years or more to build, except generating facilities fueled by petroleum products.

Third, the proposal would permit electric utilities to begin depreciation projects during the construction period.

Fourth, the proposal would provide for extending to January 1, 1981 the period during which pollution control equipment installed in a pre-1969 plant or facility will qualify for rapid five-year straightline amortization.

Fifth, the proposal would provide an election of five-year amortization, in lieu of normal depreciation and the investment credit, for the costs of converting an electric power generating facility fueled by petroleum into a facility fueled by nonpetroleum products.

Sixth, the proposal would permit a shareholder of a regulated electric utility to postpone tax on dividends paid by the utility on its common stock by electing to take additional common stock of the utility in lieu of a cash dividend. The receipt of the stock dividend would not be taxed.

PROPOSED INTEGRATION OF CORPORATE AND PERSONAL INCOME TAXES

I would like to turn now to a specific proposal to integrate corporate and personal income taxes. In my testimony before the House Ways and Means Committee last July, I discussed the details of such a proposal. Much of what I will present today is drawn from that testimony. I will also attempt to answer some of the criticism which has been leveled at the proposal.

Under our system of taxation, income earned by corporations is taxed twice: first to the corporation and then again to the shareholder, if and when it is distributed as a dividend or realized on sale.

The double tax is an extra inducement for corporations to seek debt financing, rather than increased equity capital, because the tax applies only to the income attributable to equity investment. Corporations must earn enough gross income to cover the interest payments made to compensate bondholders and other creditors for the savings which they have supplied. But interest payments are deductible at the corporate level and thus—unlike dividends—are not included in the net income which is taxable to the corporation. If we were able to remove the extra tax on dividends, we would make equity financing much more attractive and would reverse the steep and dangerous increase in debt-equity ratios of recent years. I have already indicated how high debt-equity ratios make businesses extremely vulnerable to business cycle changes, and that a high proportion of debt in the financial structure will further discourage investment by introducing added uncertainty for lenders and borrowers. This is just another example of how the tax structure hinders the efficient operation of markets, in this case by increasing the cost of equity compared to debt capital. We must remove this tax impediment to business expansion and economic growth.

A double corporate tax creates a market bias against dividend yielding stocks. So long as earnings are retained, the second tax on dividends need not be paid. If the stock is ultimately sold, its value will generally be higher because of the retained earnings, but the capital gains tax on the increase in value is imposd at preferential rates. Thus, the second tax in the case of retained earnings may be substantially lower than in the case of dividends. Consequently, companies such as utilities, which have traditionally relied on high dividend payouts to attract the capital needed for expansion, are placed at a substantial disadvantage because the double tax imposed on their income is greater than the double tax on companies which retain earnings and do not distribute them. Moreover, moderate income investors who prefer dividends to capital gains are discouraged from stock ownership. Elimination of the second tax would greatly assist utilities and other companies similarly situated in raising equity money. Given our energy problems, this is a particularly important point.

The double tax places a heavy penalty on corporate decisions to distribute earnings. In an ideal free market, the tax system would be neutral with respect to retention or distribution of earnings. Corporate managers would be led to retain earnings only if they would use them more productively in their businesses than their stockholders might use them in other investments. Integration would remove the tax reasons for retaining rather than distributing earnings. At present, the tax penalty on paying out earnings puts corporate managers under great pressure to do almost anything that might be productive with retained earnings rather than pay them out. The double corporate tax thus tends to "lock-in" corporate capital and keep it out of the capital markets which allocate capital more efficiently among uses.

The European Economic Committee has adopted a resolution urging all of its members to adopt such a system and is presently engaged in an effort to promote greater uniformity of existing systems and to harmonize the differences that remain.

We propose eliminating the double tax on income from savings invested in corporate equity and to do so in six phases, with the first phase effective January 1, 1976. The remainder would phase in equally over the succeeding 5 years. The proposal would, thus, have no effect on the budget for fiscal year 1977.

We propose to eliminate the double tax by combining the two mechanisms of a dividend deduction and a stockholder credit. When fully effective, the credit at the stockholder level in combination with the dividend deduction at the corporate level will completely remove the double tax on dividends.

The combination of the dividend deduction and the stockholder gross-up and credit has two major advantages: First: Use of the dividend deduction will initially create additional cash flow at the corporate level, which provides an immediate increase in funds available for investment. Second: Use of the stockholder credit mechanism permits flexibility with respect to tax-exempt organizations and foreign stockholders. Of course, it may be appropriate in particular cases to extend the benefit of the stockholder credit to foreign stockholders by means of an income tax treaty.

Four major arguments have been mounted against the integration plan. Let me answer these arguments.

The first argument is that the plan is heavily weighted toward big business and high-income individuals at the expense of the "little guy."

This argument first ignores the fact that all Americans would benefit from the plan as highest levels of real income are generated by higher levels of productivity.

Second: The ownership of corporate capital is much more widespread than many may realize. In addition to the gains to direct owners of corporate stock, benefits will flow to people who receive corporate income indirectly through pension funds, insurance companies, and other financial institutions. These institutions have been increasing their ownership of stock and now own about a quarter of all outstanding corporate shares.

Third: The integrated nature of our Nation's capital markets assures that benefits will spread to people who receive all types of capital income, from bonds, notes and savings accounts, as well as from stocks. Thus, an initial buoyant effect of integration on rates of return to stockholders will be dispersed to all capital ownership, to higher money wages, and to real incomes for all, not just rich stockholders.

The second argument is that the cost of the program is too high in proportion to the benefits. I fail to see how retaining a tax system which incurs for us a current loss of economic welfare and consigns us to a lower growth rate can be less costly than reforming it.

The third argument is that integration favors dividend-paying corporations. Plainly, the present unintegrated corporation income tax favors corporate retentions over dividend distributions. If we were to propose to so distort private choices by some tax scheme, we justifiably would be criticized. I am, therefore, puzzled when critics chastise me for proposing to neutralize the present distorting effect of tax policy on corporate financial management policies.

The fourth argument is that reducing the corporate income tax would be simpler and just as effective a means to stimulate capital formation.

I agree that this alternative is sound and would help achieve the overall objective. However, simply reducing corporate rates would fail to confront the inherent inequity and inefficiency of maintaining higher tax rates against income from corporate as compared to non-corporate capital. Reducing the corporate tax rate by itself would also do nothing about the grave problem of tax bias in favor of debt financing.

Lowering corporate tax rates would lead to increased capital formation, but integration will improve corporate financial structures and bring about more efficient and effective use of that capital as well.

PROPOSALS RELATING TO CAPITAL GAINS AND LOSSES

Now to capital gains and losses.

H.R. 10612 contains two relevant provisions dealing with the taxation of capital gains. The first provides for an extension of the holding period requirement to qualify for long-term capital gains. The second provision increases from $1,000 to $4,000 the amount of net capital losses which may be used to offset ordinary income.

We support both provisions of the House bill.

We are today proposing the adoption of a sliding scale approach for the taxation of capital gains and losses. Under our proposal. the tax burdens on capital gains will be reduced the longer the asset has been held by a taxpayer. This will promote capital formation and the efficient allocation of investments. The proposal is a sensible rule-of-thumb to avoid converting the income tax into a capital levy on shifts in investments. In addition, we believe the sliding scale mechanism will reduce the unwarranted taxation of inflationary gains.

Specifically, we propose just the amount of capital gain which may be deducted in computing adjusted gross income will be based on the holding period of the asset. Capital losses will also ~~be subject~~ to the sliding scale proposal. All transactions which presently generate capital gains and losses will be subject to the sliding scale.

Personally, I believe that the unlocking will be substantial and generate significant revenue increases in fiscal 1977. However, we are assuming that the sliding scale proposal will produce no material change for budget purposes in fiscal 1977 receipts.

PROPOSALS RELATING TO ESTATE AND GIFT TAXES

I would like to turn now to estate and gift taxes. As you know, the House Ways and Means Committee is now holding hearings on the major issues of estate and gift tax revisions, and, Treasury Department officials will be testifying on that subject next Monday, March 22. We believe that a complete reexamination of estate and gift taxes is long overdue and we look forward to cooperating with the tax-writing committees in this undertaking. As you also know, the President has already recommended an increase of the estate tax exemption from $60,000 to $150,000.

The basic structure of the estate and gift tax has remained fundamentally unchanged since 1932, and the estate and gift tax exemptions were last changed in 1942. Since that time, the ravages of inflation have substantially eroded the value of the $60,000 estate tax exemption. No longer does the estate tax impact principally on the relatively larger estates. Rather, the estate tax now has shifted to a more broadly based tax on the private capital accumulations of more moderate estates.

We believe that an increase in the estate tax exemption is clearly warranted. Indeed, such an increase is essential if the estate tax is to be returned to its historic role as an excise on the transfer of relatively larger wealth accumulations. At the same time, we cannot ignore the significant revenue consequences that would result. Thus, we recommend that the estate tax exemption be increased to $150,000 over a 5-year transition period and that the lower bracket estate tax rates on the first $90,000 of taxable estate be eliminated. Limiting the increase to $150,000 (with the proposed restructuring of rates) will permit the revenue less to be held to an acceptable amount, which can be absorbed gradually during the phase-in period.

The CHAIRMAN. Mr. Secretary, if I may just interrupt——

Secretary SIMON. I am running out of breath myself, Mr. Chairman.

The CHAIRMAN. I will give you a chance to catch your breath. In view of the length of your statement, and in view of the fact that you have to be down at the White House, and since you have touched upon the more important matters, why don't we open this hearing up to questions now. We can let somebody else read the remainder of your statement, if you want it read. Your prepared statement will be inserted in the record.[1]

The CHAIRMAN. We have about 1 hour and 15 minutes to ask you the questions that are on the Senators' minds.

Secretary SIMON. Fine.

The CHAIRMAN. Mr. Goldstein there on your right told a story that I stole from him. I do not know whether it was original with him or not.

A fellow came home one night after consuming altogether too much alcohol, and he had lost his key. He had to rap on the door to wake his wife in order to get in. It was late at night and he stumbled over the rug. As the fellow fell to the floor, he looked up at his wife and said, "If it is all the same to you, I will just dispense with my prepared remarks and proceed with questions from the floor."

I know that we would like to ask some questions at this point.

Our seniority rule on this committee goes on a day-to-day basis. The first man in the room gets to ask the first questions. So we will go by seniority today, and the early bird today was Senator Harry Byrd, Jr.

Senator HARRY F. BYRD, JR. Thank you, Mr. Chairman.

Mr. Secretary, this is a very comprehensive statement and it would take a little time to study it, of course.

REVENUE LOSS FROM PROPOSED CORPORATE TAX REDUCTIONS

I would like to turn to the beginning of your statement and ask, because of these items, the first one has to do with permanent reduc-

[1] See p. 51.

tion in corporate income tax rates from 48 percent to 46 percent, and that varies slightly, as I read it, from your proposal on page 25. You put a big $3.2 billion as a revenue loss on page 25. Is that the same, roughly the same revenue loss that you envision?

Secretary SIMON. It is $1 billion per 1 percentage point in reduction in the corporate tax rate.

Senator HARRY F. BYRD, JR. On page 45, you propose 47 percent.

Secretary SIMON. That includes the change in the surtax exemption rate, Mr. Byrd, which is from 22 to 20 percent the first $25,000. This reduction was in the original Tax Reduction Act of 1975.

Senator HARRY F. BYRD, JR. I am trying to understand if that $3.2 billion applies to the statement on page 7.

Secretary SIMON. Let me read it. The total corporate effect, 2 percentage points reduction is $2 billion, the change in the rate of the surtax exemption that I spoke of is $1.7 billion; extension of the investment tax credit in fiscal year 1977 is $1.2 billion. The utility relief is $800 million. The total corporate is $5.7 billion out of the total $28.1 billion proposal. The figures get confusing because we are comparing calendar years and fiscal years. That might be where the confusion is.

Senator HARRY F. BYRD, JR. Well, then take your proposal to eliminate the double on the corporate dividends. What cost?

Secretary SIMON. That costs approximately $13½ billion. That is why we recommend a phase-in over a 6-year period.

REVENUE LOSS FROM PROPOSED REVISION OF CAPITAL GAINS TAX

Senator HARRY F. BYRD, JR. Now, revisions in taxation of capital gains what did that cost you?

Secretary SIMON. A lot of this is judgmental. I can think of no subject we have deliberated longer and harder on in the Treasury. We all agree, I believe, there is going to be a significant unlocking effect as a result of the capital gains proposal in the short run. The disagreement is how many years is short run. I happen to believe that the unlocking would take somewhere between 3 and 5 years.

So the ultimate revenue effect would be about an $800 million loss a year.

I can remember discussing this with Wilbur Mills, who was in favor of this several years ago, when I first arrived here in Washington. I believe at that time that the unlocking effect on the revenue impact would have been far greater. It is very difficult to quantify the ripple effect in our economy through freeing up these funds. Again, economists can have long and hard debates on this. I think it would be significant myself, but for budgetary purposes, we put in neutrality, even though everybody's bias is on the plus side.

In the longer run, the negative impact is about $800 million.

REDUCED REVENUES FROM PROPOSED INTEGRATION OF CORPORATE AND PERSONAL INCOME TAXES

Senator HARRY F. BYRD, JR. I am inclined to favor most of these proposals, but I am wondering whether it is realistic to think that we could reduce revenues by $13½ to $14 billion by the elimination of the double tax on the corporate dividends.

Secretary SIMON. Of course, that is why we recommend that it be done, Senator, over a 5- or over a 6-year period. This proposal of course, also has international ramifications. As far as the competitiveness of our trading partners, they have already done this—well, all but a very few European communities. It has been recommended that the balance of the countries that have not adopted an integration mechanism do it now.

Obviously, if these countries have removed a tax on capital, which you do when you are eliminating the double taxation, their ability to produce goods at cheaper prices is obvious. I think it is an important proposal and, of course, it is, as I say in my prepared statement, the only proposal that I am aware of that directs itself to the debt-equity ratio. The debt burden of our corporations in the United States has gone up alarmingly in my judgment and puts them in a very sensitive position as far as being able to withstand cyclical changes in our economy.

It does cost money and that is why, as I say, we phased it into the projected budget process to take it into consideration, but obviously it is a major capital formation tool.

Senator HARRY F. BYRD, JR. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Ribicoff?

PARTICIPATION IN ARAB BOYCOTT OF ISRAELI BUSINESSES

Senator RIBICOFF. Mr. Secretary, if the policy of the United States is to discourage participation by Americans in the Arab boycott, should we not draw a clear distinction between those Americans who promote the boycott and those who do not?

Secretary SIMON. When you say, distinction, those who promote the boycott and those who do not?

Senator RIBICOFF. That is right.

Secretary SIMON. Well, the President has come up very strongly against any boycott based on race, creed, national origin, religion, et cetera.

Senator RIBICOFF. So if that is the case, then the United States continues to offer companies that participate in the boycott the same beneficial tax treatment as other companies by granting them the foreign tax credit, tax deferral on foreign source income and DISC benefits. These benefits currently apply to income derived from boycott dealings.

Isn't the United States actually adding incentives to comply with the boycott and resulting in the clear contradiction of our policy regarding foreign boycotts?

Secretary SIMON. When you say contradiction, I just returned, as you know, Senator Ribicoff, from the Middle East. I visited Israel and the Arab countries. There are a lot of inconsistencies, I guess I would say, in life. I find a lot of inconsistencies in this boycott problem.

The Saudi Arabians made a public statement while I was there that it was not, nor will it be—and it was a very strong statement—

their policy to discriminate on the basis of race, national origin or religion. They are conducting an economic boycott against an enemy, and they then ask us, and say, well, what is the difference between an economic boycott such as that, and it is as old as the world, and the boycott that you, the United States, have with Cuba and the one you have with Communist China.

Those, as I say, are inconsistencies. As I say, we are opposed to boycotts based on discrimination and, yes, we will take action against people. We believe our policies, Senator Ribicoff, are attempting to assure a just and lasting peace in the Middle East.

Senator RIBICOFF. Let us go further. We have got 3,000 American companies involved in a boycott against 2,000 American companies. I see by this morning's paper that General Motors, and it named a few more—RCA, Texaco—have agreed not to comply with the Arab boycott.

Now, you have General Motors refusing to comply with the Arab boycott, and let us say—I do not know if this is the case—if Ford and Chrysler do not agree to that and do the opposite, under those circumstances, why should General Motors be penalized and Ford and Chrysler get a benefit?

Secretary SIMON. I do not think they necessarily should, Senator Ribicoff, and the point is that we have instituted, or the Justice Department has instituted, an action against Bechtel, which, of course, will be adjudicated in the court, and this will go with the problem that you just brought up.

Senator RIBICOFF. That is one company.

PROPOSED DENIAL OF FOREIGN TAX CREDIT FOR PARTICIPANTS OF ARAB BOYCOTT

Now, I have introduced a bill, and this committee is going to have to vote on it here and on the floor of the U.S. Senate, which would deny foreign tax credit benefits—tax deferral on foreign source income and DISC benefits to any company that participates in the boycott.

If a company cooperates with the boycott, it would lose those benefits on its dealing with any country that sponsors the boycott. Now, that amounts to $1 billion in tax benefits that are being received by American companies involved in the boycott. What is the administration's position on giving these tax benefits to those companies involved in the boycott?

Secretary SIMON. We just recently received this proposal, I think it was yesterday, Senator Ribicoff, and I have not had the time to study it for recommendations. When I get into the details on its ramifications, I will guarantee you that in a short period of time we will have a policy. We want to effectively discourage and eliminate this very contemptuous issue of the boycott.

I am not sure that the tax system is the proper instrument to use. I truly believe that our diplomatic and persuasive measures are working, resulting in what the Saudi Arabians announced when I had my recent visit there, and I think we can, as I say, solve this issue. I am not sure this legislation would be it, but without the suggestion that I have prejudged exactly what your bill is and what it would do, let us take a look at it and we will advise you very rapidly.

Senator RIBICOFF. You have 99 pages of policy decisions which you are making for the people of the United States involving the tax laws.

Now, if it is a policy of the United States to be against this un-American procedure of encouraging boycotts, then you will be faced with the proposition of whether or not you are going to encourage a continuation of the boycott by giving tax benefits to those who are involved in it. What is your response to that?

Secretary SIMON. Our position is eminently clear on the boycott issue, Senator Ribicoff. We absolutely will not tolerate a boycott as it relates to discrimination based on race, creed, color, national origin, sex, et cetera. As I say, this is not inconsistent with what the Saudi Arabians announced during my visit, that they will not exercise a boycott based on those principles, which I am opposed to having with the United States

Senator RIBICOFF. One second, Mr. Chairman, if I may.

It is not what they say, but what they do.

Secretary SIMON. I agree with you; yes, sir.

Senator RIBICOFF. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Secretary, I am very impressed with your statement, and I am in agreement with most of the proposals that you have made. I am very impressed with them.

INVESTMENT TAX CREDIT FOR UTILITIES

On page 35, I am a little concerned with the investment tax and how it would apply. I quote one of your paragraphs, "These proposed changes with respect to the investment credit would be limited to those utilities"—and it goes on to explain this.

My problem with this is that in many States the regulatory agencies are holding down utility rates due purely to political pressure. In fact, they will not agree to what would be normalization. Consequently, the utilities would not be in any way responsible for that decision, but they would be penalized.

Is there any way we can get around that where the utilities would not be penalized for actions by regulatory bodies?

Secretary SIMON. One of our utility proposals directs itself to your concern, because we too have that very basic concern. We do not want tax benefits given that are just going to flow through. There would be no economic benefit, no efficiency resulting from something like that. So these proposals for the regulatory agencies to do what is proper as far as ratemaking is concerned——

Senator FANNIN. I would hope it would have an effect—in my own State, in Tucson, Arizona, the utilities are in real trouble and the regulatory agency is not giving them relief. Consequently, they have had to cut back some of their partial ownership in the proposed construction of a nuclear power plant. This action takes away from them the investment tax credit which they very badly need.

Secretary SIMON. Yes. You have had different actions in different States and, sure, ratemaking agencies, because they are so politically sensitive, are going to be slow to act in some States, yours obviously being one, but these proposals are going to build up pressure and editorials, and when the public pressure comes on, then they are going to recognize basically that the people are going to have to pay for the cost of generating the electrical capacity in the United States.

This is not a substitute for that recognition; this is a supplement and incentive on top of that.

Senator FANNIN. I certainly hope that it works out that way, and I can see that if the press would capitalize on this opportunity to bring forcibly the pressure of the community upon the regulatory agency, it would work out that way.

TAX INCENTIVES NEEDED FOR GEOTHERMAL ENERGY DEVELOPMENT

Mr. Secretary, I have a continuing concern for the lack of clarity in the tax laws as they relate to geothermal energy development. We have opportunities in the West to provide massive amounts of energy from geothermal sources. The Internal Revenue Service has refused to acquiesce in the decision in the *Reich* case, thereby creating great uncertainty in the geothermal industry. Do you see any possible change of policy in this area of energy development?

Secretary SIMON. We are studying in the Treasury right now the whole subject of incentives to geothermal activities, Senator Fannin.

Senator FANNIN. If we are going forward, as has been certainly illustrated we saw at Geyserville, some clarity must be brought to this area. I understand that industry has been able to get results out of the Treasury that would permit them to go forward with new development, and I would very much appreciate if a report could be made in that regard. It seems to me that this is a great opportunity that we have.

When we are talking about a 5-year amortization, we are getting back some other problems. In the geothermal, we have the problem of the equipment that was needed because of the pollution matters, and that comes about, and the 5-year amortization, it seems to me, a pretty difficult problem.

When they are spending money in 1 year, they are not getting any advantages~~ as far as~~ productivity is concerned. It is adding to their cost of operations.

Shouldn't that be allowed too, for deductions in the year in which it is spent, rather than the 5-year amortization?

Secretary SIMON. See what happened, and I am sure you in industry share the frustration of not only the Secretary of the Treasury, but of the highest tax policy group also, on these long delays on terribly critical regulations. You get into these very complex subjects and debates on the issue of whether steam is a gas or a hydrocarbon. That is the problem.

So you have to arrive at the definitional response also and get all the technical arguments on both sides of the issue before you can do something that is going to be proper and fair.

Senator FANNIN. We are trying to get legislation through, and at the same time I would hope that, even if we do not get the legislation through, that the Secretary will delve into this to try to alleviate the problems we have in developing these resources.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Thank you, Mr. Chairman.

Mr. Secretary, I want to commend you and the President of the United States on your overall approach in this paper carrying a number of tax recommendations. I thoroughly believe that they are for the good of our economy, and they would also move toward full employment of the country.

As a matter of fact, I believe acceptance by the Congress of the approach you have made to taxes for our economy would very rapidly bring, in just a matter of months, removal of the excessive and above normal unemployment in the country.

ESTATE AND GIFT TAXES

I especially want to commend you for your position on relief in the estate taxes, as well as gift taxes. Many business decisions can be delayed, transactions, contract purchases, and so on, can be arranged to take care of the future change in the tax law, but it is not given to man to be able to postpone his debts.

Therefore, I am glad that a recommendation in reference to estate tax is included at this time.

DENIAL OF DISC BENEFITS TO AGRICULTURAL EXPORTS

I understand that the House bill denies the DISC benefits in reference to agricultural exports, the Domestic and International Sales Corporation.

Do you have a position on that?

Secretary SIMON. Of course, our overall policy on DISC is that we oppose any tinkering with DISC at this time, because it has been in operation a very few years. It is arguable as to what the impact has been. We know it has helped exports. All we can do is just argue about how much it has helped exports.

Senator CURTIS. Isn't the DISC designed to permit a more competitive approach to exports and at the same time retain the payrolls in this country?

Secretary SIMON. Yes.

Senator CURTIS. Isn't that the essence of the DISC?

Secretary SIMON. That is correct, and for every billion dollars of exports, depending upon what the commodity is, represents 40,000 to 70,000 jobs in the United States, and helps our balance of payments.

Senator CURTIS. It has been pretty well documented that $1 billion worth of farm exports generates 50,000 jobs in the United States.

Secretary SIMON. It depends on the industry. Sometimes it goes as high as 70.

INVESTMENT TAX CREDIT

Senator CURTIS. In respect to the investment tax credit, do you agree with me that we should once and for all make that permanent, rather than have it off and on?

Secretary SIMON. I sure do. You know, we have some history to support that statement, Senator Curtis. It went on in 1962, off in 1966, on in 1967, off in 1969, and back on in 1971. The businessman gets dizzy when you jiggle the tax system like that.

One thing that business needs is certainly of the investment tax credit, if you think it is worthwhile. If you have the notion of turning it on and off, it returns inefficiency to the system.

It is arguable that increased investment might have occurred anyway due to the economy, the general state of the economy, but, yes, this is part of the President's program to make the investment tax credit permanent at 10 percent, and of course our utilities proposal makes the investment 12 percent for utilities.

Senator CURTIS. I anticipated that that was your position.

I want to commend you for it, because in addition to all the confusion and destruction of the objectives of the law, it is also very unfair as between competitors when one transaction falls within a period that the benefit is granted and another one falls outside that period.

Secretary SIMON. It takes several years to plan.

CAPITAL GAINS

Senator CURTIS. In reference to the capital gains, the House's provision, as I understand it, extends the holding period for capital gains and made its effective date as of the date of their action: is that correct? Or else the 1st of January?

Secretary SIMON. I believe it was January 1, Senator Curtis, but I also assume that the conference committee would do what is fair as far as the effective date is concerned.

Senator CURTIS. I think that it is very important that we not make it retroactive from the standpoint of the small investor. The large investor who has tax information available can comply with the act, but I believe if we accepted the House's effective date we would find many small investors making a sale believing that they would be entitled to a capital gains tax and end up to their surprise being liable for ordinary income.

Secretary SIMON. I agree with that.

Senator CURTIS. Mr. Secretary, again, I commend you.

There are many other points and as the days go on I will be involved in it, but I want to give back the balance of my time.

The CHAIRMAN. I will take my turn at this point.

INCREASED STANDARD DEDUCTIONS

Mr. Secretary, 71 percent of the taxpayers will use the short form to file their income tax this year, I am told. Isn't that the most simple form used in paying taxes?

Secretary SIMON. It is the simplest that we have.
The CHAIRMAN. You agree that it is simple?
Secretary SIMON. Yes.
The CHAIRMAN. Now, we could change it.
Secretary SIMON. A lot of people out there do not think it is so simple, I guess.
The CHAIRMAN. It looks pretty simple to me. I do not see how we could make it much simpler.

We could change about two-thirds of those people who use the itemized deductions over to the simple form if we made more people eligible for the standard deduction and if we undertook to make the simple approach much more attractive to the taxpayer and the long form less attractive to the taxpayer.

If we cannot agree on some of the other matters, why could we not at least agree on that approach?

Secretary SIMON. We would have to increase the standard deductions to do it. I guess it would be a cost factor in that. Of course, some people cannot avoid all the massive deductions; some lives are more complex financially than others.

The CHAIRMAN. We can go into more detail with you about that later.

EXAMPLES OF POOR COST ESTIMATING WHEN ENACTING LEGISLATION

Now let's turn to another matter.

I believe that we should be able to be honest with one another. When we make mistakes, we ought to admit it, face up to it, try to do better the next time. Sometimes the pride of authorship keeps people from admitting when they have made an error. In my judgment, we made an error in the Tax Reform Act of 1969. I asked President Nixon to sign that bill, and he went along with it.

Wilbur Mills did the same thing. We estimated that we were going to pick up almost $3 billion in revenue by repealing the investment tax credit, and I believe that the Treasury agreed with that estimate at that time.

In retrospect, it looks as though we did not pick up any revenue, that people canceled out orders, which put people out of work. The repeal slowed the economy down. It helped play a major part, in my judgment, in the recession that followed, which caused the President to ask us to restore the investment tax credit.

In looking at it in hindsight, do your Treasury experts think that we made money or lost money when we repealed the investment tax credit?

Secretary SIMON. I do not think that that would be subject just to judgment. You cannot quantify the numbers, but, certainly, by looking at the putting on and taking off of the investment tax credit since 1962, you can make the argument, very strongly, that it has an effect on the investment planned expansion.

The CHAIRMAN. I think that we ought to try to look at what kind of changes occur when we enact legislation. I can illustrate it better in certain other areas. When we enacted the medicaid program, we had an estimate that it was going to cost something like $200 million a year. That estimate was based merely on the assumption that the States would continue to put up the same amount of money for medical care for the poor and indigent that they had been putting up before.

Well, if you are going to give a State much more favorable matching for medical care for the poor, it stands to reason that the State will put a lot more money into that program. In fact, they will take revenues that they are using for some other purpose and make it available for medicaid matching. That is exactly what happened, and in a few years that program was costing 15 times what the revenue estimate was.

The same thing happened in social services. The estimate of the Department when we made these social services expenditures available for matching on a 3-for-1 basis was that it was going to cost $40 million. But then in a few years it was going to cost $4 billion a year. Apparently, nobody had bothered to think about what logic and human nature would dictate, that if you are going to make something eligible for 3-to-1 matching, the States will seek anything they can lay their hands on to make it available for that matching.

Down in Mississippi—and I do not blame them, because everybody else was trying to do the same thing—they were getting around to calling public education a social service. Highways were a social service, if they could get the 3-for-1 matching.

The cost estimate was shamefully wrong. But this will always be the case when all you do is just look at what the numbers would be if you simply applied a calculation to those numbers without recognizing that people would change their decisions.

Your Assistant Secretary sitting beside you, the present-day Charles Walker, says if you do that, you are just guessing as to what is going to happen. My response to him is to ask, what is an estimate but a guess? It has to be a very bad guess if you guess that you are going to make money and you wind up losing money.

Secretary SIMON. We can make several guesses and we can make a lot of different assumptions. I am a great believer in the ripple effect and the secondary effects. Feedback is what the experts call it. We are working on that in the Treasury now and the methodology is extremely complicated because you have to gauge what the world economic conditions are going to be and, what you said, the human behavior. What is the response of an individual in both the short term and the long term; and, of course, the actions of human beings are extremely difficult to predict; but we are doing this and we are going to have a judgment which I hope will turn out better.

The CHAIRMAN. I would like them to send the estimates to the committee.

DISC

The study that you have in the Treasury right now, and the studies over in the Commerce Department, indicate that if we repeal the DISC, we are not going to make a nickel for the Treasury. It looks like the overall effect would be to cause us to lose money for the Treasury. I would like to have your people study that.

LAL AND OIL AND GAS INVESTMENTS

Senator HANSEN. Mr. Secretary, I noticed for March 5 that this Nation imported in crude oil and products a total of 7,866,000 barrels of crude oil products. The estimated domestic crude oil products for that same date was 8,013,500 barrels. That isn't of course, 50 percent, but on that particular date it was edging up pretty close.

Secretary SIMON. Those are new numbers. Back when I was doing it, I used crude and natural gas liquid because I consider that part of our domestic.

Senator HANSEN. I am sorry, but I do not have those. But just restricting it to crude oil products——

Secretary SIMON. We are about 40 percent right now.

Senator HANSEN. Well, of course, this was the highest time. If I did not make that clear, let me say that.

On March 5, the ratio of imported crude oil and products, and the relation to what was produced in crude oil and products, excluding natural gas liquid and natural gas, were those figures corresponding to the information I have.

You have in your oral statement said that you generally support the limitation on the artificial losses approach and agree with the provision in the House bill. But then in your prepared statement on page 75 you say that we strongly oppose the application of the LAL to any oil and gas activity.

It might be helpful if you could spell out for us why you think the distinction should be made in the proposal in the limitation on the artificial losses that have not been applied to oil and gas activity.

Secretary SIMON. Well, you have to go back to when we first proposed the limitation on the artificial accounting losses in March of 1973. World conditions and our domestic condition on the subject of energy were totally different. That was about 9 months before a quadrupling of the price and the subsequent increase. We still had a depletion allowance that covered 100 percent of the domestic producers versus about 30 percent of them today.

We all know what has happened since then. Our original proposal applied LAL to oil and gas investment and I felt personally, as a businessman, fully well satisfied that it would not be a severe impediment, but in my opinion we have done enough damage to this industry. I recognize this as being a great point with the economic facts of life, because the economic facts of life, unfortunately, are not terribly well understood. We have removed the depletion allowance as to which, I guess, I was the last fellow opposed to that removal.

I recognized I was a loner, but alone we ended up removing the $2.00 tariff. Of course, we effectively reduced the price, which rolled back the price of oil, which is exactly the opposite of what should have been done. We continued to erect impediments on the production of oil and gas, and the result is just as the first numbers hold. We would rather pay the 27 billion to our domestic producer here in the United States to bring about the ability for self-sufficiency, not only for the economy but for very important political and foreign policy reasons in this country.

So I think that until we are willing to face the facts as far as pricing commodities at their economic cost in this country, that we ought to stop monkeying with it counterproductively. Maybe we have some seemingly political benefits by working on the economic illiteracy, not only in this country but indeed around the world, by promising to control prices on one hand and providing a plentiful supply at the same time.

That is an inaccuracy and a fallacy, and that is why, in a nutshell, we are opposed to the application of LAL to oil and gas. Let us talk about a free market first.

ESTATE AND GIFT TAXES

Senator HANSEN. Mr. Secretary, in your prepared statement, you say that the administration proposes estate tax relief for farmers and owners of small businesses to make it easier to continue family ownership of small farms or businesses after the owner has died. You had pointed out earlier that you proposed increasing the tax exemption from 60,000 to 150,000, and yet in your prepared statement, I note that you say if we were to keep with the consent that was embodied in the 1942 change in raising the estate tax exemption at that time to $60,000, considering inflation, it would now require that we exempted $210,000, and yet your proposal was that we exempt only $150,000.

Are there other proposals that you have in mind that would retain the small farms and small businesses as well that you think are important to America?

Secretary SIMON. Well, of course, the combination of the two is tremendous protection. We have to take the cost factors into consideration as well. Going to 150 is a major step in the right direction. The availability for a small business of $300,000, phased out up to $600,000 on a 5-year moratorium on payments, a stretch out for one payment of taxes of 20 additional years at reduced interest rates—presently at 7 percent, down to 4 percent—gives tremendous protection against heirs having to sell their small business or farm.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator Nelson?

PROPOSED ESTATE TAX CREDIT

Senator NELSON. In that precise question, a number of bills that have been introduced approach the estate tax exemption question in roughly the same way as the administration's proposal. I joined on one that was introduced in December. In looking at it, some of the staff people evaluating it pointed out that any increase in the exemption would reduce the progressivity of the tax structure, and that strikes me as being important, so yesterday or the day before yesterday, Senator Packwood and I introduced another concept so that the House could look at it before they completed their deliberations.

This is the question: instead of a great exemption increase, since an exemption is always more beneficial to the larger estates than to smaller ones, why are we not tackling it by establishing a tax credit instead of an exemption, so that the largest estates do not get the greatest dollar tax benefit out of the tax relief we provide, as they will if we simply raise the exemption?

That is No. 1. It seems to me to be more efficient and more equitable to use the credit approach.

No. 2. It costs the Treasury, much less if we use a credit instead of an exemption, according to Treasury estimates, in providing the same amount of tax relief to the smaller estates. For example, a $30,000 tax credit would make all estates completely tax free up to a net size of $131,000. That is, it would be the same as raising the exemption to $131,000, but the difference in cost would be $850 million for the credit and about $1.5 billion for the exemption approach.

What is your view on that?

Secretary SIMON. I think, I am, of course, hearing this for the first time and I have not had the opportunity to study this, Mr. Nelson. I think it does deserve study.

Senator NELSON. Looking at it bothers me. If you get up to the $5 million estate, or your 6 million or 10 million estate, any size exemption is more valuable in dollar amount of tax relief to these large estates than it is to the $200, 300 or 400,000 estate.

Secretary SIMON. Yes, I can see that.

Senator NELSON. Take a while to look at it.

Secretary SIMON. Yes. It sure is.

TAX CREDIT VS. INCREASING PERSONAL EXEMPTIONS

Senator NELSON. Two more questions. One is on page 23, where you suggest that it has been the conventional approach to raise the personal exemption from the $750 to the $1,000 level, and that it has always been the approach of the labor movement in this country, for example, arguing for the increase in the exemption, and it struck me that, again, there is a great inequity here. For example, you increase the personal exemption to $1,000 and you have somebody in the 50-percent bracket with four exemptions, that is $4,000 in exemptions. It saves him $2,000 on his tax return.

On the other hand, for the person who is in the 15-percent bracket, he saves $600. You give much greater benefits to those in the higher income brackets to take care of their dependents than the person in the lower brackets gets. The difference between the $600 in tax savings due to the four exemptions of the person in the 15-percent bracket is pretty dramatic compared with the person of the 50-percent bracket who ends up with a $2,000 tax saving.

Wouldn't it be better in this instance also to increase the personal tax credit, the credit against taxes, rather than raising the deduction for personal exemptions?

Secretary SIMON. We were aware of that problem, and in order to maintain progressivity of the system, we did that simultaneously through the tax rate adjustment. We simplified it at the same time, of course, with the higher exemption and standard deductions. That is why you have to look at all these proposals together.

Senator NELSON. I have not looked at them all together, but the precise reason, as I understand it, for granting the exemption is to give some tax benefits to those who have dependents that they have to support. If that is the objective of the exemption provision, it seems to me that the credit would be a better method and a more accurate method, so that the person in the lowest bracket is getting the same amount of money to support his dependent children and wife as somebody in the higher bracket. They should both get the same amount of money for that purpose, as they would with a tax credit; the same for everyone.

Secretary SIMON. I would agree with that, but to move all these people at the lower end and adjusting the rates at the lower end of the scale to maintain the progressivity that you speak of, and the fairness——

Senator NELSON. Increase the progressivity a little bit.

PROPOSED RAPID DEPRECIATION

One more question. We look at the question of capital accumulation and look at the investment tax credit for the purposes of expanding investment capital, and then our depreciation schedules, which are very complicated and have different rates of depreciation, as you know very well, for all kinds of machinery, the question is this: Why wouldn't it make some sense to simplify the whole thing, as they have done in the Canadian system, and just have a 2-year tax writeoff, 50 percent the first year, the rest in one or more later years.

Then you eliminate all the investment tax credits and separate depreciation schedules. Wouldn't that be a simpler and, in fact, a better way, to tackle this whole question?

Secretary SIMON. I am not familiar, Mr. Nelson, with the Canadian system.

Senator NELSON. They just give you a 2-year writeoff.

Secretary SIMON. I will let Charles, who was mentioned before, handle this.

Mr. WALKER. May I comment on that, Senator Nelson?

The question that needs to be faced, is whether you wish to base taxes on economic income, or if you wish to depart from that for the purpose of stimulating the recovery of the investment in plant equipment, for example. Moving to a system like the Canadian system, and I am not saying that we should not take it, is a deliberate move away from basing the tax on the economic income.

One way to articulate this is to imagine, for example, the opportunity to simply write off an investment at whatever speed you wish to write it off. I think the economists will say—and I would like to have someone respond directly if we want to get into this——

Senator NELSON. No, we will get a clearer answer from you.

Mr. WALKER. If you were giving the businessman their free choice of one period they should use, they would probably write it off as fast as they put it in place.

If that were to occur, I think the economic consequences, as you are removing the tax burden from the capital entirely, may be desirable. However, we have addressed that question: As long as we are presently basing our system on taxes imposed on an economic income, then I think it would be preferable to stay with some kind of economic life.

The investment credit is a deliberate design to reduce the cost of placing the asset in service. You just have a reduced cost on the acquisition of that asset. So this does not discourage the concept of the basic income. That is my economics for the day, Senator.

The CHAIRMAN. The gentleman's time has expired.

I call on Senator Dole.

Senator DOLE. Mr. Secretary, I have a number of quick questions. I know that your time is limited.

ESTATE AND GIFT TAX PROPOSALS

With reference to your estate tax proposals: Is this the same exemption that President Ford has been talking about in Illinois and other areas where he has been very successful?

Secretary SIMON. The President has announced this proposal, I believe, in Illinois, and said that I would be presenting this to Congress in the very near future, which I have.

Senator DOLE. I read all of that with interest. I think it was a good step. It is good politics, too, but I had not been aware of the 5-year phase. I thought it started off with $150,000. I don't know whether the President spelled that out or left that to you.

Secretary SIMON. The fact is, Senator, that the revenue impact is so heavy, with the budget constraint that we have, we felt it required a 5-year phasein period.

Senator DOLE. But is this consistent with what the President has been saying?

Secretary SIMON. Absolutely.

Senator DOLE. I just had not read the fine print about the $18,000 a year. Maybe he did not have time to work that into his speech, but we will take it anyway we can get it in Kansas. Maybe we will want to raise it a little bit.

Secretary SIMON. You can imagine putting in all the technical details of the tax proposals in the President's speech.

DISC BENEFITS AND AGRICULTURAL EXPORTS

Senator DOLE. Yes, right before an election; yes.

Did I understand your answer to Senator Curtis on why you are opposed to eliminating the agricultural products from the DISC benefits?

Secretary SIMON. Well, we removed products from DISC that are in short supply. That is what the law requires us to do, Senator Dole.

Senator DOLE. You said that you would just as soon not tamper with it right now.

Secretary SIMON. I am talking about the overall DISC program, that is, the new base period approach that was adopted by the Ways and Means Committee.

EMPLOYMENT TAX CREDITS

Senator DOLE. Then, with reference to the job creation incentives, I am wondering if the administration has given any thought to employment tax credits, the credits being based on the national unemployment rate and how many employees might be hired by employers in certain high unemployment times.

It seems to me that might have some merit. I do not know if it is in your statement, but it may be in there.

Secretary SIMON. No, Senator, we had long debates on that subject. When we attempt to tackle the subject of unemployment, any time we are using a tax system as an incentive, we also look at whether the money is being well spent, whether it is efficient or not. We try to quantify as best we can.

In this instance, as far as an employment tax credit is concerned, how can we give an unemployment tax credit and clearly say that this is going to create X, Y, and Z? They could say that they would be hiring a lot of people anyway and improve the economy. So we do not think that is an efficient way.

Senator DOLE. But it was studied by the Administration?

Secretary SIMON. Yes, sir; it was.

Senator DOLE. There may be some efforts by some of us to at least look at it. Maybe it is not a wise program.

INVESTMENT TAX CREDIT

Secretary SIMON. Let us send up to you our results in this study. We can debate it a lot. It is a matter of judgment, but we think in all of our other proposals the money will be spent efficiently and help this unemployment rate.

Senator DOLE. You want to make it permanent.

Does that apply to used equipment as well as new? I think your statement is silent on used equipment—now up to $100,000.

Secretary SIMON. I think the same thing applies, Senator Dole.

Senator DOLE. And you are willing to bring in used equipment to help this?

Secretary SIMON. With the same limitation, which I believe is $100,000 also.

ESTATE AND GIFT TAXES

Senator DOLE. With the gift taxes, I notice that you mention estate taxes, but there is nothing in the statement about gift taxes.

Secretary SIMON. We are going to be testifiying before the Ways and Means Committee, which is holding hearings on estate and gift taxes on Monday.

Senator DOLE. But there are some changes in it, as well as estate tax with reference to the gift tax as well as to estate tax.

Secretary SIMON. We are going to propose an interspousal transfer on Monday, Senator Dole.

Senator DOLE. What kind?

Secretary SIMON. A free interspousal.

Senator DOLE. Trading wives?

Secretary SIMON. I didn't know that that cost anything these days.
Senator DOLE. I will yield back to the Chairman.
The CHAIRMAN. Senator Gravel.
Senator GRAVEL. Thank you, Mr. Chairman.

INVESTMENT TAX CREDITS FOR UTILITIES AND SOLAR ENERGY

Mr. Secretary, you propose a 12-percent tax credit on utilities. I wonder if you would also extend that for all solar activity. You are decreasing to some degree the competitiveness of the solar heating and cooling of individual homes. I do not think that you want to do that.

Secretary SIMON. Our proposals direct themselves, Senator Gravel, to utilities, and if the utility was generated by solar energy——

Senator GRAVEL. I am talking about the home. Why do you want to give an investment tax credit to the utility? Is there a purpose?

Secretary SIMON. Let me start first by saying what I said to the Ways and Means Committee last July when I made this proposal. We do not wish as a general rule to be giving massive incentives, but the energy problem in general and the utility problem, in particular, is of pressing importance. In the last year; we have had approximately 250 nuclear coal-fired plants canceled for a lot of reasons.

So we think that to present a program that directs itself to this problem of utility financing, construction of nuclear coal-fired facilities, deserves the attention that it does get in this six-point program. That is why we just direct ourselves specifically or purely to utilities.

Senator GRAVEL. If we are making mistakes in the nuclear area, it does not make much sense to give investment tax credits to try and paper it over. It could be a very serious technological or social error that we are making. So I am suggesting, if you want to do that, if you want to help build nuclear plants and build coal plants, then why don't you also build some solar plants which are not tied into the umbilical cord of the utilities?

Secretary SIMON. I do not pretend to be an expert in solar energy. There has not been the technical research and development that has been able to bring the cost down to a reasonable level.

Senator GRAVEL. Well, I am sure when you bring it down, you will still have the 12-percent differential.

Secretary SIMON. That is why in our research and development, $2 billion in R. & D., we are spending a portion of that on solar.

Senator GRAVEL. The administration has just cut down drastically in the solar energy and has cut down on the conservation. Since you want to help the utilities, maybe we could put on a similar tax device so that energy conservation and solar share in that benefit, and I will even throw in the recycling of materials.

If I could get an agreement from you on saving energy in all of these areas——

Secretary SIMON. Let me get the costs of these various areas and find out also from ERDA—I assume you are asking——

Senator GRAVEL. I have a letter here from EPA that talks about recycling and the inequity that exists.

Mr. Secretary, I do not know if you are skewing something in the wrong direction. You already have a cost for utiliites, and you have decided we should do it for utilities. But if it costs so much, we will not do it for another part of society. Either make them all equal in treatment and give them incentives——

Secretary SIMON. The point in the utilities areas, both in the nuclear and coal-fired plants, is the dramatic need for putting back into investment not only the 250 plants postponed and deferred, but also to provide for future electrical generating plants. It is apparent that the cost of solar energy and the supplying of solar energy, which is necessary, is longer term.

Senator GRAVEL. Mr. Secretary, we have spent $50 billion on nuclear up to today, and it is still in trouble. Now you are giving a greater tax incentive in that direction. If we wanted to spend that kind of money on solar, we would probably be 25 percent dependent on solar and the people would have an option.

I submit that I cannot take that as an answer. I would just suggest that we should look again. I believe that we should give a similar tax credit for solar energy, for conservation and for recycling. If I could get a response to that, I would appreciate it.

Secretary SIMON. Well sir——

Senator GRAVEL. Thank you.

POSSIBLE ADVERSE EFFECTS IN REPEAL OF DISC

The CHAIRMAN. Mr. Secretary, Senator Bentsen will be right back. Meanwhile, I have your Department's response to some questions I asked on the DISC. The memo says that if we repeal the DISC, we will lose somewhere between 200,000 and 350,000 jobs. It also estimates that it will reduce our exports by somewhere between $4 and $6 billion.

Now, if you took an average figure, that means a repeal of the DISC would reduce exports by about $5 billion and that it would cause us to lose, if you took an average figure, about 300,000 jobs a year.

As I understand it, the DISC seeks to do for our manufacturers what the Europeans are doing for theirs. Most of their taxes are excise-type taxes, value-added taxes. They simply rebate those value-added taxes and consumer-type taxes to their manufacturers on things that they export to us.

Most of our tax revenues come from income tax. As I understand it, the DISC is an effort to reduce the tax burden on the people who manufacture the things here and ship them abroad. Now, if it is providing us with 300,000 jobs——

Secretary SIMON. 330,000 jobs.

The CHAIRMAN. I do not have the figure here.

Secretary SIMON. We gave this to you in response to your questions of DISC.

The CHAIRMAN. The job impact is from 235,000 to 350,000 additional persons employed.

Secretary SIMON. Yes, sir.

The CHAIRMAN. Now, we voted for a jobs bill which the President said would cost us about $20,000 per job. Now, you can argue about the figure, but the DISC acts to reduce our deficit in the balance of payments by putting people to work, and the only cost is just not to tax as much on the production of those jobs as you would tax if those were jobs with the market being inside the United States. So the jobs we get by the DISC come at no cost to the Treasury because you would not have the jobs if you did not have the DISC.

Secretary SIMON. I agree with everything you are saying, Mr. Chairman.

The CHAIRMAN. If you repeal the DISC, you are going to put 300,000 people out of work and lose money from the Treasury, unless you plan to just turn your back on the fact that all these people are out of work. I do not know of one of my liberal colleagues who is in favor of doing that.

It would seem to me that unless someone can demonstrate that they are making money for the Treasury or that they are somehow picking up jobs with it, it seems to me that we would do well to leave this thing alone.

Secretary SIMON. We can go on debating about this DISC program, Mr. Chairman. It has not been in place long enough to really come up with some firm and hard statistics on it, but we do know that there have been many, many corporations that have gone to a great expense to put the DISC program into effect in their corporations.

We are at a point in our economy with unutilized capacity, and during a period of unutilized capacity, anything that promotes exports is going to promote jobs in our economy. This economic fact of life is clear. As you look at these statistics, you find that where we had about a 15-percent share of the total world exports in 1971 and 1974, it is up around 16½ percent now. All of this is not, certainly, DISC, floating exchange rates and other things, of course have had an impact. The DISC has had a positive effect.

We can argue whether or not the positive effect has been worth the cost, although your point is one I can see. The creation of jobs during this period would not have occurred, had it not been for a tremendous amount of exports.

The CHAIRMAN. You allow the Europeans to rebate taxes and help the people to ship their products into our market, which costs us jobs over here. This DISC is just a drop in the bucket compared to what those people are doing to help their manufacturers capture our market. You are nodding, and it will not be recorded in the record.

Secretary SIMON. Put in a nod.

The CHAIRMAN. The record will show that the witness is nodding in the affirmative.

Senator FANNIN. I ask that my statement be placed in the record.

The CHAIRMAN. I will have it placed in the record and the other inserts also will be placed in the record.[1]

The CHAIRMAN. Senator Bentsen, who has hastily made his way to the floor to answer the rollcall, is prepared to chair this hearing

[1] See p. 43.

while the rest of us go vote. If the other Senators do not come back here by the time Senator Bentsen has finished questioning you, perhaps it would be better if we could carefully read and study your statement and maybe you could come back up and answer some further questions about it later on.

Senator BENTSEN. Have I been left with all of the proxies?

The CHAIRMAN. You also have mine.

GRADUATED CAPITAL GAINS TAX

Senator BENTSEN [presiding]. I do not believe anyone should be able to live off of economic income or a big cash flow without paying any taxes. Yet even if the present minimum tax were doubled, or tripled, it would still not affect the person who pays no tax but has a big cash flow.

Secretary SIMON. I agree with you, Mr. Chairman, and that is why we are back with our old proposal which I originally submitted in 1973. The present tax is basically a tax on long-term capital gains and not just an increase. I agree with you completely.

Senator BENTSEN. What your proposal is and what I have been working for is an alternative tax to help assure that all persons pay a reasonable tax on large cash flow.

Secretary SIMON. Yes, sir.

Senator BENTSEN. That is the purpose of your proposals, as I understand it.

Secretary SIMON. Yes, sir.

Senator BENTSEN. It is a graduated tax.

Secretary SIMON. Yes, and it is simpler, too.

Senator BENTSEN. I voted against the amendment offered on the Senate floor to the present minimum tax that would have resulted in no increase at all to persons who paid no tax and who had a big cash flow, but would have merrily increased taxes for persons already paying large taxes. I think that would work absolutely reverse of what we are trying to accomplish here. Do you concur in that?

Secretary SIMON. Yes, of course. That is the direction that we are trying to head in, the same direction you did. We, of course, are not including any charts in this for the obvious reasons. I do feel compelled to mention that.

Senator BENTSEN. For the obvious reasons that you did not want to answer all of that mail from persons who oppose changes in the taxation of charitable gifts either.

Let me get to the graduated capital gains tax. I am very pleased to see that you have proposed what I introduced in 1973. Today, where you have an asset held for a long time and with the inflation factor built in, often you do not really see a true increase in value, but you see the inflation factor reflected.

So you have people making tax decisions and not economic decisions. You are locking up capital in this country. You see the small businessman. He looks at his retirement age and he does not like to carry the business on. He does not want to merge into some company because he wants diversion, yet he looks at his potential capital gains tax. He has a 35-percent rate and then if he is in New York or California, has a high State tax.

He looks at the preference tax, and the tax is up to about a 45-percent rate. So he does not sell it. It is all locked up. He is making a tax decision and not an economic decision, and the capital is blocked, and the Treasury does not get any of it either.

Secretary SIMON. Right.

Senator BENTSEN. So you are proposing a graduated capital gains tax and, in turn, as I understand it, increasing the holding provision to a full year.

Secretary SIMON. Yes, sir.

Senator BENTSEN. Which is what I proposed in my legislation in 1973.

Secretary SIMON. In the Ways and Means when we first talked about this in the spring of 1973, they adopted a proposal similar to what we are talking about here this morning. No one knows fully what the ripple effect will be in the economy by unlocking all of these assets.

We have had long economic debates on it. I happen to think it will be substantial.

Senator BENTSEN. At least, certainly, we will begin to pick up more taxes as a result of it.

Secretary SIMON. Potentially, very substantially.

Senator BENTSEN. Now, on the capital loss provision, that has not been increased, as I recall, since 1942. $1,000 capital loss provision.

We have had about a 400-percent increase in disposable income since then.

Back in about 1963, the private investor had about 70 percent of the cash flow in the New York Stock Exchange. Well, he must be under 30 percent now. Hopefully, raising the capital loss provision to $4,000, where it would moderate some risk to the small investor, would be helpful.

Secretary SIMON. I agree with that. I agree with that, Mr. Chairman.

Senator BENTSEN. Mr. Secretary, I understand that the chairman has agreed to your departure at 12 o'clock. You have a meeting?

Secretary SIMON. I have an appointment with the President but I will be glad to leave Charlie and Bill here to answer any questions.

Senator BENTSEN. Thank you very much, Mr. Secretary.

We will recess, then, until tomorrow morning at 10 o'clock.

Mr. Secretary, thank you very much.

Secretary SIMON. Thank you very much, Mr. Chairman.

[The prepared statement of Secretary Simon and material referred to by the chairman at p. 23 of this volume, follows. Oral testimony continues on p. 127.]

QUESTIONS RAISED BY SENATOR LONG RELATING TO DISC

(Prepared by the Treasury Department)

This memorandum responds to the points raised in Senator Long's letter of September 30, 1975, to Secretary Simon. The Senator raises specific questions regarding DISC, its operation and effectiveness. In answering these questions, reference is made to the Annual DISC Report, to underlying data, and to a number of private surveys and studies which examine the effect of the DISC legislation. The Treasury Department does not endorse the

methodology or results of the surveys and studies other than its own Annual Report. The surveys and studies presented as attachments are:[1] Attachment A—Special Committee for U.S. Exports; Attachment B—International Trade Club of Chicago; Attachment C—Eastman Kodak; Attachment D—General Electric; and Attachment E—FMC Corporation.

1. *DISC Elections and Active DISCs.*—The number of DISC elections as of October 31, 1975 was 8,303. This number greatly exaggerates the use of DISC as many of these DISCs are currently-inactive. The 1974 DISC Report will cover about 4,000 DISC returns, an increase of over 40 percent over the 2,827 DISC returns covered in the 1973 DISC Report. While this is a substantial increase in the number of active DISCs, DISC exports as a percent of total United States exports have not increased as dramatically. In fiscal 1973, DISC exports accounted for 37 percent of total U.S. exports, while in fiscal 1974, DISC exports accounted for about 50 percent of the total.

2. *Cost-Effectiveness of DISC.*—Much of the dispute concerning the cost-effectiveness of DISC arises from contrary assumptions concerning its general equilibrium impact. A general equilibrium analysis would attempt to evaluate all direct and indirect changes brought about in the U.S. economy by the DISC legislation. In other words, how does DISC affect the exchange rate? How do increases in export employment affect total employment? How do changes in total employment affect total tax collections? Answers to these questions depend on a variety of assumptions concerning the trade account of the balance of payments, the capital account of the balance of payments, the "multiplier" effect of export employment, and the responsiveness of Federal tax collections to total employment. Rather than make difficult assumptions concerning these issues, this memorandum focuses on the immediate export, employment, and revenue consequences of the DISC program.

3. *Incremental Export Effect of DISC.*—It is difficult to estimate the incremental export effect of DISC for at least three reasons: (1) the statistical problems explained on pages 26-28 of the 1973 Annual Report; (2) the fact that the export stimulus probably takes a number of years to make itself fully felt; (3) the possible general equilibrium effects under a system of flexible exchange rates. The Treasury has nevertheless attempted to use the available data to make an estimate of incremental exports created by DISC, leaving aside the general equilibrium aspects.

During the period July 1972 to June 1973, it seems unlikely that DISC provided any significant stimulus to nonmanufactured products. However, there appears to have been a $1.6 billion increase in exports of manufactured products as a result of DISC. The $1.6 billion increase is in addition to export growth caused by devaluation of the dollar, expansion of foreign income, and other forces. The methodology underlying this estimate appears in Exhibit 1. The revenue cost of DISC was approximately $400 million during the July 1972 to June 1973 period. These figures suggest that exports were increased by about $4 for each $1 of revenue loss. Estimates using different approaches suggest that the ratio could be somewhat higher or lower than $4 to $1. In 1975, the revenue cost of DISC was about $1.3 billion. Assuming the same ratio between incremental exports and revenue loss, the implied increase in 1975 exports on account of DISC would perhaps be in the range of $4 to $6 billion. Certain companies have submitted information to the Treasury concerning the impact of DISC on their export operations. Statements received from Ingersoll-Rand, Eastman Kodak, General Electric, and FMC Corporation appear as Attachments A, C, D, and E.

4. *Effect of DISC on New Exporters.*—The effect of DISC on new exporters cannot be estimated from available data. Because of the numerous factors which go into a decision to enter export markets, we do not believe that any reliable estimate of the impact of DISC in encouraging new firms to become exporters can be made.

5. *Effect of DISC on Export Marketing and Export Sales Promotion.*—It would be difficult to obtain a quantitative measure concerning the incremental effect of DISC on export marketing and sales promotion efforts. An attempt to assess the effect of DISC on export marketing and sales promo-

[1] These attachments were made a part of the official files of the commitee.

tion efforts has nevertheless been made by the International Trade Club of Chicago by circulating a questionnaire which asked questions on the subject (Attachment B). The statements received from the Special Committee, General Electric, and FMC Corporation also bear on this question (Attachments A, D, and E). We understand that the Department of Commerce has also used a survey approach in an attempt to assess export marketing efforts. However, it seems doubtful whether any survey could accurately determine the incremental effect of DISC on export marketing and sales promotion efforts.

6. *Product and Country Effect of DISC.*—The available data does not permit a reliable determination of the export effect of DISC by product and country. Nonmanufactured products are probably least affected both because DISC income tends to be a small portion of the sales price (Table 3-2 of the 1973 Annual Report) and because other factors principally determine the export outlook for nonmanufactured products. The impact on manufactured goods may be distributed approximately in accordance with the importance of those goods in DISC export sales (Table 3-2 of the 1973 Annual Report). Likewise, the impact by country may be distributed approximately in accordance with the geographic destination of DISC sales (Table 3-4 of the Annual Report).

7. *Domestic Employment and Capital Investment.*—Leaving aside general equilibrium aspects, the effect on domestic employment follows from the export consequences of DISC. On average, an additional $17,000 of manufactured export sales may produce one additional job. The methodology underlying this estimate appears in Exhibit 2. Thus, if DISC stimulated 1975 exports by between $4 and $6 billion, the job impact would be between 235,000 and 350,000 additional persons employed. This is an estimate of the average impact; it does not reflect possible changes in productivity per man associated with marginal changes in output. Attachments A, C, D, and E present statements by Ingersoll-Rand, Eastman Kodak, General Electric and FMC Corporation concerning the employment effect of DISC for their firms. DISC would also encourage investments in the export industries, but the amount of new investment will depend on many things including the level of existing spare capacity, the prospect for future export sales, and the competition for capital from non-export industries. The prospect of repeal or limitation of DISC would adversely affect its investment incentive.

8. *DISC and the Ability to Meet Foreign Competition*—An important argument for the DISC legislation was to enable U.S. exporters to compete on a tax basis both with foreign production for the local market and with exports from our principal industrial competitors. Evidence on preferential foreign tax practices and the importance of DISC to particular U.S. firms in meeting foreign competition has been presented by the Special Committee for U.S. Exports, Eastman Kodak, and General Electric. This evidence is contained in Attachments A, C, and D.

9. *The Use of DISC by Small Business.*—Since the great bulk of exports are shipped by large firms, it is not surprising that a major share of the tax benefits of DISCs accrued to large exporters. Nevertheless, the 1973 Annual Report indicates that small firms have made use of the DISC mechanism (Tables 4-4 and 4-5 of the 1973 Annual Report). Of 1,510 DISCs with corporate owners for which asset size data was available, some 767 DISCs belonged to parent companies with assets under $10 million. Of 1,167 DISCs reporting full year gross receipts, about 570 DISCs had gross receipts of less than $1 million.

10. *Impact of DISC on Multinational Companies.*—Most American-based multinational companies have established a DISC. To the extent that DISC has promoted U.S. exports, it seems reasonable to suppose that these firms have altered the worldwide sourcing of their export sales. However, neither the DISC return nor other tax returns gather information on the worldwide sourcing of export sales. We understand that the Commerce Department is planning a survey of U.S. direct investments abroad, and the survey should cover the worldwide sourcing of export sales. The survey was originally scheduled to cover the year 1973, but it has been delayed by other work. The Department of Commerce can provide more detailed information on the planned coverage and scheduling of the survey.

11. *The Effect of DISC on Corporate Foreign Investment Decisions.*—By making export production in the United States more attractive, DISC has probably encouraged firms to invest in the United States rather than abroad. Again, neither the DISC return nor other tax returns gather information on this question. One way of evaluating the impact of DISC on corporate investment decisions would be to circulate a questionnaire eliciting qualitative responses from senior executives. For example, the question might be asked: "Has DISC caused a relative increase in your domestic investment, with a corresponding reduction in your foreign investment?" This type of question has certain difficulties. In a large company, the person answering the question will often not have first hand knowledge of foreign investment planning decisions. Moreover, biased answers may be given, particularly if it is known that the survey could have an effect on tax legislation. A better approach is to evaluate foreign investment decisions on the basis of quantitative data concerning past events. This approach awaits the data that the Department of Commerce will collect in its planned survey of U.S. direct investments abroad.

Exhibit 1

ESTIMATED EFFECT OF DISC ON U.S. EXPORTS IN "1973"

SUMMARY

During the period covered by the 1973 DISC report, the estimated effect of DISC on U.S. exports of manufactured products was $1.64 billion and the associated revenue cost was $331 million. The 1973 DISC report covered annual accounting periods of DISCs ending between July 1972 and June 1973. This period is referred to below, for convenience, as "1973", and the corresponding year earlier period as "1972".

In interpreting these figures, the severe time period and product class incomparabilities between DISC and total U.S. export figures noted in the 1973 DISC report must be borne in mind. In addition, it must be pointed out that these estimates do not include the general equilibrium effects of the DISC legislation on U.S. exports, imports, or revenue collections.

METHODOLOGY

(i) Manufactured products—Using the growth rates in Table 5-1 of the 1973 DISC Report and underlying dollar amounts, U.S. exports in "1972" and "1973" were divided into DISC-related and non-DISC-related goods. The growth rates for non-DISC-related exports between "1972" and "1973" were then applied to total "1972" exports, yielding an estimate of what "1973" total U.S. exports would have been in the absence of DISC. The difference between this figure and actual total U.S. exports in "1972" represents the estimated effect of DISC on U.S. exports. The associated revenue cost is 24% of the net income earned by manufactured products DISCs in "1973".

(ii) Nonmanufactured products—Agricultural commodities constitute virtually all DISC exports of nonmanufactured products. Because factors other than DISC completely dominate exports of agricultural commodities, it is impossible to estimate the effect of DISC on exports of nonmanufactured products.

Exhibit 2

ESTIMATED EFFECT OF DISC ON U.S. DOMESTIC EMPLOYMENT IN 1975

SUMMARY

Ignoring general equilibrium and "multiplier" effects of DISC on U.S. exports, U.S. imports, and employment, the effect of DISC on employment in export industries and their suppliers for 1975 is estimated at between 235,000 and 350,000 additional persons employed. This estimate is based on an underlying estimate that DISC stimulated U.S. exports by between $4 and $6 billion during 1975.

METHODOLOGY

Using national income and employment figures from the *Survey of Current Business* (shown in the table below), nonagricultural GNP was divided by nonagricultural employment to arrive at an average output figure. This average output per job figure of $17,000 was then divided into the estimated $4-$6 billion export increase stimulated by DISC. The result is an estimated DISC-related employment stimulus of between 235,000 and 350,000 additional jobs.

This estimate does not reflect the general equilibrium impact of DISC on the exchange rate for the dollar, on U.S. imports, or on non-DISC U.S. exports. Nor does the estimate reflect the "multiplier" effect of a DISC-related employment stimulus on other sectors. Finally, the estimate does not reflect possible changes in productivity per person associated with marginal changes in output.

1975 gross national product and employment figures

[Dollars in billions]

Gross national product:	
Agricultural[1]	$55
Nonagricultural	1,373
Total[2]	1,428
Employment: Nonagricultural[3]	80,387,000

[1] *Survey of Current Business*, Aug. 1975, p. S-1. This is an average figure based on the first 3 quarters of 1975.
[2] *Survey of Current Business*, Jan. 1975, p. 31. Estimates based on 1974 figures.
[3] *Survey of Current Business*, Aug. 1975, p. S-13. Estimate based on the average employment from January-June 1975.

[Annex III]

INTERNATIONAL ECONOMIC POLICY AND RESEARCH—ESTIMATE OF COST EFFECTIVENESS OF THE DISC LEGISLATION

(By Charles S. Friedman)

FOREWORD

The Department of Commerce has received inquiries on the effectiveness of the benefit to exporters which is available under the Domestic International Sales Corporation (DISC) law. The DISC provisions were enacted as Title V of the Revenue Act of 1971 (P.L. 92-178) and permit the deferral of income tax on one-half of the profits from export sales, subject to conditions prescribed by the law.

Measuring DISC's cost-effectiveness is difficult for a variety of reasons: the data available from the Treasury Department's Annual Report on DISC lags the year of operations it covers by almost two years; data are so far available from only about a third of the total number of DISC's; export performance during the period since DISC was enacted has been strongly affected by large exchange rate changes and other powerful forces. However, the most recent DISC Report, published by the Department of the Treasury in April of 1975, and some subsequent data permit an appraisal to be made of DISC's performance which goes a little way beyond what has hitherto been available.

Since the beginning of 1972 exporters have been able to defer Federal income taxes on up to one-half of their export profits by forming special corporations called Domestic International Sales Corporations (DISCs). The DISC legislation was added to the tax code in December 1971 as an incentive to exporters in order to increase U.S. exports. According to Treasury Department estimates, this incentive has generated a significant loss of current revenue to the U.S. Treasury, i.e., $1.3 billion in tax deferrals during 1975. This loss, which represents the price to the U.S. taxpayer for maintaining this export incentive, must be compared with the amount of U.S. exports the DISC incentive generates to measure the cost effectiveness of the DISC legislation.

According to Treasury staff estimates based on data from the first full year of operation of DISC, i.e., returns from tax years ending on or before June 30, 1973, the value of the contribution to U.S. exports caused by the DISC is about four times the amount of current revenue loss caused by the DISC tax deferral. Based on this estimate, in 1975 the DISC generated about 5.2 billion dollars worth of extra exports out of a total of $107 billion U.S. exports.[1] Thus without the DISC incentive U.S. exports would have only been about $102 billion.

Changes in the U.S. export performance affect the amount of Gross National Product (GNP). According to the latest econometric studies, GNP tends to increase by two to three times the value of the increase in U.S. exports. This relationship implies that the approximate $5 billion increase in U.S. exports induced by DISC in 1975 would have accounted for a $10 to $15 billion increase in GNP for that year. Recent studies also indicate that a $10 to $15 billion gain in GNP will generate $2-$3 billion in Federal taxes. Accordingly, the direct revenue loss by the DISC tax deferrals ($1.3 billion in 1975) is more than offset by the indirect effect of the increased exports on increased GNP revenue gains ($2 to $3 billion indirect revenue gains in 1975).

Treasury estimates also indicate that the $5.2 billion in DISC induced exports in 1975 gave rise to about 300,000 export related jobs. Based on Bureau of Labor Statistics (BLS) data on the average number of jobs per $1 billion of merchandise exports, the number of export related jobs generated by the DISC was about 180,000 in 1975 out of a total of some 4 million export-related jobs. Furthermore, the $10 to $15 billion GNP gain, which resuted from the DISC induced exports in 1975, is estimated to have given rise to about 600,000 to 900,000 jobs in the entire economy, out of the total U.S. employment figure of approximately 85 million.

An exposition of the methodology used to determine the export increase due to the DISC, with an appropriate caveat follows, (Annex I), as well as the methodology for the GNP, employment and indirect revenue gains (Annex II). Also attached is a table showing the projected estimates of DISC performance over several years (Annex III). Finally, there are the basic Treasury documents on the "Estimated Effect of DISC on U.S. Exports in 1973" (Annex IV), and "Estimated Effect of DISC on U.S. Domestic Employment in 1975" (Annex V).

Annex I

Export Increase Attributable to DISC

According to the latest Treasury Annual Report on "The Operation and Effect of the DISC Legislation"—published in April 1975—the weighted average growth rate of all DISC related exports in 1973[1] was 32.6 percent relative to 23.4 percent growth for all U.S. exports adjusted to correspond to the product class and time period composition of the DISC figure (See Table 5-1 of the April 1975 Treasury Report). The DISC figures are based on reports from 321 DISCs with current export receipts of $16 billion which reported with at least one year of usable data on exports by June 30, 1973. The assumption underlying these adjusted growth rates was that the exports of both DISC and non-DISC firms were equally affected by events influencing U.S. exports during the period in question, such as devaluation, inflation, expanding world trade, price controls, agricultural problems etc.[2] The Treasury's growth estimates for manufactured products, estimated by the Treasury report was 18.2% for DISC and 11.8% for U.S. exports. These growth rates make it possible to calculate the dollar amount of the export of manufactured products attributable to DISC. The Treasury Tax Policy Staff estimates that during the FY 1973 period covered by the April 1975 DISC report, the effect of DISC on U.S. exports of manufactured products was $1.64 billion and the associated revenue cost was $331 million (See Annex IV).

---

[1] Treasury estimates that the amount of export going through DISCs was $78 billion in 1975.

[1] The DISC data covered full taxable years ending from December 1972 to June 1973.

[2] In order to compare DISC data with that of U.S. exports a partial adjustment for time period disparities was made by calculating growth rate of U.S. exports for each of the 12-months periods ending between December 1972 and June 1973 and then calculating a weighted average of these rates, using as weights the export sales of full year DISCs with corresponding fiscal years.

According to the Treasury, "the $1.6 billion increase is in addition to export growth caused by devaluation of the dollar, expansion of foreign income, and other forces." However, Treasury assumes that DISC did not provide "any significant stimulus to non-manufactured products." As a result of this assumption, the $1.64 billion increase in exports of manufactured products for the period is shown as the total contribution of DISC. The total revenue cost of DISC was approximately $380 million during the period covered by the DISC report. These figures suggest that exports were increased by more than $4 for each $1 revenue loss, assuming that exporters of non-manufactured goods are not affected by the DISC incentive.

If this four to one ratio of cost effectiveness is projected to 1975 one should consider potentially positive and negative developments. The positive is that pronounced changes in export pattern in response to the DISC incentive are bound to be more in the later year of operation than in the initial year. The negative is that aggressive export oriented firms are likely to have established DISCs earlier than others. If it is assumed that these two factors are about equally important, the cost effectiveness ratio is likely to remain 4 to 1 in 1975. Since the cost estimate of the Treasury for calendar year 1975 was $1.31 billion, $5.2 billion is the likely export increase attributable to DISC in that year.

CAVEAT

It is necessary to point out that caution must be exercised regarding these estimates. One reason is that only one year's data on DISC are available. Moreover, sufficient precision in the adjustment for composition and time period differences between DISC and U.S. exports could not be achieved. Rapid export growth by DISC relative to non-DISC exporters during the first year of the DISC incentive may have been the result, to some extent, of the readiness of the more export conscious firms to form DISCs at the outset. The estimated effects of export on GNP and taxes are based on econometric models of which the underlying equation structure attempts to approximate the working of the economy. However, forecasts and relationships derived from econometric models may not always be correct and varies from model to model as well. The employment impact of additional exports presented in this paper is based on estimates of average relationships from earlier input-output tables. The actual job effect of a change in exports may be different from the average relationship. In conclusion, these actual and potential shortcomings in the available data base could have an important effect on the above estimates.

Annex II

Effect on GNP, Employment and Revenues

The GNP effect of the DISC induced exports can be estimated from the econometric model of the United States economy of the Bureau of Economic Analysis of the Department of Commerce. A $1 billion sustained increase in the value of exports is likely to result in about $3 billion annual increase in GNP. These figures are similar to unpublished estimates prepared by the Wharton School of the University of Pennsylvania. Using these figures, the GNP effect of the DISC incentive in 1975 was likely to have been $15.6 billion, i.e., three times the $5.2 billion export increase attributable to DISC and 12 times the $1.3 billion tax deferral caused by the DISC legislation. It should be noted, however, that according to some econometric estimates the export multiplier may be as low as 2. Thus, the DISC induced GNP expansion could be as low as 8 times the tax deferral, i.e., $10.4 billion in 1975. Based on average relationships between GNP and Federal tax revenue one-fifth of these GNP increases can be estimated as the related increase in Federal tax revenue, i.e., $2 to $3 billion. This estimated increase in Federal tax revenue is considerably more than the $1.3 billion DISC related tax deferral.

The $5.2 billion export increase attributable to DISC in 1975 was likely to account for 181,000 export related jobs, on the basis of a preliminary BLS estimate of 34,900 jobs associated with $1 billion merchandise exports in 1975. BLS estimates for 1972, 1973 and 1974 used in this paper are 57,400, 47,600

[1] The reason for the declining numbers is inflation and increased productivity.

and 38,600 jobs per $1 billion exports.[1] However, it should be noted that according to Treasury estimates, the same $5.2 billion exports accounted for as much as 300,000 jobs in 1975. This estimate is based on the number of jobs associated with $1 billion non-agricultural GNP (58,500 in 1975).

This paper estimates that the $10.4 to $15.6 increase in GNP generated by DISC induced exports in 1975 created 600,000-900,000 jobs since the number of jobs per $1 billion GNP was about 57,000 in 1975. These estimates and other relevant indicators are summarized in the following table.

Annex III

INDICATORS AND ESTIMATES OF DISC PERFORMANCE

	1972	1973	1974	1975 [1]	1976 [2]
	Billions of dollars				
U.S. exports (total)	48.4	69.7	97.8	107.0	120.0
DISC exports (total)	19.7	38.4	62.8	77.8	88.8
Taxes deferred by DISC	.35	.64	1.05	1.31	1.49
DISC induced U.S. exports [3]	1.4	2.6	4.2	5.2	6.0
Effects of the DISC induced U.S. exports:					
(1) GNP gain:					
A. Low estimate (2X)	2.8	5.2	8.4	10.4	12.0
B. High estimate (3X)	4.2	7.8	12.6	15.6	18.0
(2) Federal tax receipts associated with GNP gain (1/5 of GNP gain):					
A. Based on low estimate of GNP gain (2X)	.56	1.04	1.68	2.08	2.40
B. Based on high estimate of GNP gain (3X)	.84	1.56	2.52	3.12	3.60
	Thousands of jobs				
(3) Jobs generated by DISC stimulated exports:					
(1) Using Labor (BLS) assumptions	80	124	162	181	192
(2) Using Treasury assumptions				300	
(4) Jobs associated with GNP gain:					
(A) Based on low estimate of GNP gain (2X)	198	339	517	595	638
(b) Based on high estimate of GNP gain (3X)	296	508	775	892	957

[1] Preliminary.
[2] Projection.
[3] Four times tax deferral.

Source: Office of tax analysis, U.S. Treasury Department; Bureau of Labor Statistics, U.S. Department of Labor; Bureau of Economic Analysis, and Bureau of International Economic Policy and Research, U.S. Department of Commerce.

Annex IV

Exhibit 1

Estimated Effect of DISC on U.S. Exports in "1973"

SUMMARY

During the period covered by the 1973 DISC report, the estimated effect of DISC on U.S. exports of manufactured products was $1.64 billion and the associated revenue cost was $331. The 1973 DISC report covered annual accounting periods of DISC's ending between July 1972 and June 1973. This period is referred to below, for convenience, as "1973", and the corresponding year earlier period as "1972".

In interpreting these figures, the severe time period and product class incomparabilities between DISC and total U.S. export figures noted in the 1973 DISC report must be borne in mind. In addition, it must be pointed out that these estimates do not include the general equilibrium effects of the DISC legislation on U.S. exports, imports, or revenue collections.

METHODOLOGY

(1) Manufactured products—Using the growth rates in Table 5–1 of the period 1973 DISC Report and underlying dollar amounts, U.S. exports in "1972" and "1973" were divided into DISC-related and non-DISC related

goods. The growth rates for non-DISC-related exports between "1972" and "1973" were then applied to total "1972" exports, yielding an estimate of what "1973" total U.S. exports would have been in the absence of DISC. The difference between this figure and actual total U.S. exports in "1972" represents the estimated effect of DISC on U.S. exports. The associated revenue cost is 24% of the net income earned by manufactured products DISCs in "1973".

(ii) Non-manufactured products—Agricultural commodities constitute virtually all DISC exports of non-manufactured products. Because factors other than DISC completely dominate exports of agricultural commodities, it is impossible to estimate the effect of DISC on exports of non-manufactured products.

Statement of Hon. William E. Simon, Secretary of the Treasury

Mr. Chairman and members of this distinguished Committee: I am pleased to be here this morning as you begin your deliberations on major tax revisions and the extension of expiring tax cut provisions. You have before you an extremely challenging agenda.

This morning I will discuss H.R. 10612—the House-passed Tax Reform Bill. While many of the provisions of H.R. 10612 incorporate proposals initiated by the Administration in 1973, more work remains to be done.

I will also discuss the President's proposals to cut individual and business taxes and to reduce the rate of growth of Federal spending. I will present proposals to encourage capital formation. These proposals include integration of the corporate and personal income taxes; a job creation incentive proposal; the six-point utilities tax program: a proposal to reduce the tax on capital gains and alleviate the burden of taxation on inflationary gains by the mechanism of a sliding scale; and elimination of the withholding system on foreign investments. In addition, I will discuss general and specific estate tax revisions, as well as the relationship of the Administration's energy policy and tax policy.

The overall objectives of the Administration's tax policy are simple and fundamental. First, and foremost, our tax system must be fair. Its fairness and integrity rest upon three premises: equity, simplicity, and efficiency. A tax system not built on this foundation erodes both the confidence of taxpayers and the incentive required for economic progress and well being.

Second, our tax policy must complement and supplement our basic economic goal of achieving a growing, vigorous, and noninflationary economy. We achieve this by removing the tax barriers which impede our growth and prevent the most efficient use of our economic resources.

Third, our tax policy must contribute to a sound energy policy. Here, again, I must emphasize that allowing market incentives to operate would be the most efficient and effective means of achieving energy independence. As long as we are unwilling to rely on the market, we should retain the tax incentives we now have in place and by no means erect further impediments by increasing the tax burden on oil and gas investments.

The Administration has already proposed the following measures:

Permanent personal and business income tax reductions coupled with corresponding reductions in the size of the Federal Budget. This is the proposal which the President first made last October and reiterated in his 1976 State of the Union Message.

A plan to integrate corporate and personal income taxes and thereby eliminate the perverse effects of the current double tax on equity investments. This is the proposal I presented last July before the House Ways and Means Committee.

A six-point utilities tax program to stimulate construction of additional facilities by electric utilities, to reduce imports of foreign oil, and to insure adequate electric generating capacity in the years ahead.

A proposal to repeal the undesirable and inefficient present withholding system on portfolio dividends and interest earned by foreign investors on U.S. securities.

The Administration has also taken new initiatives to maintain and improve the health and vigor of the economy. These proposals are:

A job creation incentive program which provides for accelerated depreciation of new plant facilities and equipment in areas which experienced unemployment of 7 percent or more in 1975.

A tax incentive to encourage broadened stock ownership by low and middle income working Americans by allowing deferral of taxes on certain funds invested in common stocks.

Estate tax relief which will alleviate the effect of inflation by increasing the estate tax exemption from $60,000 to $150,000. The current exemption level has been in effect since 1942.

Estate tax relief for farmers and owners of small businesses to make it easier to continue the family ownership of a small farm or business after the owner's death.

A proposal to encourage capital formation and the efficient allocation of investment resources by the introduction of a sliding scale for the taxation of capital gains which will, in addition, alleviate the burden of taxation on inflationary gains.

The Administration is also committed to an energy policy that will achieve our goal of energy self-sufficiency.

In January 1975, the President proposed measures to conserve energy, increased domestic production and provide for strategic reserves. Although the Energy Policy and Conservation Act contemplates eventual decontrol of oil prices, its immediate effect is to roll back the average price of oil. Prices of natural gas are still controlled in interstate markets. As long as we refuse to remove these government-imposed controls, and thereby prevent free market incentives from increasing domestic energy supplies, we will continue our dependence on foreign imports and our vulnerability to political blackmail. For these reasons, we are opposed to the provisions of H.R. 10612 which would erect further impediments by increasing the tax burden on investments in oil and gas.

Further, in order to accelerate the replacement of obsolete oil and gas fired electric generating capacity, we are proposing that you enact the six-point electric utilities program recommended by the President's Labor Management Advisory Committee.

With respect to tax reform, the Administration's goals are to:

Improve the equity of our tax system at all income levels. This principle goes beyond the concept of vertical equity or progressivity which holds that those with higher incomes should pay a larger share. It extends to the more basic idea that the tax system of a democratic society must be fair to all taxpayers and must be widely recognized as such;

Simplify many of the tax provisions of the Code which seriously affect the taxpayer's ability to cope with the preparation of his income tax return;

Make improvements in the ways in which our tax law is administered.

At the same time, of course, our tax system must be conducive to the stable growth of our domestic economy and the long-run improvement of our position in world markets.

In 1973, the Administration made a number of tax reform proposals. In the nearly three years that have elapsed, much has been done by the House Ways and Means Committee. H.R. 10612 incorporates to varying degrees many of our 1973 proposals. We are, therefore, renewing the following proposals:

LAL (Limitation on Artificial Losses) to deal effectively with the problems associated with tax shelters by a solution which reaches their most common feature: Bad tax accounting rules which mismatch expenses and revenues and thereby produce artificial accounting losses. While we continue to endorse the LAL concept, under current circumstances we find its application to oil and gas investments to be inappropriate and inefficient.

MTI (Minimum Taxable Income) which, in combination with LAL, deals with the problem of taxpayers with high economic income who pay little or no Federal income tax. H.R. 10612 rejects this proposal in favor of an expansion of the current minimum tax which does not subject taxpayers with high economic income to progressive tax rates.

A simplification package designed to alleviate the intolerable reporting burden imposed upon the average taxpayer.

We also have a number of specific recommendations on various aspects of the House Bill and I shall therefore devote a substantial portion of my time to H.R. 10612.

I. CONTEXT FOR TAX POLICY

Maintaining and Improving the Health and Vigor of the Economy

The Administration's economic policies, as outlined by the President in his State of the Union Message, are designed to keep the economy on an upward path toward two central long-term objectives: Increasing steadily the number of real, rewarding, permanent jobs, and sustained noninflationary economic growth.

The most immediate concern, of course, has been to support the recovery of the economy from the most severe recession in the post-World War II period in a manner which will achieve full employment as rapidly as possible without rekindling inflationary pressures and expectations. Achievement of this objective will not only provide jobs for all who wish to work but, equally important, will reestablish the basic economic conditions necessary to sustain strong and continuous real economic growth which can provide permanent employment gains and a rising standard of living for all Americans.

Status of Economy

I am pleased to be able to report substantial progress in the recovery of the U.S. economy. Gross national product in real terms has increased by 5 percent since the trough of the first quarter of 1975 and is rapidly approaching the peak level of the fourth quarter of 1973. (Table 1). At the same time, the rate of increase in consumer prices has continued to diminish. During the last three months of 1975, the rate of inflation fell to 6.6 percent on an annual basis. January data are even more favorable, showing a seasonally adjusted annual rise of only 5 percent in the consumer price index (Table 2). The recent declines in the wholesale price index augur well for continuing progress on the inflation front.

Civilian employment continues to improve, showing an increase, seasonally adjusted, of over 900,000 in January and February to 86.3 million, the highest level since mid-1974. This improvement is reflected in unemployment rates which dropped seven-tenths of a percentage point in January and February to 7.6 percent—substantially below the peak unemployment rate of 8.9 percent in May of last year. Furthermore, improvements in employment have been accompanied by greater labor productivity which increased over 4 percent from the first quarter to the last quarter of 1975.

Short-Term Policies

Despite this advance of the economy, the overall rate of utilization of physical and particularly human resources remains unacceptably low relative to long-term objectives. Many advocate a highly stimulative fiscal and monetary policy to cure this problem quickly. However, the risk in greatly stimulating the economy at this time is that this will set off another round of inflation, thereby undermining the economic recovery under way. Thus, our policies for the short term must be to keep the present recovery on track in order to provide a steady and sustainable increase in productive jobs. While employment might be raised somewhat more rapidly in the short run with massive fiscal and monetary stimulation, such stimulus would lead to renewed inflation, an eventual decline in the pace of economic activity, and renewed unemployment.

There is still an important role for tax policy for the short term. Thus, as discussed in more detail later, the Administration proposed special temporary tax incentives to encourage construction of new facilities and purchases of equipment in areas in which unemployment exceeds 7 percent. The objective of this program is two fold. First, it will provide immediate relief to the unemployment problem of the construction industry, one of the most depressed industries in our economy. Second, the incentive will be provided in areas of high unemployment where new jobs are most needed.

Long-Term Policies

Our policies for the long term must be to create an economic environment which encourages individuals to save and businesses to invest, and thereby to restore the dynamism of our economy. The Administration has long and continuously emphasized the need for a higher rate of capital formation, and

I shall have more to say on this topic in a moment. At this point, I simply note that we cannot expect businessmen to assume the risks of business expansion unless the Federal government does its share to provide a stable climate in which sound business decisions can be made. This means stable prices, ready access to financial markets, and the certainty that the Federal government will not make increasing tax claims on the returns flowing from these investments.

Two conditions are essential if we are to make substantial progress toward achieving our long-term goals:

First, the rate of growth of Federal spending must be reduced and we must move to a position of budgetary balance. The Administration's program of spending restraint coupled with tax reductions will help us meet the first condition. The Federal deficit will be reduced from an estimated $76 billion in Fiscal 1976 to $43 billion in Fiscal 1977 and to budgetary balance by Fiscal 1979.

Second, economic incentives must be provided for saving and investment in order to increase the rate of capital formation. Several of the tax proposals which the Administration recommends are designed to promote such saving and investment. More precisely, these recommendations are designed to remove some of the disincentives to saving and investment which are inherent in our existing tax structure. Thus, as I will discuss in greater detail later, we recommend the following tax measures: A permanent reduction in corporate income tax rates from 48 percent to 46 percent and a permanent reduction of the tax rate on the first $50,000 of corporate income to replace the current temporary provisions; a permanent 10 percent investment tax credit; elimination of the double tax on corporate dividends; revisions in the taxation of capital gains; tax incentives to broaden stock ownership; and tax incentives to expand the use of individual retirement accounts.

We also recommend the elimination of withholding taxes on foreign investment to encourage the inflow of capital from abroad.

All of these recommendations are made out of a deep concern that the failure to increase the rate of capital formation can have profound consequences for our economy for years to come.

The dangers that can arise from inadequate capital investments over a period of years are best illustrated by the 1973 production bottleneck. In that year, industries that process such materials as steel, paper, fertilizers, chemicals, cement, nonferrous metals, and textiles were operating at the limits of their physical capacity. But they still were not producing enough goods and services to meet the demands from industries that manufacture automobiles, clothing, machine tools, and other finished products. This situation contributed to the rapid rise in inflation and ultimately to the recession of 1974–75.

Another consequence of inadequate saving and investment is that annual gains in productivity, that is total output per worker, have significantly slowed during the post-World War II period. As shown in the figures below, the growth rate of productivity, which had averaged between 2.0 and 3.3 percent per year until the mid-sixties decreased to an average of 1.5 percent over the past ten years.

U.S. productivity growth, 1950–1975

[Average annual rate over 5 year intervals]

Period:	*Gross domestic product per employed person*
1950–54	2.44
1955–59	2.13
1960–64	3.27
1965–69	1.73
1970–74	1.33

The diminishing of U.S. productivity gains takes on added significance when compared with the experience of our major trading partners. Over the past fifteen years, Japan, West Germany, France, Canada, Italy and the United Kingdom have all experienced more rapid rates of productivity growth than the U.S.: and, taken together, their rate of productivity growth is more than double ours (Table 3).

The rate of capital formation is a major determinant of the growth of productivity. Therefore, an increased rate of capital formation is required to maintain the competitive positioning of U.S. business in world markets.

Increased productivity also means that higher wages need not be passed forward as higher prices so that real income can rise for all. This point should be emphasized. In a world where yearly increases in money wages are customarily expected, our main line of defense against inflation is an economy with growing productivity. Wage increases need not lead to higher per unit costs of production as long as output per worker, or productivity, rises sufficiently. This can happen if we provide workers with more and better equipment, that is, if we maintain high rates of capital formation.

However, as I have noted on other occasions, our investment performance has not been satisfactory. The share of our national output which goes to investment has been below that of other major industrialized countries. When we look at the future, we find little grounds for believing that our capital needs will become any less intense. Indeed, all studies on this subject conclude that if we are to realize our economic goals, we must commit an even higher portion of our income to national saving and investment in the future than we have in the past.

Consider, for example, a recent study by the Bureau of Economic Analysis of the Department of Commerce on projected capital needs of the country in 1980—only four years away. That study concluded that in order to achieve our goals of full employment, greater energy independence, and pollution abatement, the ratio of business fixed investment to GNP for the decade of the seventies must be increased.

Several other studies have also concluded that to meet employment and growth objectives, the demands for investment as a proportion of GNP will increase very substantially beyond what had been experienced in the recent past. To finance the shift in resources toward more investment, more private savings and sharp reversals of government deficits will be required.

Results of these studies are summarized briefly in Table 4. Taken together, they imply a need for an increase in the rate of private savings from 15 percent to 16 percent of GNP.

Sources of Demand for Capital

The sources of demand for capital should be carefully identified.

First, there are enormous investment demands generated just in maintaining a growing labor force properly equipped with capital. Between now and 1985, the labor force will expand by approximately 16 million persons. When we add to this the three to four million unemployed today, the total is nearly half again the 13 million jobs generated during the past decade.

Second, capital is needed to achieve specific public policy objectives: accelerated development of new energy resources to make us more self-sufficient; improvement of environmental quality; safer working conditions; better housing. In the energy field alone, estimated investment needs for the next decade total $1 trillion.

Third, and most important, is the economic necessity to increase our production efficiency to raise the real standard of living enjoyed by Americans. If anything has been clearly established by economic studies over the years, it is the close relationship between capital investment and productivity. Capital investment is a key factor in increasing productivity, economic growth, and real earnings.

I do not mean to imply that investment in plant and equipment is the only factor that affects productivity. There are, of course, other factors such as new technology, the skills and growth of the labor force, access to raw materials, and the stage of the business cycle. But the more capital investment we have, the more these other factors can increase productivity.

The tax proposals which I have already mentioned and will discuss in considerably more detail are directed towards stimulating more saving and investment to meet our long-term capital needs. They will operate through increasing the after-tax profitability of investment and thereby encourage businessment to undertake more capital projects. The proposals will also provide a higher after-tax return to those who save, thereby encouraging them to reduce somewhat the customary amount of consumption. Along with the reduction in the growth of Federal spending, these proposals should help tilt slightly the overall allocation of our total income in favor of investment.

Other Capital Formation Problems

There are a number of related problems concerning capital formation which our tax policies address. These problems are: The tax bias against savings and investment; the inefficiency with which the present capital stock is used; the overstatement of profits as a result of inflation; and the problems of corporate finance. Let me comment on each of these in turn.

Tax Bias Against Saving and Investment

The willingness of people to save and invest depends in large part on the financial reward which flows from the investment. Thus, to the extent the income tax system takes away the reward, it lessens the incentive to save and invest. Our income tax system is heavily biased against investments producing financial returns that constitute taxable income.

A simple example illustrates this point: Assume you have $5,000 and that the question is whether to spend it on consumption items or to save it and buy a bond. In weighing the consumption alternative, you would not take income taxes into account, but in weighing the bond alternative, you would have to consider the fact that some percentage of the interest income on the bond would go to the government in the form of income taxes. While this result is not necessarily improper, it does mean that the existence of the income tax system, or any income tax system, tilts the scale significantly when people are deciding whether to save or consume.

Moreover, it is frequently forgotten that income from capital is not only included in our income tax base, it is also taxed more than once in our Federal tax system—as corporate income, as personal income, and when transferred at death or by gift under the estate and gift taxes—and that such income is also taxed in state and local tax systems.

In sum, the existing tax system—the combination of income, estate and gift and state and local property and income taxes—imposes a heavy burden on capital. Obviously, if we wish to increase saving and investment, a lessening of this tax burden is the logical place to begin.

Inefficiency in the Use of Capital

While I have emphasized the need to increase the total volume of investment, we should be concerned as well about the tax system's effect on efficient allocation of investment among competing uses. In fact, to the extent that existing investment may be made to work more efficiently, we would be reaching much the same results as we would from additional investment. We should, therefore, work to remove those features of the tax system which causes the flow of savings to be channeled away from more productive investment and into less productive investment. The most important such distortion in the existing tax system is the two-tiered tax upon corporate income.

Moreover, viewing the economy in the aggregate, it is not just corporate shareholders who have lower earnings as a result of this tax. If that were the case, that is, if corporate stock investments provided a lower rate of return than other kinds of investment, no one would invest in stock. In a competitive capital market, capital is constantly flowing from one kind of investment to another until the after-tax rates of return are comparable. If investment in corporate equities is less profitable, then capital will flow out of such investment, or less capital will flow in. If there is less demand for stock on the stock exchange, the price of stock will fall and yields will rise. For example, if a $100 stock pays a $5 dividend, the return is 5 percent. But if the demand for stock declines and the price falls to $80, the $5 dividend provides a yield of better than 6 percent. At the same time, capital which is diverted from corporate stock accounts will increase and result in a greater demand for bonds and other debt instruments as well as a greater demand for investments in assets and enterprises not held in corporate form. The greater demand for that kind of investment will in turn depress the return on that investment.

The market, therefore, operates to equalize rates of return between different kinds of investment. In the end, a part of the corporate tax is a net additional burden on wage earners and consumers, and a part is a burden distributed across the owners of all kinds of capital, not just corporate shareholders.

The factors I have just described have major implications for the efficient use of capital and for tax policy. The price charged by corporations to their customers must be adequate to provide funds to cover the return. This necessarily means that prices for goods produced by corporation must be relatively higher than prices of goods produced in the noncorporate sector. In turn, consumers are discouraged from purchasing goods from the corporate sector and spend less of their money on such goods than they would if taxes were neutral with respect to different kinds of investment. If the extra tax burden on corporate investment were eliminated, this bias would disappear and there would be increased demand for corporate goods and services. People would be able to have more of the things which they prefer, and the efficiency of our stock of capital would be increased. The real income of the nation would rise significantly, as more desired output is substituted for less desired output. Thus, the two-tier tax on corporate income is a barrier to the most efficient use of existing capital.

Getting more out of the capital we already have is as good as having more capital. In fact, it is better because in order to get more capital we must give up some current consumption, which need not be the case if we are only increasing the efficiency of what we already have.

Overstatement of Profits as a Result of Inflation

Inventories and depreciation are two major elements which substantially overstate profits in periods of inflation.

The inventory situation may be illustrated by assuming a company that normally maintains an inventory of 100,000 widgets. Under traditional FIFO accounting, if inflation causes the price of widgets to increase by $1, from $2 to $3, the $100,000 increase in the value of the inventories is reported as profits, even though the company is no better off in real terms than it was before the inflation. Economists have long recognized that this increase is not a true "profit" and the Department of Commerce national income accounts have, from the inception of those accounts in the 1940s, separated it from profit figures.

A similar siuation exists with respect to depreciation. In a period of rapid inflation, depreciation deductions based on historical cost result in reporting as income amounts which do not represent an increase in wealth but which are required merely to stay even.

These inventory and depreciation effects produce a dramatic overstatement of real income: Nonfinancial corporations reported profits after taxes in 1975 of $60.1 billion as compared to $37.2 billion in 1965, an apparent 62 percent increase. But, when depreciation is calculated (under the double declining balance method) on a basis that provides a more realistic accounting for the current value of the capital used in production, and when the effect of inflation on inventory values is eliminated, after-tax profits actually were constant: $35.8 billion in 1975 and $35.6 billion in 1965. However, income taxes were payable on the fictitious profit element. In effect, then, there has been a rise in the effective tax rate on true profits from about 43 percent in 1965 to 51 percent in 1975.

The overstatement and overtaxation of operating profits caused by inflation is a problem for all business which represents yet another barrier to our goal of stimulating a higher rate of capital formation. Our recommendations to reduce business taxes should be considered in this context.

Problems of Corporate Finance

One of the factors which can inhibit the future growth of needed capital formation is the financial condition of American corporations. Analysis of debt-equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade, which is a break from the pattern which persisted in earlier periods. Debt has increased dramatically, both in absolute terms and relative to assets and income. Interest costs have risen appreciably, roughly doubling over the past ten years. The combination of increased debt financing and higher interest rates has resulted in a decline in the coverage ratios reported by American corporations—that is, the ratio of earnings to interest charges. The ratio of liquid assets to debt has shrunk. As a result of these developments, there is a serious question about the potential capability of companies to be able to finance the capital investment that will be required to achieve our basic economic goals of reducing unemployment and inflation as I outlined earlier in my testimony.

For many years there has been a discernible trend toward growing dependence by business on outside funds to finance their growth. The percent of business financing needs raised externally by nonfinancial corporations declined from 1958 to 1964 and averaged about 30 percent of total needs during that period. However, that trend was reversed beginning in the mid-1960's and the proportion of external financing rose to over 60 percent in 1974. The growing dependence on external financing really began in the mid-1960's and has risen steadily since then. This shift in financing methods from reliance on internal to external sources of funds follows the pattern of inflation pressures which also began to accelerate in the mid-1960's. Inflation rapidly increases the costs of new investments and erodes corporate profits which are a major internal source of capital for financing new projects. The distorting effects of inflation force companies to rely more heavily on external sources of funds.

Another, and perhaps more important, change appearing on corporate balance sheets is that the increased emphasis on external financing has been dependent on debt rather than equity sources of funds. There are several fundamental reasons for the shift toward debt: (1) corporate treasurers have been reluctant to raise new equity capital because the sale of additional shares of ownership dilutes the earnings per share and ownership rights of existing stockholders; (2) in the 1950's and throughout most of the 1960's, the cost of debt was low relative to the cost of equity; (3) because of the depressed level of stock prices in recent years, the shares of many companies have had historically low price earnings ratios—indeed many stocks are selling at prices below their book values which discourages new equity financing; (4) the financing costs of arranging new debt issues or loans are usually must less than the costs of selling new shares of stock and there is less uncertainty about placement of the securities; and (5) the use of debt enables the borrower to deduct the interest payments from earnings before determining the amount of taxes to be paid. The tax deductibility of interest payments creates a major advantage in favor of debt financing and has encouraged the sharp shift in the debt-equity relationship. Unfortunately, the emphasis on debt commitments has made our financial system more rigid and more vulnerable to economic shocks.

From 1965 to 1974 nonfinancial corporations raised a total of $267.4 billion of long-term funds. Long-term debt accounted for 83 percent of that total. This means that the incremental debt-equity ratio for external funds was an extremely high 4 to 1. The balance sheet impact of this change was to cause long-term debt outstanding to rise from $141.4 billion to $362.3 billion over the same time span—a two and one-half fold increase in just 10 years time. What this means, of course, is that there has been a significant rise in debt-equity ratios over the past decade. These have roughly doubled for manufacturing firms as indicated in Table 5.

The implication of these fundamental shifts in the patterns of financing is that the structure of corporate balance sheets is much more brittle and less liquid than it was 10 years ago. Obviously there is no single level where the corporate financial structure suddenly becomes too illiquid and inflexible, but at the same time an ever higher burden of debt commitments relative both to financial assets and to income is a matter for some concern. Coverage ratios have dropped sharply over the past decade and operating breakeven points have risen. This makes companies less able to withstand even modest-sized recessions. Accordingly, the potential for bankruptcy has greatly increased across the entire spectrum of U.S. business. This potential in and of itself will discourage future investment as lenders become more reluctant to make long-term commitments and companies become less willing to take on fixed payments of interest and repayment of debt obligations. Some investments which would have been undertaken in earlier periods will be passed over in the future.

We must achieve fundamental reforms in our tax system to redress the imbalances in corporate balance sheets and broaden equity ownership—reforms that will encourage the levels of savings and capital investment that are so vitally needed for our future. The increasing aversion to risk taking in the lending and investing process must be arrested.

Toward those ends, the Administration is proposing to integrate corporate and personal income taxes. This proposal would eliminate the double taxation of corporate earnings which results from first taxing corporate incomes and then taxing individuals who receive dividends. I strongly believe that this proposal—which has already been adopted in most of the other major industrialized countries—would make a significant contribution toward meeting our capital needs of the future. Moreover, it is the only major tax proposal of which I am aware that comes to grips with the growing imbalances between corporate debt and equity.

Energy Policy

No subject is more basic to the future of our economic prosperity than energy. Unfortunately, we have been without a comprehensive energy policy for too long. The oil embargo of 1973 and subsequent price increases demonstrate how vulnerable we have become. Neither the supply nor the price of a central ingredient in our economy is under our control. Our well-being and progress have become subject to the will of others. If there is a major lesson to be learned from our past energy policies, or the lack of them, it is that a system of patchwork government regulations and short-run measures designed to head off specific crises leads to more patchwork regulations and short-term measures—not to a viable energy policy that will produce energy efficiently at the lowest prices to consumers.

The President is committed to ensuring an energy policy that will achieve our goals. In January 1975, he submitted a set of measures to conserve energy, increase domestic production and provide for strategic reserves. The Energy Policy and Conservation Act contains important steps in the right direction, but the penalty for ultimately ending oil decontrol is first to roll back the average oil price. This action, coupled with the action taken by Congress to effectively repeal 70 percent of the depletion allowance for oil and gas, cannot help but have a retarding effect on exploration and development. The President is committed to bringing about decontrol as rapidly as possible, and we must make sure that the 40-month period for decontrol is not extended.

This legislationis certainly not the end of our efforts to bring about a more rational energy policy. Prices of our natural gas are still prohibited from rising to their market level in interestate markets, and shortages will continually plague us unless price is allowed to rise. Domestic marketed natural gas production has declined by approximately 11 percent in the last two years—a trend that must be reversed.

We have the resources to change this if we will only adopt policies that will develop these resources. As long as we refuse to remove these government-imposed controls, and thereby prevent free market incentives from increasing domestic energy supplies, we will continue our dependence on foreign imports and our vulnerability to political blackmail. For these reasons, we are opposed to the provisions of H.R. 10612 which would erect further impediments by increasing the tax burden on investments in oil and gas.

Further, in order to accelerate the replacement of obsolete oil and gas fired electric generating capacity, I am once more urging this Committee to enact the six-point electric utilities program recommended by the President's Labor Management Advisory Committee.

Tax Reform

The third major issue before you concerns the ways to enhance the fairness and simplicity of the tax system.

Over the years, the continuing efforts by various groups to achieve narrow, but often worthy, objectives through the use of special provisions in the Code have led us to a situation in which the confidence of the American taxpayer in the very foundation of the Federal revenue system—the individual income tax—is being seriously threatened.

We are fortunate to have a highly successful tax system, one which has over the years commanded widespread respect and a high degree of voluntary compliance. We can be sure that Americans will continue to support this system so long as they have confidence that all are paying their fair share and as long as they feel they are getting their money's worth. However, as the system has become increasingly complex, we have begun to erode that basic faith in the fairness of the system. Many people today feel that taxes are being imposed upon them without their consent, that too many of their fellow taxpayers are escaping their responsibility through dozens of loopholes, and that the Code itself has become a Byzantine labyrinth of legal double talk.

To be sure, reasonable persons will differ on the importance of particular bits or pieces of the income tax law. Broad agreement can be reached on the overall objectives toward which meaningful tax reform strive: The tax system should be fair and euitable; the tax system should be simple; and the tax system should promote efficient use of the Nation's resources.

I have addressed earlier some of the critical ways in which the tax system needs to be improved in the interests of efficient allocation of resources. When we focus instead on the fairness or equity of the tax system, we must be concerned with the relationship of tax burdens borne by households to their ability to pay. Tax burdens should be similar for taxpayers whose opportunities and capabilities of supporting a standard of living are the same. Further, the tax burdens of those relatively better off should also be relatively larger. Because of some of the provisions in the Code, we have reached a situation in which there is a widespread perception that neither of these criteria is sufficiently well satisfied by our tax law.

As I shall subsequently develop in greater detail, the Administration's tax cuts will also promote fairness and simplicity. Thus, the proposed permanent increases in the standard deduction and personal exemptions as well as the reduction of the tax rates will more equitably relate tax burdens to the ability to pay and simplify considerably the preparation of tax returns. These tax cuts also continue the pattern of reducing the tax burdens of low-income families—removing many from the tax rolls—while moving to restore the eroded position of the middle-income group.

The House Bill contains many provisions designed to limit the benefits which high-income individuals receive from certain investment incentives provided in the Code. These incentives include preferential capital cost recovery deductions to encourage investment in such activities as real estate, minerals and farming. The effect of these incentives is a deferral of taxes which is worth more to taxpayers in the highest marginal tax brackets. Individuals responding to these incentives are not acting illegally and represent a small fraction of all taxpayers. However, excessive use of such incentives by high-income individuals may undermine the progressivity of the income tax as well as its perceived fairness.

In 1973 the Administration originated the LAL (limitation on artificial losses) proposal which limits the benefits of these tax incentives—often called tax shelters. We are pleased that the House Bill generally follows our proposal and we continue to support the broad objectives toward which LAL is directed.

Further, to deal with the problem of high income taxpayers who do not pay their fair share of tax, the Administration is renewing in modified form, its 1973 MTI (minimum taxable income) proposal. MTI is an alternative tax which will subject taxpayers to progressive income tax rates. We continue to feel that this approach is superior to the minimum tax which is an additional flat rate tax on tax preferences, primarily capital gains. H.R. 10612 would increase the minimum tax rate and would leave intact its structural deficiency as an additional tax.

The objectives of equity, simplicity, and efficiency can best be served by appropriate broadening of the base for the income tax, moving toward a more inclusive concept, and ultimately leading to a lower structure of rates for all. Whereas the minimum tax represents an additional layer of complexity in the system, the minimum taxable income concept is consistent with the long-term program of developing an alternative and more comprehensive tax base and taxing that new base at lower rates.

While the House Bill contains some measures to improve the simplicity of the tax system as it is encountered by the average taxpayer, it need hardly be pointed out that the overall effect of H.R. 10612 is to add another substantial dose of complexity to the Code. In my view, we have reached the situation in which the objective of simplicity, which might ordinarily be viewed as merely a minor or supporting objective of the fundamental objectives of fairness and efficiency, has to be raised to a level of first importance.

Much of the complexity of the tax system is encountered by relatively affluent households or by business firms. Yet, the number of taxpayers affected by such complexities as the computation of the retirement income credit or the sick pay exclusion has steadily grown. Furthermore, the complexity of the Code as it confronts the relatively affluent must be of concern to all taxpayers since it is this very impenetrability of the law which leads to the feeling of the average taxpayer that his neighbor who can afford highly talented tax advisors is able to manipulate the system to his advantage. We are, therefore, renewing many of our 1973 simplification proposals including the miscellaneous deduction allowance to substitute for hard-to-itemize deductions, repeal of the sick pay exclusion, and revision of the retirement income credit.

Having set the context for our approach to the issues before this Committee, let me turn now to some of the specifics. I shall take up first the main elements of the Administration's tax proposals, discuss the relationship of energy policy and tax policy, and close with a discussion of tax reform, focusing specifically on H.R. 10612.

II. ADMINISTRATION PROPOSALS

Permanent Tax Reductions

Last October President Ford proposed that permanent large tax reductions be made possible for American taxpayers by Congress joining with him to limit the rate of growth of federal expenditures. Specifically, the President proposed a $28 billion tax cut (Table 6) linked to the adoption by the Congress of a spending ceiling of $395 billion for Fiscal 1977. That spending ceiling, and the budget presented to the Congress this January, represent a reduction of about $28 billion from the projected levels of spending that would have applied for Fiscal 1977 had actions to limit federal spending not been taken.

In my testimony before this Committee last December 9, I set forth in detail the budgetary and economic trends that had caused the President to conclude that decisive action to regain control over the budget was immediately required. Today I will summarize briefly the objectives underlying the Administration's proposal for permanent tax reductions. I will also describe the details of that proposal, as modified to take account of the temporary tax cuts enacted last December.

Administration Objectives

The proposed dollar-for-dollar reduction in federal taxes and federal expenditures has two fundamental objectives. The first is to restore fiscal discipline in the consideration of tax and expenditure measures; the second is to return more decision-making discretion to individuals and families to determine how they will allocate their incomes and personal financial resources.

Fiscal Discipline

Our recent fiscal history demonstrates that the failure to link tax cuts with expenditure cuts, and expenditure increases with tax increases, has resulted in substituting the capricious tax of inflation for the more equitable, but politically difficult, legislated tax increase.

In Fiscal 1962 the Federal budget exceeded $100 billion for the first time in history. By Fiscal 1971 it exceeded $200 billion. By Fiscal 1975 it exceeded $300 billion, and a figure of $425 billion was in prospect for Fiscal 1977 without some restraint—a fourfold increase in just 15 years! Federal government outlays increased at an annual rate of 6.6 percent during the period 1961–1966, at 9.4 percent per year during the next 5 years, and at 11.8 percent per year from 1971 and 1976. If Fiscal 1977 expenditures should be permitted to grow to $423 billion, the rate of growth will reach 14.3 percent.

Furthermore, the growth in spending has far exceeded the growth in revenues. During these same years we have posted a string of budget deficits that are unprecedented in peacetime. The Federal Government (including its agencies) will have been forced to borrow over $350 billion from our private money markets over the decade ending with the current fiscal year. That is over a third of a trillion dollars that might otherwise have been used to build new plants and to create new jobs in the private sector.

It is no wonder that inflation has been such a severe problem and that interest rates have risen to historic levels as a natural consequence of these policies. Moreover, an even worse result of such budgetary practices is that continuing deficits tend to undermine the confidence of the public in the capacity of our government to deal with inflation.

Thus, a principal goal of the President's program is to restore the Federal budget to balance. Reducing the projected Fiscal 1977 deficit to $43 billion will make possible a balanced budget by Fiscal 1979. We are, of course, extremely pleased that your Committee, in its budget recommendations for Fiscal 1977, has substantially agreed with the President's target for that year's deficit and, as provided in section 1A of the Revenue Adjustment Act of 1975, has accepted the basic premise underlying the President's program that expenditure increases reduce, dollar-for-dollar, the total tax reductions that may be enacted.

Decision-Making Process

The second objective of the President's program is to return more decision-making discretion to individuals and families to determine how they will allocate their incomes and personal financial resources. The growth of Federal expenditures has brought with it increasing government dominance in basic decisions respecting the use of our nation's resources and a corresponding diminution in the role of private decision-making.

Over the past 10 fiscal years, Federal expenditures have grown 175 percent while total GNP has increased about 120 percent—that is, the rate of growth in government outlays was nearly 50 percent greater than that of the economy itself.

Some analysts have claimed that the surge of government spending and deficits is only temporary and that more moderate outlay growth rates and budget balance will return as soon as economic conditions stabilize. It is true that part of the increases in the budget outlay can be traced to the "automatic stabilizers" that should respond to recession problems. For example, unemployment compensation benefits have increased from $6 billion in Fiscal 1974 to over $19 billion in Fiscal 1976. However, a review of the actual budget figures clearly indicates that large spending increases have been occurring across the traditional programs of the entire federal government. These spending increases cannot realistically be regarded as "temporary" since government programs are rarely eliminated or curtailed.

Our choice then is clear. We can regain control over Federal spending, stop the trend toward the Federal Government's direction of the use of an ever increasing portion of our national wealth, and restore a greater share in decision-making to individuals and families through large permanent tax cuts. Or, we can continue down the road of the past which leads toward even larger budgets, continuous deficits, and increasing domination of government over our economic affairs.

Description of Administration Proposal

Let me turn now to the specifics of the Administration proposal for permanent tax reductions. The enactment of the Revenue Adjustment Act of 1975 had made it impossible to apply the President's full proposed tax cuts for all of 1976. We are, thus, proposing distinct liability changes for 1976 and 1977, which have the combined effect of applying the Administration's permanent tax reductions effective July 1, 1976.

Calendar year 1977 and beyond

The Administration's permanent program has the following major features: An increase in the personal exemption from $750 to $1,000; substitution of a single standard deduction—$2,500 for married coupled filing jointly and $1,800 for single taxpayers—for the existing low income allowance and percentage standard deduction; a reduction in individual income tax rates (Table 7-8); a permanent 10 percent investment tax credit; a reduction in the maximum corporate income tax rate from 48 percent to 46 percent and making permanent the current temporary tax cuts on the first $50,000 of corporate income; and a program to stimulate construction of new electric utility facilities to insure that long-run economic growth is not limited by capacity shortages in the production of electricity.

Calendar year 1976

Since taxpayers compute their taxes on a calendar year basis, the Administration is proposing tax liability changes for calendar year 1976 that mesh the permanent proposal with the Revenue Adjustment Act of 1975 and approximate the effect of applying in 1976 the current temporary tax cuts for six months and the Administration's permanent tax cuts for six months. The Administration's full proposed tax liability changes will apply for 1977 and subsequent years.

The Administration's proposals would result in lower withholding tax rates (and higher take-home pay) effective July 1, 1976. The lower withholding tax rates would reflect the full impact of the tax cuts proposed by the President last October and would remain constant in 1977.

The specific tax liability provisions that will apply in calendar year 1976 are:

	Tax cuts (compared to 1974 law) (billion)
For individuals:	
A personal exemption of $875	$5.4
A per capita exemption credit of $17.50, with alternative taxable income credit equal to 1 percent of the first $9,000 of taxable income (i.e., maximum credit equals $90)	4.9
Standard deduction changes: A low income allowance of $2,300 for joint returns and $1,750 for singles; a percentage standard deduction of 16 percent of adjusted gross income with a maximum of $2,650 for joint returns and $2,100 for singles	3.9
An average of the rate structures under present law and the Presidents' permanent tax cut program (see tables 7–8)	3.6
An earned income credit equal to 5 percent of earned income with a maximum of $200, phasing out at $8,000 of earned income or adjusted gross income, whichever is greater	.7
Total individual cuts	18.5
For business:	
A reduction in corporate rates: The rates will be 20 percent for the first $25,000 of taxable income, 22 percent for the second $25,000 of taxable income, and 47 percent for taxable income above $50,000	$3.2
The program to stimulate construction of electric facilities, effective July 1, 1976	.6
Total individual and business tax cuts	22.2

Tables 9–13 illustrate the effect of the Administration's tax cut proposal when it is fully effective in 1977 on different individual taxpayers compared to (1) tax liabilities under 1972–74 law, (2) 1975 tax liabilities, (3) 1976 tax liabilities under the Revenue Adjustment Act, (4) the Administration's transitional proposal for 1976, and (5) proposed 1977 law.

Individual Tax Cuts

The recently adopted budget recommendations of your Committee and of the House Ways and Means Committee contemplate that reductions in taxes from 1974 law will be provided through calendar year 1977, without specifying the details of those reductions. Consistent with that approach, and in recognition that the so-called "temporary" tax reductions are in fact in process of becoming permanent, we believe it is essential to face the necessity for making fundamental decisions regarding the permanent structure of the individual income tax, as opposed to the patchwork approach that has prevailed to date.

The Administration's proposed individual tax reductions are designed to achieve two important goals. The first goal is to simplify the existing tax structure by providing a single standard deduction as a substitute for the present low income allowance and maximum standard deduction. The second goal is to begin the difficult, but most vital, task of realigning the tax rate structure to relieve the middle income taxpayer from the onerous tax burden imposed as a result of industriousness and thrift.

Let me elaborate: simplification should begin with those provisions that affect the greatest number of taxpayers. The provision of a single standard deduction would in itself be a major simplification. In contrast, the addition of the per capita exemption credit has been a major complication, and many taxpayers are failing to claim the credit. The situation will be worsened by the addition of the alternative taxable income credit by the Revenue Adjustment Act of 1975.

Because of rising productivity, but more particularly because of the effect of inflation on nominal money incomes, families comprising the middle and upper-middle classes of society have been moved up the tax scales to positions previously occupied by only the top one or two percent of American families. As a result, the middle-income taxpayers find that larger and larger tax bites are being taken from their paychecks and entrepreneurial incomes. For this particular group of taxpayers, the rewards of enterprise, of sustained effort, and of the accumulation of capital have been eroded. As we all benefit from the vigor of this group, so are we hurt when its vitality is threatened. The Administration's proposals are designed to reverse the trend, by providing relief to the middle-income taxpayer while more than preserving the gains of the lower-income taxpayer.

Tables 14-21 provide further information on the individual tax cuts.

Business Tax Cuts

The Tax Reduction Act of 1975 increased the nominal rate of the investment credit to 10 percent from 7 (4 percent in the case of utilities) for the years 1975 and 1976. The President's proposal would make the increase permanent. It is well known that any tax provision intended to encourage investment is most effective when investors may regard it as permanent, for then they may take it into account over the full range of their investment planning horizons, which are frequently 10 years or longer. As part of a program of structural fiscal change, the investment credit helps offset the anti-capital formation bias of the Federal tax system and should have permanent status.

The Tax Reduction Act, for the year 1975, raised the corporation surtax exemption to $50,000 from $25,000, and lowered the tax rate on the first $25,000 of taxable income from 22 to 20 percent. The Revenue Adjustment Act of 1975 extended this tax reduction an additional six months. Again, the President's proposal would make this change permanent.

In addition to this modification of the corporation tax schedule, the President proposes to reduce the top rate 2 points so that the maximum applicable tax rate would be 46 percent. Until we, working with the committees of Congress, can effect integration of the corporation and personal income taxes, this modest relief of the extra burden of tax should cause beneficial increases in the rate of capital formation.

Finally, the President's proposals include a 6-part tax incentive program for electric utilities to accelerate the replacement of facilities now made obsolete by the higher costs of fossil fuels and to encourage the application of more adequate capital cost pricing formulas by utility commissions.

Table 22 indicates the business tax cuts.

Job Creation Incentivess

As I mentioned earlier, this Administration is committed to two fundamental economic policies: sustained noninflationary economic growth and jobs for all who seek work. The proposed tax cuts, coupled with the corresponding reduction in the growth of Federal spending which I have just described, go a long way toward achieving our goal over the long run. But tax cuts alone are not enough. There is a pressing need for more immediate measures to alleviate the unemployment problem that is particularly severe in certain segments of our industry and in certain areas of our Nation. What we need and must do is to create a favorable climate for private industry to create more jobs. This, we believe, can best be accomplished by the adoption of tax incentives. As the President stated in his State of the Union Message, "One test of a healthy economy is a job for every American who wants to work. Government—our kind of government—cannot create that many jobs. But the Federal Government can create conditions and incentives for private business and industry to make more and more jobs."

The Administration has proposed just such a job-creation incentive. Introduced in the House as H.R. 11854, the proposal will permit rapid depreciation for businesses which construct new plants or expand existing facilities in areas where the unemployment rate exceeds 7 percent, or purchase equipment for use in these new or expanded facilities. The tax incentive approach to provide jobs through the private sector is preferable to creating public service jobs typically are temporary, often not production, and subsequently require the recipient to find permanent employment after the program has been terminated. Public service jobs also typically require bureaucracies that are difficult to establish and difficult to liquidate. The purpose of the Administration's proposal is to establish rewarding, permanent employment opportunities through the private sector.

The Administration's proposal has the following advantages:

First, the stimulation of plant construction and expansion, and equipment purchases will lead to the creation of new and permanent jobs, in the private sector, in areas where they are needed most.

Second, we expect the proposed tax incentive will provide substantial impetus for businesses to embark upon projects now deferred and to undertake new projects which otherwise might not get started.

Third, the Administration proposal will provide immediate benefit to the construction industry, one of the most depressed in the economy. The plan will stimulate construction in areas where that industry has been hardest hit by the recession and thereby provide jobs for unemployed persons concentrated in those areas.

Fourth, the proposal will also encourage capital investment. While not directly affecting the overall suply of capital, the plan will provide an incentive for capital spending to creat jobs. By improving the cash flow of companies, it will encourage investment in 1976.

Let me turn now to some of the specifics of the Administration's proposal.

Timing of Plan

The plan is proposed as a temporary measure, pending return to full employment in an economy that is steadily recovering from the recession. Therefore, investment projects must begin during the year beginning on January 19, 1976, and must be completed within 36 months. That is, facility construction must be commenced, or production equipment ordered, on or after January 19, 1976, and before January 20, 1977, and must be completed and placed in service within 36 months thereafter.

This time period has been chosen for several reasons. The requirement that projects be begun in the year starting January 19, 1976, will result in immediate employment opportunities—particularly in the construction sector. The plan will also have immediate employment effects in the capital goods industries, which also have been badly hit in the current recession and are operating at well below normal utilization rates throughout the country. Furthermore, requiring projects to be completed and placed in service within three years will avoid the risk of unduly extending the temporary relief measure. The bulk of construction and equipment manufacture will take place in 1976 and 1977, when capacity will be available. Moreover, because of its short time period, the plan will not threaten the relocation of projects already planned.

Qualifying Location

Facilities and equipment will qualify for rapid depreciation under the plan only if constructed and placed in service in areas which had an average unemployment rate of 7 percent or more for calendar year 1975. Geographic areas with high unemployment will be defined by the Department of Labor in accordance with the functional definition of Labor Market Areas (LMAs) presently used by the Department of Labor in the development of unemployment statistics. Areas of a state that are outside defined LMAs will be considered as a whole, and if this portion of a State had an unemployment rate of 7 percent or more in 1975, it also will be eligible. Attached is a list of potentially qualified areas.

With the 7 percent trigger, about two-thirds of the metropolitan areas of the country will be eligible for the plan. Eligible areas are found in 42 States, plus the District of Columbia and the Virgin Islands, and include about 80 percent of the labor force.

According to the Department of Labor, since the middle 1960's there has been a dramatic shift toward greater regional variation in unemployment. Pockets of high unemployment are not only persisting but increasing. By focusing our efforts on pockets of high unemployment, we hope to provide stimulus to areas with the greatest need. A desirable by-product of these efforts is the potential benefit to the Nation as a whole because equipment orders will flow to productive areas, whether or not they also may be an area eligible for relief.

Application to Real Estate

The Administration proposal will apply to any commercial or industrial facility located in a qualifying area, the construction of which is started and finished within the time period previously described. Commercial and industrial facilities include factories, warehouses, shopping centers and office buildings. Distinct additions to existing facilities will also qualify, but not mere alterations or improvements.

Certain limitations will be applicable to the proposal. Thus, the tax incentive will not be applied to facilities used for lodging or to governmental facilities or facilities or certain tax-exempt organizations. Moreover, the proposal will not apply to any residential real estate activities. Housing and residential construction have received substantial stimulus from recent actions by the Department of Housing and Urban Development and will receive additional stimulus from other proposals made by the President in his State of the Union Message. This particular proposal seeks comparable incentives for the nonresidential sector.

Amortization of qualified real estate will be allowed over a period equal to one-half the shortest life which a taxpayer may now claim under the provisions of the Internal Revenue Code and the regulations. This is a very substantial tax incentive. For example, in the case of a building with a 30-year useful life, the taxpayer will be able to write off one-third of the cost in the first five years as compared with 23 percent under the most accelerated method of depreciation now available. Recapture of depreciation upon a disposition of qualified real estate, under the rules of Code section 1250, will apply.

Application to Equipment

The proposal will also apply to equipment which is ordered during the year beginning January 19, 1976, and placed in service within 36 months thereafter in a facility or addition which also qualifies for the incentives under the Administration's proposal. Equipment placed in existing facilities in areas of high employment will not qualify. Nor will over-the-road equipment or rolling stock.

Under the proposal, at the taxpayer's election, straight-line amortization of qualified equipment will be allowed over 60 months commencing on the date the equipment is placed in service. For example, the amortizable cost of equipment with a 10-year useful life could be written off in five years compared to about 67 percent under the double declining balance method which would now be available. For this purpose, the definition of equipment—as distinguished from real estate—will be the same as is used in the investment credit provisions. Here, too, the depreciation recapture rules will apply upon a disposition of the property.

Notwithstanding the election to amortize qualified equipment over five years, the full investment tax credit will still be allowed if the useful life of such equipment is seven years or more. This is a most significant benefit which will make the election to amortize much more attractive than if the electing taxpayer were limited to two-thirds of the investment credit as is the case under current law with respect to property with a useful life of five years.

This proposal will not apply to those electric utilities covered by the Administration's six-point utility program which I will discuss later.

Revenue Estimates

The revenue cost of the proposed job-creation tax incentive is estimated at $300 million for Fiscal Year 1977, $650 million for 1978, $900 million for 1979, and $1.0 billion for 1980. However, over the long-run, the same amount of taxes will be paid because, generally, accelerating depreciation of capital investment simply defers taxes.

Broadened Stock Ownership Proposal

I would like to turn now to the subject of broadened stock ownership in the United States. The Administration believes that broadening the private ownership of business will further an American tradition, and thereby strengthen the economic, social and political base of support for our free enterprise system. In this respect, it is important to encourage participation by low and middle income working Americans in private ownership. Widespread stock ownership among all Americans will promote stability in the financial markets, provide individuals with a greater sense of participation in the free market system, and give them an opportunity to build a reasonable estate for themselves and their heirs.

There are many approaches which can foster broadened stock ownership through the tax system. In his State of the Union Address, the President proposed the adoption of a Broadened Stock Ownership Plan (BSOP). This plan would have three principal characteristics which the Administration deems important to any program designed to encourage broadened stock ownership. First, the plan should be available to all Americans, whether self-employed, employed by a corporation, or employed by the government, federal, state or local. Second, participiton should be voluntary, but the plan can be established by individuals or by their employers through payroll deductions. Third, participants in a BSOP should have a choice as to their investment in common stocks.

Other aspects of the plan include the following:

First, contribution would be deductible from taxable income, with participation being restricted to individuals in the low- and middle-income ranges and limited to the maximum amount eligible for deduction. In addition, there would be a phase-out of the amount deductible at the higher income levels. For example, a taxpayer might be allowed to deduct $1,500 a year or, if less, 15 percent of his compensation, subject to a phase-out in the case of compensation between $20,000 and $40,000.

Second, income earned by a BSOP would be exempt from income taxation until withdrawn from the plan. Upon withdrawal, a participant would be subject to a current tax at capital gain rates to provide participants with the benefits normally associated with the accumulation of capital values. However, there would be a holding period requirement. Thus, funds held in a BSOP would have to remain invested for at least seven years. Premature withdrawals would be subject to a penalty tax in order to discourage early withdrawals.

Third, the contributions made to a BSOP would have to be invested in common stocks, the selection of which would be entirely up to the participant. He could, for example, select individual stocks or mutual funds.

Under the Administration's proposal, taxpayers could establish a BSOP on or after July 1, 1976, and qualify for a full tax deduction for calendar year 1976. Further details of the BSOP proposal will be worked out with Congress.

It should be noted that BSOP's would have no effect upon a taxpayer's ability to participate in any pension or profit-sharing plan established by his employer, or to establish his own individual retirement account or Keogh plan. The contemplated statutory pattern for BSOP's would be unrelated to deferred compensation, retirement or employee benefit plans.

Electric Utilities Tax Program

The electric utilities tax program is another important part of the Administration's program. It not only will serve as a stimulus to construction of additional facilities by electric utilities, but will also provide a means to minimize imports of foreign oil and to insure adequate electric generating capacity in the several years ahead. The construction activity will help put many people back to work in the near term and, in the longer run, will help insure that economic expansion will not be limited by energy shortages. In sum, the program is highly important to the national economy.

Background

The proposal I presented last July 8 before the House Ways and Means Committee, and before your Committee on December 9, represents the recommendations of the President's Labor-Management Committee, and the President has endorsed them. The need for this legislation has not lessened since I last urged its adoption. In summary, the reasons for this legislation are:

1. Financing difficulties have prevented the construction, or completion, of badly needed nuclear and coal fired plants.

2. The need to minimize our dependence on foreign oil demands adoption of means to increase electric generating facilities fueled otherwise than by petroleum products.

3. The energy shortage must be met. Insufficient electric power will inhibit construction of new manufacturing and commercial facilities. This cannot be allowed to happen.

This Committee is acutely aware of the nature of our overall energy shortage and the adjustments that our enocomy must make. We will never again want to rely on foreign oil, as we dd for so many years. We must greatly increase our domestic capacity for the generation of energy, and we must begin to make progress immediately. The indispensable core of any sensible energy program is the construction of electric power facilities which do not operate on petroleum products—which, today, means primarily coal, nuclear and hydroelectric. But these electric power facilities will not come off the shelf in someone's store. The lead times required to construct these generating plants range up to seven or eight years. Generating plants are complex and their construction cannot be turned on and off without incurring major expense and causing great delay. The coal and nuclear fueled electric power plants that we defer today will be missing tomorrow and will prolong our dependence on foreign oil imports.

A recapitulation of the problems of the electric power industry may be helpful. When fossil fuel prices started their rapid rise in mid-1973, the consequence for electric utilities, whose rates are regulated, was a shrinkage in the residual cash-flow. This reduced the return to equity and made increasingly difficult the simultaneous (1) maintenance of dividend payments which were needed to continue to attract and hold equity capital, (2) payment of interest on obligations to bond-holders, and (3) carrying out of investment programs to replace existing capacity as well as to add additional capacity needed to meet forecast growth in demand for electric power.

This squeeze on the electric power industry, resulting from what is commonly called "regulatory lag" or the slow adjustment of allowable prices to reflect changed cost canditions, was exacerbated by two other factors: the actual costs of replacement capital were pushed-up by inflation while the allowances for this portion of capital cost embedded in utility rate structures remained unchanged; and interest rates on refunding and new issues of bonds rose to incorporate the inflation premium. For many utility companies the resultant drop in realized return to equity owners was so severe that dividend payments were suspended and/or construction programs were cancelled or suspended.

It is true that the problems visited on the utility sector differed only in degree from those faced by the entire private sector. Unregulated businesses were also caught in a cash-flow squeeze as their costs rose more rapidly than the prices they could recapture in the market. But, in the unregulated sector, restoration of balance between prices and costs has been quicker, not only because price regulation procedural lags are generally absent, but also because their capital costs are generally a smaller fraction of total costs.

Specifics of Program

I would now like to turn to the specifics of the six-point proposal.

First, the proposal would increase the investment tax credit permanently to 12 percent for all electric utility property except generating facilities fueled by petroleum products. Under current law, utilities, like other taxpayers, are eligible for a maximum investment tax credit of 10 percent. Although the 10 percent credit is scheduled to revert to lower rates at the end of this year, the Administration has proposed the higher rates be made permanent.

Second, the proposal would give electric utilities full, immediate investment tax credits on construction progress payments for construction of property that takes two years or more to build, except generating facilities fueled by petroleum products. Under present law, utilities, like other taxpayers, are entitled to investment tax credits as they make progress payments on long-term construction projects. However, the Tax Reduction Act of 1975 provided a five year phase-in of construction progress payment credits so that entitlement to the full investment credit at the time a progress payment is made will not occur until 1980.

These proposed changes with respect to the investment credit would be limited to those utilities which "normalize" the increase in the investment credit for ratemaking purposes and which are permitted by their respective state regulatory agencies to include construction work in progress in their rate base for ratemaking purposes. "Normalization" means reflecting the tax benefit for ratemaking purposes pro rata over the life of the asset which generates the benefit instead of recognizing the entire tax benefit in the year the utility's taxes are actually reduced. In the absence of normalization, the entire tax benefit would flow through immediately in the form of reduced utility rates for consumers, and no real economic benefit would result for the utility.

Third, the proposal would permit electric utilities to begin depreciation of major construction projects during the construction period. Under present law, a deduction for depreciation is allowed commencing when a depreciation asset is placed in service. The depreciation deduction would be based on the accumulated construction costs which qualify for the investment credit under the construction progress payment system enacted as part of the Tax Reduction Act of 1975. Accelerated methods of depreciation would be permitted, and the depreciation deduction would be based on an assumed useful life which would include the remaining construction period plus the estimated useful life (or asset depreciation range period) attributable to the property as of the time it is placed in service. Depreciation after the property is placed in service would be reduced by depreciation taken during the construction period.

Electric generating facilities fueled by petroleum products would not qualify for this construction period depreciation. Further, construction period depreciation would be conditioned on the utility's normalizing the benefits of the provision for ratemaking purposes and upon the agreement of the relevant state regulatory agency to include construction work in progress in the utility's rate base for ratemaking purposes.

Fourth, the proposal would provide for extending to January 1, 1981 the period during which pollution control equipment installed in a pre-1969 plant or facility will qualify for rapid five-year straight-line amortization in lieu of normal depreciation and qualification for the investment credit. Section 169 of the Internal Revenue Code, which provides for this treatment of pollution control equipment, expired December 31, 1975, and the proposal is to extend the qualification period an additional five years.

Fifth, the proposal would provide an election of five-year amortization in lieu of normal depreciation and the investment credit for the costs of converting an electric power generating facility fuel by petroleum products into a facility fueled by nonpetroleum products, or for the cost of replacing petroleum products fueled facilities.

Sixth, the proposal would permit a shareholder of a regulated electric utility to postpone tax on dividends paid by the utility on its common stock by electing to take additional common stock of the utility in lieu of a cash dividend. The receipt of the stock dividend would not be taxed. The amount of the dividend would be taxed as ordinary income when the shareholder sells the dividend stock, and the amount of capital gain realized on the sale would be decreased (or the amount of capital loss increased) accordingly. Dividend stock would be deemed sold by the shareholder before any other stock of the same utility.

Revenue Estimates

Altogether, the six-point electric utilities tax program will reduce tax revenues by an estimated $800 million in the transitional quarter of 1976 and $800 million in Fiscal 1977. The long-run benefits are an orderly restructuring of the American electric utility plant to de-emphasize the use of petroleum-based fuels and an acceleration of annual investment to meet future electric power needs of the economy.

Proposal for Integration of Corporate and Personal Income Taxes

I would like to turn now to a specific proposal to integrate corporate and personal income taxes. In my testimony before the House Ways and Means Committee last July, I discussed the details of such a proposal. Much of what I will present today is drawn from that testimony. I will also attempt to answer some of the criticism which has been levelled at the proposal.

Perverse Effects of the Double Tax on Corporate Dividends

Under our system of taxation, income earned by corporations is taxed twice: first to the corporation and then again to the shareholder, if and when it is distributed as a dividend or realized on sale. The existence of this two-tier tax has a number of perverse results:

1. The system reduces rates of return for all savers. Viewing the economy in the aggregate, it is not just corporate shareholders who have lower profits because of the double tax on dividends.

With due allowance for risk, no one would invest in corporate equities if the return to him, after payment of tax at the corporate level, differed from that which he could earn from investment in real estate, bonds, or other assets. In a competitive capital market, there are constant flows of capital from one kind of investment to another until the after-tax rates of return are comparable. If investment in corporate equities is less profitable, then capital will flow out of such investment (or less capital will flow in). If there is less demand for stock on the stock exchange, the price of stock will fall and yields will rise. At the same time, capital which is diverted from corporate stock will flow into other kinds of investment. Money in savings accounts will increase and there will be a greater demand for bonds and other debt instruments and a greater demand for investments in assets and enterprises not held in corporate form. That greater demand for that kind of investment will in turn depress the return on it. For example, when more people wish to have money in savings accounts, the interest rates which banks are willing to pay falls.

Since investors have had 25 years to accommodate to the nearly 50 percent rate of corporate tax, yields to investors after the tax have surely been equalized with those elsewhere. This means that the corporate tax has reduced the yields on all forms of saving, and that eliminating the extra tax on dividends will reverse the process, raising rates of return to all savers.

2. By imposing an extra penalty on the rewards for saving, the existing system restrains the capital expansion needed to meet our economic goals. I have already detailed the crucial importance of increased capital formation. Integration will help to achieve our needed increases in the capital stock in three ways.

First, domestic savings will respond to the increased return. The response may be small, but even a modest change in savings habits would lead to a substantial savings increase in the aggregate. Several recent econometric studies of savings behavior have shown this savings response to be positive and significant.

Second, with a higher return to capital in the United States, relatively more of the world's investment will take place here. Less domestic savings will flow abroad, and more investment by foreigners will be undertaken here.

Third, the method of integration which we propose allows deductions to the corporation for a portion of dividends currently paid. This makes available additional cash flow to businesses for immediate investment. While in the long run, this aspect of the policy is less important for capital formation than is increased profitability, additional cash flow may help to speed the adjustment to the larger volumes of capital investment.

3. The extra tax on corporate income leads to economic inefficiency by requiring that prices of corporate sector products be relatively higher than prices of products produced by unincorporated business. The products of corporations must sell at prices high enough to cover the additional burden of the corporation income tax or else corporations would be unable to attract and hold the capital needed to product those goods.

This tilting of prices makes corporate products relatively less in demand than they would be in the absence of the extra corporate tax. Economic activity will, of course, be carried on in the corporate form in order to aggregate the large amounts of capital required and to assure continuity of management. Heavy manufacture, minerals development and production, and the utilities could operate in no other way, and there are many other activities for which the sheer economies of scale outweigh the advantages of personal management and the tax savings possible in a proprietorship or partnership. But, the inefficiency of the corporation income tax is that it makes it more expensive to realize these advantages of corporate organization.

Consequently, as measured by the prices we are willing to pay in the market place, we have too little output from the corporate sector and too much from elsewhere. If we could eliminate the cause of this misallocation of resources, we would clearly be better off: we would have more of the things we currently value more highly, fewer of the things we value less. Professor Harberger, who has pioneered the analysis of this waste, has estimated that the value of this loss to society is equal to 0.5 percent of our national product annually.

4. The double tax is an extra inducement for corporations to seek debt financing, rather than increased equity capital, because the tax applies only to the income attributable to equity investment. Corporations must earn enough gross income to cover the interest payments made to compensate bondholders and other creditors for the savings which they have supplied. But interest payments are deductible at the corporate level and thus—unlike dividends—are not included in the net income which is taxable to the corporation. If we were able to remove the extra tax on dividends, we would make equity financing much more attractive and would reverse the steep and dangerous increase in debt-equity ratios of recent years. I have already indicated how high debt-equity ratios make businesses extremely vulnerable to business cycle changes and that a high proportion of debt in the financial structure will further discourage investment by introducing added uncertainty for lenders and borrowers. This is just another example of how the tax structure hinders the efficient operation of markets, in this case by increasing the cost of equity compared to debt capital. We must remove this tax impediment to business expansion and economic growth.

5. A double corporate tax creates a market bias against dividend yielding stocks. So long as earnings are retained, the second tax on dividends need not be paid. If the stock is ultimately sold, its value will generally be higher because of the retained earnings, but the capital gains tax on the increase in value is imposed at preferential rates. Thus, the second tax in the case of retained earnings may be substantially lower than in the case of dividends. Consequently, companies like utilities which have traditionally relied on high dividend payouts to attract the capital needed for expansion, are placed at a substantial disadvantage because the double tax imposed on their income is greater than the double tax on companies which retain earnings and do not distribute them. Moreover, moderate income investors who prefer dividends to capital gains are discouraged from stock ownership. Elimination of the second tax would greatly assist utilities and other companies similarly situated in raising equity money. Given our energy problems, this is a particularly important point.

6. The double tax places a heavy penalty on corporate decisions to distribute earnings. In an ideal free market, the tax system would be neutral with respect to retention or distribution of earnings. Corporate managers would be led to retain earnings only if they would use them more productively in their businesses than their stockholders might use them in other investments. Integration would remove the tax reasons for retaining rather than distributing earnings. At present, the tax penalty on paying out earnings puts corporate managers under great pressure to do almost anything that might be productive with retained earnings rather than pay them out. The double corporate tax thus tends to "lock-in" corporate capital and keep it out of the capital markets which allocate capital more efficiently among uses.

International Comparisons

For many years our system of imposing a double tax on corporate profits by taxing them at each of two tiers was also widely used abroad, and it is often referred to as the "classical" system of corporate taxation. So long as tax rates at the corporate level remained relatively low, the system did not create undue mischief. In the United States, the corporate tax rate was less than 15 percent as late as 1935; it rose to 40 percent during World War II dropped back to 38 percent in the last of the 1940s and rose again to 52 percent during the Korean War. The current 48 percent rate was enacted in 1965. Thus, basically, it was only as recently as the Korean War in the early 1950s that corporate rates reached their present high levels.

Similarly, corporate rates have been rising in other countries, but not so fast as in the United States. As rates have risen abroad and as the need for economic development and investment increased in other countries, changes were made in their corporate tax system. Today, virtually all of our major trading partners eliminate much of the double tax. Such systems are in effect in Canada, the United Kingdom, France, Germany, Belgium and Japan.

The European Economic Committee has adopted a resolution urging all of its members to adopt such a system and is presently engaged in an effort to promote greater uniformity of existing systems and to harmonize the differences that remain. Since our two-tier tax system results in higher prices for corporate products, and our major trading partners have taken steps to eliminate this extra tax burden, we have placed U.S. corporations at a competitive disadvantage in international markets.

The Administration's Integration Proposal: Combination of Dividend Deductions and Stockholder Credits

We propose eliminating the double tax on income from savings invested in corporate equity and to do so in six phases, with the first phase effective January 1, 1978. The remainder would phase in equally over the succeeding five years. The proposal would, thus, have no effect on the budget for Fiscal 1977.

We propose to eliminate the double tax by combining the two mechanisms of a dividend deduction and a stockholder credit. When fully effective, the credit at the stockholder level in combination with the dividend deduction at the corporate level will completely remove the double tax on dividends.

The Dividend Deduction

Approximately half of the total relief would be accomplished by a dividend deduction. Thus, ultimately there would be a deduction from corporate taxable income of roughly 50 percent of the dividends distributed. The reason that I say "roughly 50 percent," rather than exactly 50 percent is that in order for the mechanism to achieve its objective with the maximum simplicity, the fraction deductible at the corporate level must be geared to the stockholder credit procedure.

The accompanying table illustrates the effect of dividend deductibility at the corporate level.

ILLUSTRATIVE COMPUTATION OF 50 PERCENT CORPORATE DIVIDEND DEDUCTION

	Present law[1]	Proposed Law: With same dividend payout	Proposed Law: With maximum dividend payout
	(1)	(2)	(3)
A. Corporate income subject to tax	$110	$100.00	$100.00
B. Dividend paid	50	50.00	66.67
C. 50 percent dividend deduction (50 percent of line b)		25.00	33.33
D. Taxable corporate income line A — line C)	100	75.00	66.67
E. Corporate income tax (50 percent of line D)	50	37.50	33.33
F. Coroprate income after tax (line A — line E)	50	62.50	66.67
G. Retained earnings (line F — line B)	0	12.50	0

Source: Office of the Secretary of the Treasury and Office of Tax Analysis. Mar. 11, 1976.

[1] Assumes, for simplicity, a 50 percent corporate tax rate.

For simplicity, we assume the corporation earns $100, that the corporation tax rate is 50 percent and that 50 percent of the dividends are deductible at the corporate level in computing the corporation income tax. Under present law, as is shown in the table, the corporation pays $50 in tax and has $50 left over, to retain or pay out in dividends. Under the proposed dividend deductibility procedure, if the corporation merely continues to pay out $50, its tax payment is reduced to $37.50, for its taxable income is $100 less 50 percent of $50, or $75, and the tax rate is 50 percent. Without changing its dividend payout, the corporation has $12.50 of additional retained earnings. On the other hand, if the corporation wishes to pay out the maximum amount of its earnings and retain nothing, it may pay out $66.67 in dividends and pay tax of $33.33. In this instance, the taxable income at the corporate level is $66.67—$100 less half the $66.67 in dividends paid—and it pays $33.33 in tax. Thus, the dividend deductibility feature of the Administration's proposal provides great flexibility to corporate management in adjusting its financial policy to the overall reduction in corporate tax burden realized by integration.

The dividend deduction provided for the first year, 1978, would be that percentage which produces a net reduction of approximately $2.4 billion in corporate tax liabilities for that year.

Additional dividend deductions required to bring the total deduction up to approximately 50 percent of dividends distributed would be phased in from 1979 through 1983, causing the revenue loss to increase at a rate of about $1 billion per year (at 1978 levels).

The Stockholder Credit

The balance of the double tax on dividends would be eliminated by a stockholder credit to be phased in equally over the five-year period from 1979 to 1983 inclusive. This would cause a revenue loss in each of those years, increasing at the rate of about $1.5 to $2.0 billion a year (at 1978 levels).

The credit mechanism would be quite simple. The taxpayer would "gross-up" his dividend by adding to his taxable income an amount equal to 50 percent of the dividends he receives and would then take a tax credit equal to the gross-up. This is precisely the same procedure as the taxpayer follows with labor income subject to withholding. The taxpayer adds the withheld income tax to his "take-home" pay, calculates the tax on the gross amount, then subtracts the taxes withheld. In the case of the proposed stockholder credit, the taxpayer adds to his "take-home dividends" corporate taxes paid by the corporation on his behalf, calculates his tax liability on the gross amount, and then takes a credit for the tax "withheld" for him by the corporation.

We may illustrate the operation of this portion of the proposal by extending the prior example to the cases of stockholders subject to personal tax at 20 to 50 percent in the following table.

ILLUSTRATIVE COMPUTATION OF 50 PERCENT INDIVIDUAL DIVIDEND GROSS-UP AND CREDIT

	Case I—taxpayer in 20 percent marginal tax bracket			Case II—taxpayer in 50 percent marginal tax bracket		
		Proposed law			Proposed law	
	Present law	With $50 dividend	With maximum dividend	Present law	With $50 dividend	With maximum dividend
	(1)	(2)	(3)	(4)	(5)	(6)
A. Dividend income received	$50	$50	$66.67	$50	$50.00	$66.67
B. Gross-up of dividend (50 percent of line A)		25	33.33		25.00	33.33
C. Dividend income plus gross-up (line A + line B)		75	100.00		75.00	100.00
D. Tentative tax (tax rate×line C)	10	15	20.00	25	37.50	50.00
E. Dividend tax credit (equals line B)		25	33.33		25.00	33.33
F. Tax liability or refund (−) (line D−line E)	10	−10	−13.33	25	12.50	16.67
G. Total income after tax (line A−line F)	40	60	80.00	25	37.50	50.00

Source: Office of the Secretary of the Treasury and Office of Tax Analysis. Mar. 11, 1976.

Under present law, the 20 percent stockholder receives $50 in dividends, pays $10 in tax and retains $40. In effect, the combined corporate and personal tax rate he has paid is 60 percent. If the corporation still pays out $50 under the proposed integration procedure, the stockholder would add $25 to the $50—that is, he could gross-up for the 50 percent corporation income tax—and compute a $15 tax liability on the entire $75. He would then be permitted to take a tax credit for $25, receiving a net refund of $10. Altogether, this stockholder would net $60 after tax, 50 percent more than under present law, and additionally have a claim to $12.50 of retained earnings. And if the corporation maintains its policy of paying out all income possible, the 20 percent stockholder would receive a dividend of $66.67 which he would gross-up to $100 to include the $33.33 tax paid by the corporation, and compute his tax at $20 which would entitle him to a refund of $13.33. This refund, plus the $66.67 in dividends received yield the 20 percent taxpayer a total return of $80. This is exactly what he should net from a $100 income, given that he is subject to a 20 percent tax rate: and this is twice his yield from such an income under present law. In effect, this taxpayer's burden on income earned by the corporate enterprise has been reduced from 60 to 20 percent, and his return has doubled.

The table shows similar results for the stockholder who is a 50 percent taxpayer. Under present law, he nets $25 of the original $100 income, a tax rate of 75 percent. Under integration, with the same $50 dividend payment, he nets $37.50 plus retaining a claim to the $12.50 of retained earnings; and with maximum payout, he nets $50 after taxes. Again, the proposal imposes only the stockholder's own tax rate on the income of the corporation he owns, so that with full payout of corporate income the reduction in his tax rate is from 75 to 50 percent, and his return is also doubled.

As a matter of arithmetic, a 50 percent dividends paid deduction and a 50 percent gross-up and credit, when combined with a 50 percent corporate rate, exactly eliminates the double tax. With a 46 or 48 percent corporate tax rate, either the 50 percent dividends paid deduction or the 50 percent gross-up and credit must be adjusted slightly. In terms of tax return simplicity, it is obviously very desirable for tens of millions of shareholders to use a gross-up and credit of 50 percent rather than an odd percentage which requires more complicated arithmetic. Therefore, we recommend that the required compensating adjustment be made by reducing somewhat the percentage of dividends which are deductible. It is for that reason that I suggested earlier that the dividend deduction might ultimately be for slightly less than 50 percent of the deduction.

The combination of the dividend deduction and the stockholder gross-up and credit has two major-advantages:

First, use of the dividend deduction will initially create additional cash flow at the corporate level, which provides an immediate increase in funds available for investment.

Second, use of the stockholder credit mechanism permits flexibility with respect to tax-exempt organizations and foreign stockholders in U.S. corporations. We do not believe the stockholder credit should be extended automatically to them. Like other stockholders, they will receive indirectly the benefits of the dividend deduction at the corporate level. Thus, the tax burden on income going to such stockholders will be reduced, but will not be totally eliminated. That seems an appropriate way to deal generally with such stockholders and it significantly reduces the revenue loss. Of course, it may be appropriate in particular cases to extend the benefit of the stockholder credit to foreign stockholders by means of an income tax treaty.

Answering the Critics

Four major arguments have been mounted against the integration plan. Let me answer these arguments.

1. *Plan Favors Big Business.*—The first argument is that the plan is heavily weighted toward big business and high-income individuals at the expense of the "little guy."

This argument first ignores the fact that all Americans would benefit from the plan as higher levels of real income are generated by higher levels of productivity. As indicated earlier, our experience has been that we achieve greater productivity through increased capital investment. Greater productivity means more jobs, greater price stability, and more goods and services to fill rising demands. In short, it means a higher standard of living for all.

Second, the ownership of corporate capital is much more widespread than many may realize. In addition to the gains to direct owners of corporate stock, benefits will flow to people who receive corporate income indirectly through participation in pension funds, insurance companies, and other financial institutions. These institutions have been increasing their ownership of stock and now own about a quarter of all outstanding corporate shares.

About half of our work force is now covered by private pension plans. Eighty-four percent of American adults are covered by some type of life insurance policy, according to the Institute of Life Insurance. Other Americans have other types of insurance or participate in mutual funds, trust funds, and other types of dividend income. Thus, most American families have some direct or indirect dividend income, and they all would benefit from our program.

Third, the integrated nature of our nation's capital markets assures that benefits will spread to people who receive all types of capital income, from bonds, notes and savings accounts, as well as from stocks. Because in our competitive economic system investment flows to those opportunities with the highest after-tax returns, after-tax returns tend to be equalified. As more investment flows to the corporate sector, and corporate earnings before-tax will be reduced, the rates of return on other assets will rise until stock holding will again confer no differential advantage relative to other forms of capital people own. Thus, an initial buoyant effect of integration on rates of return to stockholders will be dispersed to all capital ownership, to higher money wages, and to higher real incomes for all, not just rich stockholders as the critics assert.

If corporations had it in their power to make their rates of return higher than others, they would now be exercising that power. If they do not have that power under present tax law, I am at a loss to see how the proposal I have outlined for you will confer that power.

Finally, I should like to note that the lengthy period which is proposed for phasing in this fundamental change in the tax law is calculated to mesh the changes in rates of return to feasible adjustment rates in the structure of the economy. There will be no sharp increases in rates of return, no stimulation of speculative activities in the capital markets. By 1983, when the plan is fully phased in, no financial evidence of full integration will be apparent. The economic gains of a more efficient use of our capital stock will, in fact, be realized, although since we always wish we had more, we may not then recognize how much better off we will have become.

2. *Cost of Program.*—The second argument is that the cost of the program is too high in proportion to the benefits.

This argument fails to note that the whole thrust of the program will be to encourage people to save and invest more now as well as to make new capital more productive so that we will have more real output in the future to meet our economic needs. We can effect this reform by restraining growth in Federal expenditures. The cost, in this event, is merely the marginal programs which are abandoned. Or, if we regard these expenditure programs as more worthy than the benefits to be gained from this necessary reform of the tax system, we might consider moderate increases in other taxes which have less deleterious effects on our productivity and welfare.

But this program would be a good investment even if we had to increase other taxes to cover the revenue loss. For if efforts to improve capital formation and increase the efficiency of capital use are not undertaken, Americans will pay in the future through lower standards of living and poorer employment opportunities.

In either case, I fail to see how retaining a tax system which incurs for us a current loss of economic welfare and consigns us to a lower growth rate can be less costly than reforming it.

3. *The Plan Favors Dividend-Paying Corporations.*—Plainly, the present unintegrated corporation income tax favors corporate retentions over dividend distributions, particularly for wealthy stockholders in tax brackets substantially above the corporate tax rate. For such stockholders, retained earnings are translated into enhanced stock values which may be cashed at favorable capital gains rates at some distant time, or never. This makes retention for them preferable to current receipt of dividend income. As I noted before, this has two consequences, both harmful to efficient use of our resources: corporate managers are induced to retain more than they otherwise might, leading them to make poorer investment decisions and those classes of stockholders who need to hold securities which yield them current income flow have fewer opportunities left to them to invest in stocks.

If we were to propose to so distort private choices by some tax scheme, we justifiably would be criticized. I am, therefore, puzzled when critics chastise me for proposing to neutralize the present distorting affect of tax policy on corporate financial management policies.

As to the correlary argument that integration penalizes growth companies, it should be noted that true growth companies have unusually good investment opportunities. Such companies will still find it easier to raise capital than nongrowth companies, for stockholders will always prefer shares which promise higher future earnings to those with stable or declining earnings.

4. *Reduction of Corporate Tax Rates as an Alternative.*—The fourth argument is that reducing the corporate income tax would be simpler and just as effective a means to stimulate capital formation.

I agree that this alternative is sound and would help achieve the overall objective. However, simply reducing corporate rates would fail to confront the inherent inequity and inefficiency of maintaining higher tax rates against income from corporate as compared to noncorporate capital. To make most productive use of savings available for investment, we must assure that all investment opportunities meet the same test for profitability before taxes. This requires that, as nearly as practicable, tax rates on capital income be equalized regardless of the form of business organization or method of financing.

Reducing the corporate tax rate by itself would also do nothing about the grave problem of tax bias in favor of debt financing. The corporate debt-equity ratio has risen dramatically in the past decade. Together with higher interest rates resulting from inflation, lower corporate profitability, and a serious recession, we have created a situation where suppliers of capital are increasingly concerned with the safety of their investments. New companies and new enterprises particularly are experiencing difficulties attracting venture capital.

Finally, reductions in the corporate rate unaccompanied by integration serve only to increase the effective tax differential favoring corporate retention of profits rather than payment of dividends. This encourages corporations to use retained earnings for projects which may be less profitable than the investments shareholders would make for themselves. Also, potential stockholders who prefer income will choose investments other than stocks.

Lowering corporate tax rates would lead to increased capital formation, but integration will improve corporate financial formation and bring about more effective use of that capital as well.

Benefits of the Proposed Change

First, the net tax reductions on the income from savings will increase the rewards for saving and will thus increase the total amount which people and institutions will be willing and able to save. That will produce benefits not just for savers, but for everybody in the form of increased growth, higher paying jobs and greater prosperity generally.

Second, it would ultimately eliminate a double tax which is unfair and inefficient.

Third, it will elimnate the existing tax discrimination in favor of debt as compared with equity financing and strike at the heart of the debt-equity problem.

Fourth, American buseinesses will be better able to compete against foreign companies for whom the cost of capital has already been reduced by elimination of the double tax. At the same time, increased returns on savings in the United States will help attract additional foreign capital. Both of these consequences will help to maintain the stability of U.S. exports and employment and the strength of the dollar abroad.

Fifth, it will greatly improve the efficiency of the process by which capital is allocated and produce the equivalent of an increase of at least 0.5 percent in our national income.

Sixth, it will make the capital markets more competitive. Corporate managers will have to demonstrate to stockholders that they can do a better job of investing profits than the shareholders can do for themselves. It would eliminate the tax penalty which presently induces corporate managers to "lock-in" corporate capital and keep it out of the capital markets.

Seventh, it will be an immediate and major assist for equity financing. Businesses which have lost access to equity markets will again be able to compete.

Eighth, it will be a great help to utilities and to other industries whose investors rely upon steady dividends.

Capital Gains and Losses

I would like to turn now to capital gains and losses.

H.R. 10612 contains two relevant provisions dealing with the taxation of capital gains. The first provides for an extension of the holding period requirement to qualify for long-term capital gains. Under this provisoon, the holding period requirement is increased from six months to 12 months over a three-year period (1976—eight months; 1977—10 months; 1978 and thereafter—12 months). The second provision increases from $1,000 to $4,000 the amount of net capital losses which may be used to offset ordinary income, also over a three-year period (1976—$2,000; 1977—$3,000; 1978 and thereafter—$4,000).

We support both provisions of the House Bill. The increase of the holding period requirement is warranted because the reasons for distinguishing between long-term and short-term capital gains—"bunching" and distinguishing between assets held for investment and those held for speculative profits—suggest that the holding period should be one full year. The increase in the amount of losses allowable as an offset against ordinary income is also warranted because the present law $1,000 limitation has not been changed since 1942 despite substantial increases in the consumer price index.

Further, we are today proposing the adoption of a sliding scale approach for the taxation of capital gains and losses. Under our proposal, the tax burdens on capital gains will be reduced the longer the asset has been held by a taxpayer. This will promote capital formation and the efficient allocation of investments. The proposal is a sensible rule-of-thumb to avoid converting the income tax into a capital levy on shifts in investments. In addition, we believe the sliding scale mechanism will reduce the unwarranted taxation of inflationary gains.

The principal features of our proposal are:

The amount of capital gain which may be deducted in computing adjusted gross income will be based on the holding period of the asset, as follows:

Holding period	*Deduction (percent)*
Up to 1 yr (phased in)	None.
1 yr to 5 yrs	50.
5 yrs to 25 yrs	50 to 70 (Additional deduction of 1 percent for each year).

Capital losses will also be subject to the sliding scale proposal.

All transactions which presently generate capital gains and losses will be subject to the sliding scale.

The 25 percent alternative tax on the first $50,000 of the excess of net long-term capital gains over net short-term capital losses will be repealed.

The portion of any capital gain which is deductible under this proposal will be added back to a taxpayer's taxable income in order to compute his minimum taxable income.

The House-adopted capital gains provisions are effective January 1, 1976. For reasons spelled out below, we recommend the following effective dates: House provisions; January 1, 1977; sliding scale for gains: January 1, 1976; sliding scale for losses: January 1, 1977; repeal of alternative tax: January 1, 1976; and effect on minimum taxable income: January 1, 1976.

Let me elaborate:

Sliding Scale Period

We propose that the sliding scale period commence after the taxpayer has held a capital asset for five years and that the percentage increase in the amount deductible be set at 1 percent for each additional year through the 25th year.

In the short run, adoption of a sliding scale approach will cause a burst of unlocking; in the long run, it may result in a new lock-in, at least insofar as appreciated assets are concerned. To soften the impact of this potential lock-in effect, the sliding scale intervals have been pegged at one year, rather than at longer intervals.

Treatment of Capital Losses

Under present law, a net long-term capital loss may first offset short-term capital gains on a 1 for 1 basis and then offset ordinary income (up to $1,000) on a 2 for 1 basis. Thus, under present law it takes a $2 net long-term capital loss to offset $1 of ordinary income. An elaborate carryover system is provided to preserve the character (long-term or short-term) of carryover losses.

Under our recommended proposal, capital losses as well as gains will be subject to the sliding scale. Thus, for example, a $100 realized gain on a capital asset held for 15 years will result in a taxable gain of $40. A $100 realized loss on a capital asset held for 15 years will result in a $40 deductible loss, which may be offset against other capital gains, or against ordinary income (subject to the dollar limitation previously discussed).

The symmetrical treatment of gains and losses generally accords with the trend set by the Tax Reform Act of 1969 which introduced the 2 for 1 rule. A further advantage of applying a symmetrical rule for gains and losses, and computing reportable gain or loss on an asset-by-asset basis, would be simplified considerably.

Qualifying Assets

The sliding scale proposal will apply to all assets which are presently accorded capital asset status. Thus, all transactions which presently generate capital gains and losses will be treated in the same fashion without arbitrary distinctions.

Repeal of Alternative Tax

We propose repeal of the 25 percent alternative capital gains tax on the first $50,000 of the excess of net long-term capital gains over net short-term capital losses. Repeal of the alternative tax is a necessary first step in enacting a sliding scale. Coupling a sliding scale with the alternative tax would require complex "stacking" and allocation rules.

Relationship to Minimum Taxable Income

Under our minimum taxable income (MTI) proposal, a taxpayer will be required to pay a tax at the regular rates of 14 to 70 percent on the greater of his minimum taxable income or his regular taxable income. We propose that the amount of the entire capital gain deduction be included in computing a taxpayer's MTI base thus assuring that each taxpayer will bear a "fair share" of the tax burden.

Effective Dates and Revenue Estimates

As noted above, we propose the following effective dates: House provisions: January 1, 1977; sliding scale for gains: January 1, 1976; sliding scale for losses: January 1, 1977; repeal of alternative tax: January 1, 1976; and effect on MTI: January 1, 1976. The effective dates of January 1, 1976 for gains and January 1, 1977 for losses will have a maximum impact on unlocking both gains and losses in calendar year 1976. Gains will be unlocked because of the lower tax rates on realized gains. Losses will be unlocked because of the desire to realize losses in the current year rather than in 1977 when the sliding scale begins to impact on losses. The net effect will be that gain and loss transactions will, to a considerable degree, offset each other in calendar 1976.

Personally, I believe that the unlocking will be substantial and generate significant revenue increases in Fiscal 1977. However, we are assuming that the sliding scale proposal will product no material change for budget purposes in Fiscal 1977 receipts.

In the long run, when fully effective, the four capital gains provisions—(1) a sliding scale on gains and losses; (2) a holding period requirement of one year to qualify for long-term capital gain treatment: (3) an annual limitation of $4,000 on capital losses which may offset ordinary income; and (4) repeal of the 25 percent alternative tax—will generate revenue losses of about $800–$900 million per year.

Estate and Gift Tax Proposals

I would like to turn now to gift taxes. As you know, the House Ways and Means Committee is now holding hearings on the major issues of estate and gift tax revisions, and, Treasury Department officials will be testifying on that subject next Monday, March 22. We believe that a complete reexamination of estate and gift taxes is long overdue and we look forward to cooperating with the taxwriting committees in this undertaking. As you also know, the President has already recommended an increase of the estate tax exemption from $60,000 to $150,000.

Estate Tax Exemptions and Rates

The basic structure of the estate and gift tax has remained fundamentally unchanged since 1932, and the estate and gift tax exemptions were last changed in 1942. Since that time, the ravages of inflation have substantially eroded the value of the $60,000 estate tax exemption. No longer does the tax impact principally on the relatively larger estates. Rather the estate tax now has shifted to a more broadly-based tax on the private capital accumulations of more moderate estates.

Let me elaborate on these two points. First, adjusting the $60,000 estate tax exemption for inflation since 1942 would require an estate tax exemption of $210,000. Moreover, while a person with a $60,000 estate in 1942 could leave it to his family without tax, today an individual must have an estate of $260,000, on which an estate tax of $50,700 will be levied, in order to leave the equivalent amount, $210,000, to his family.

Second, during the 1920s, 1930s and 1940s, the estate tax reached about 1 to 2 percent of all estates. Thus, in 1950 there were 27,144 estate tax returns filed (1.9 percent of estates) and 18,697 taxable returns (1.3 percent of estates). By 1973 the number of estates filing tax returns had reached 174,899 (8.9 percent of all estates), of which 120,761 (6.1 percent) were taxable. And in the Fiscal Year ending June 30, 1974, there was 211,540 estates filing returns (10.7 percent of all estates) and 146,000 taxable estates (7.6 percent).

We believe that an increase in the estate tax exemption is clearly warranted. Indeed, such an increase is essential if the estate tax is to be returned to its historic role as an excise on the transfer of relatively larger wealth accumulations. At the same time, we cannot ignore the significant revenue consequences that would result from increasing the estate tax exemption. Thus, we recommend that the estate tax exemption be increased to $150,000 over a five-year transition period and that the lower bracket estate tax rates on the first $90,000 of taxable estate be eliminated. Limiting the increase to $150,000 (with the proposed restructuring of rates) will permit the revenue loss to be held to an acceptable amount, which can be absorbed gradually during the phase in period.

Our specific recommendations regarding the estate tax rates and exemptions are:

Increase the estate tax exemption to $150,000 in equal $18,000 increments over five years.

Eliminate the lower estate tax rate brackets so that the beginning estate tax rate would be 30 percent. The estate tax rate changes would be phased in over five years along with the increased exemption.

We estimate that the combination of the increased estate tax exemption and the restructuring of estate tax rates will result in a revenue loss of $1.1 to $1.2 billion when fully effective and a revenue loss of less than $100 million in Fiscal Year 1977. At the same time, much needed relief will be provided for moderate estates.

Liberalized Payment Provisions for Family Farms and Businesses

Inflation has had a particularly serious impact upon the family farm or business. Property values have risen dramatically with the result that owners have been faced with higher estate taxes. This has created a greater liquidity need than faced by many other taxpayers, because family farms or businesses generally tend to represent a significant portion of the owners' estates in terms of dollar values. Therefore, many families have found it necessary to sell the family farm or business to obtain cash to pay Federal estate taxes.

To meet these problems, the Administration has proposed a change in the Federal estate tax laws to make it easier to continue the family ownership of a small farm or business following a substantial owner's death. In summary fashion, the details are as follows:

At the estate's option, a five-year moratorium will apply to payment of that portion of the tax liability attributable to an ownership interest in a family farm or other closely-held business qualifying for ten-year installment payments under present section 6166 of the Internal Revenue Code. No interest will accrue during the five-year moratorium period and no principal or interest payments will be required during that period.

At the end of the five-year period, the deferred tax will, at the estate's option, be payable in equal annual installments over the next 20 years.

Interest on the installments will be reduced to 4 percent per annum from the 7 percent rate generally applicable to deferred tax payments.

The five-year moratorium and twenty-year extended payment provisions will apply only to the estate tax liability attributable to the first $300,000 in value of the family farm or business. Between $300,000 and $600,000 there will be a dollar for dollar reduction in the value of the farm or business qualifying for the moratorium and extended payment provisions. That portion of the tax not qualifying will continue to be subject to ten-year installment payments with the 7 percent interest rate.

We believe that enactment of the Administration's proposal would be a positive and essential step toward ensuring the survival of smaller farms and businesses for future generations.

Foreign Withholding

Let me turn briefly to the subject of foreign withholding. The Administration strongly supports the elimination of the existing withholding taxes on dividends and interest paid by United States persons to nonresident aliens and foreign corporations.

Under present law, and subject to numerous exceptions, a 30 percent withholding tax is imposed on the gross amount of dividends and interest paid to foreign investors. This tax should be eliminated and it should be done now. Elimination of this tax is desirable because:

Removal of the tax will increase investment by foreigners in the United States. It will make investing more profitable and less difficult for investors, and will make it easier for U.S. companies to seek funds in international capital markets.

It will improve the relative attractiveness of long term securities and reduce the present imbalance favoring short term securities and bank deposits (which are presently exempt from withholding). Access to foreign funds will permit the United States to continue its role as a capital exporter, including the recycling of funds flowing into and out of the oil producing countries.

It will put the United States financial community back in the center of international capital markets and help them to regain competitive ground lost.

It is consistant with principles of tax equity and other rules relative to source of income.

It will eliminate what has become a complex patchwork of legislative and treaty provisions and simplify one area of tax law.

The basic point is that the many benefits of eliminating the tax outweigh the small revenue loss.

The Desirability of Increased Foreign Investment

Increased investment by foreigners in the United States is desirable anytime. Proposals to remove impediments to investment have been under consideration for several years. Increased investment is especially important today when we are faced with a massive outflow of funds to pay for very expensive oil.

To the extent that dollars piling up abroad are used to buy goods and services produced in the United States—say wheat for example—we are exporting real wealth from our economy and are the poorer for it. Further, as dollars simply pile up abroad, their value falls in the foreign exchange market. The increased number of dollars that we must then pay for imports becomes a potential claim on an even larger part of our national production. For example, as the value of the U.S. dollar falls, every Mercedes we buy gives some German a potential claim on more bushels of our wheat than previously.

In contrast, dollars which are reinvested in the United States stay here and do not involve exporting our real wealth—at least initially. Furthermore, increased foreign investment here keeps dollars from simply piling up abroad and helps forestall further devaluation.

We have for years preached to other countries the value to them of foreign investment in their countries. It is time we took our own preaching seriously. Investment in the United States by foreigners provides capital needed by this country.

The existence of additional investment here is desirable for three reasons: First, it increases the productivity of labor within our country, which in turn increases the real income of our residents. That increased productivity is critical in the battle against inflation. Second, as capital investment located here wears out and depreciates, it tends to be replaced by machinery and equipment and other assets that are manufactured here; and that too helps our economy. Third, as the investment generates income here, we get the tax on that income. This happens whether the corporation is directly controlled by foreigners, or the corporation simply sells bonds and other securities to foreign investors.

It is true that the after-tax profits on investments by foreigners may eventually be removed from our economy and repatriated by the foreign investor.

But repatriation of income is usually only partial. And even when it is total, it usually occurs gradually over time.

In sum, we are much better off to have the investment, even if the after-tax profits are ultimately lost to us, than not to have the investment at all.

Enhanced Market Efficiency

The statutory elimination of withholding will greatly increase market efficiency for investments in the United States.

There have been so many ways—all complicated—around the United States withholding tax that the tax is as imaginary as it is real. However, even an imaginary tax can have detrimental effects. While certain foreign investors enjoy exemption or reduced rates by statute or treaty, the tax remains an impediment to broader foreign ownership of United States investments.

The present withholding tax system handicaps U.S. companies seeking foreign capital by narrowing the market in which potential foreign investors operate. Those who are unable or unwilling to deal with the complexities are discouraged from investing. Since most of the exemptions depend on the status or residence of the investor, the investor cannot freely market this investmnet. Securities which are not freely marketable throughout the world are not competitively attractive investments.

U.S. borrowers seeking long-term funds are at a competitive disadvantage compared to borrowers of other major countries which do not impose withholding taxes on investments by nonresidents. U.S. withholding taxes increase the capital costs of American companies. They either deter borrowing abroad or cause the U.S. company to bear the burden of the tax. For example, an American borrower who would otherwise borrow at 9 percent may be required to pay a nonresident as much as 13 percent to secure the same loan.

Other countries that have recently taken legislative action to eliminate their withholding on long term international bonds in order to give their borrowers greater access to international capital markets include Australia in 1973, Japan in 1975 and Canada in 1975. They have thus joined other countries, such as Austria, France, the Scandinavian countries, and the United Kingdom, that provide exemption of international issues from withholding tax.

Short-term debt investment rather than long-term debt or equity investments are favored by the present withholding tax system. This bias arises as a result of the present exemptions from withholding for interest on bank deposits and certain other short-term obligations.

We urge elimination of withholding not only with respect to interest income, where a 30 percent tax on gross payments of interest is a clear impediment, but also for dividend payments. There is no reason to perpetuate favorable tax treatment for debt investment over equity investment. Many foreign investors are interested not solely in capital appreciation, which we do not tax in the case of a foreign investor, but in yield. The 30 percent tax on portfolio dividends is clearly a deterrent to those relying on the investment yield. This deprives many of our businesses of access to a form of capital they urgently require.

Free capital markets and free capital flows are in the best interests of everyone. In early 1974, capital controls were eliminated, and it again became possible for American capital to move ahead. The repeal of withholding taxes on dividends and interest would be a further move toward unimpeded flows of capital.

The Question of Tax Equity

The repeal of these taxes is consistent with generally accepted tax principles, and is a part of tax reform. Jurisdiction to tax dividend and interest income was considered more than 50 years ago by a commission of tax experts established by the League of Nations. They concluded, back in 1923, that the right to tax investment income properly belongs to the state of the taxpayer's residence. This principle has been reaffirmed in the commentaries to the OECD Model Convention, while recognizing that some states may wish to maintain some minimal withholding tax solely on revenue grounds.

Revenue

The present withholding tax system does not raise significant revenue, due to a patchwork of statutory and treaty provisions. For 1973, the withholding taxes collected on dividends and non-bank interest were less than 10 percent of the gross payments, despite a basic statutory rate of 30 percent. In 1973, only $210 million of withholding tax was collected, $20 million with respect to interest and $190 million with respect to dividends.

The House Bill

H.R. 10612 as reported by the House Ways and Means Committee, repealed the withholding tax on portfolio dividends and interest, but a floor amendment struck the provision. This floor action was an unfortunate error which should be corrected. At the time, the House seemed to be focusing on the immediate revenue loss and to be ignoring the large potential benefits from the proposal, including the fact that increased foreign investment will produce increased domestic revenues to offset any immediate loss. In fact, the Administration strongly believes that the repeal should be broader than the Ways and Means Committee provision, that is, withholding taxes on direct as well as portfolio investments should be repealed. In the case of direct investments the United States would continue to collect the corporate tax on the underlying profits.

H.R. 10612 as passed by the House contains a provision which makes permanent the "temporary" provision removing the tax on bank deposit interest until December 31, 1976. While we are very pleased that this provision was adopted by the House, there is a particular timing problem which requires your Committee's attention. Foreign investors have already begun to withdraw their funds, or switch to shorter term investments, to remove any risk of withholding taxes being imposed next year. It is, therefore, essential that that particular provision be passed immediately.

To summarize, our present withholding system is counterproductive. It hampers our economy, denies access to foreign capital markets, favors short-term foreign debt investment, and needlessly complicates our tax law, in order to raise an insignificant amount of revenue. It should be repealed promptly.

Taxable Bond Option

The efficiency of the municipal bond market is a matter of major importance to the Nation and to government at all levels. While the municipal market is basically sound, there is an artificial and unnecessary constraint on its efficient operation—state and local borrowers are limited to only one group of potential lenders, those who can use tax-exempt income. This means that the interest rates for municipal debt are critically influenced by changes in the tax and financial situation of such lenders. In addition, the municipal market is experiencing important changes in supply/demand patterns. On average, commercial banks are absorbing smaller percentages of new municipal issues, particularly in the longer maturities. Consequently, other sources of financing must be found if the volume of municipal borrowing is to be maintained.

In order to broaden the municipal market, Treasury strongly recommends legislation giving state and local issuers the option to borrow on a taxable basis and obtain a Federal subsidy of 30 percent of the borrowing cost. For electing issuers of longer-term debt, a 30 percent subsidy will restore the customary "spread" in interest rates between municipal bonds and other debt issues.

The taxable bond option will introduce a much needed element of flexibility by permitting state and local borrowers to tap the investment resources of foundations, pension funds and other tax-exempt institutions. The Federal subsidy will enable municipal borrowers to go to the taxable market to secure lower net interest costs. As municipal bonds are issued on a taxable basis, the borrowing costs for governments which continue to issue tax-exempts will also be reduced, since there will be a smaller supply of tax-exempt bonds to be absorbed. State and local governments can thus achieve lower interest costs regardless of whether they choose to issue debt on a taxable or a tax-exempt basis.

In making this proposal, we are not suggesting that state and local governments have need for higher subsidies from the Federal government. Our objective is not to provide more in the way of a direct subsidy but rather to make the tax-exempt market itself more effective. The taxable bond option will ensure that all municipal borrowers receive a subsidy of at least 30 percent below taxable rates regardless of underlying credit conditions or the needs of particular institutions for tax-exempt income; and it will do this in a manner which maintains the viability of the tax-exempt market.

We are working to devise procedures that will minimize Federal involvement in the subsidy process. We firmly believe that state and local governments should retain their traditional rights to determine whether and when to borrow and the terms of the borrowing.

As shown in Table 23, we estimate that the cost of the 30 percent subsidy, after allowance for estimated revenue gains, will be $7 million for the first full year of operation. This net cost will rise to about $80 million by the 10th year.

Social Security and Unemployment Taxes

To assist in protecting the financial integrity of the Social Security System, the President has proposed a slight increase in the payroll tax effective in January, 1977.

The Old Age, Survivors and Disability Insurance trust funds are paying out more in benefits than their current payroll tax receipts. This is largely due to increased benefits in the past few years and payroll tax receipts which have lagged because of unemployment and slowed wage growth.

Presently the amount of trust funds is equal to about 7 months of expenditures. Under present law, the question is not whether the trust fund will be depleted; rather, it is a question of when it will be depleted. Recent estimates by the Social Security System show that if the recovery should proceed more slowly than expected, the combined trust fund would be depleted by 1981. If a recession were to develop, it would be depleted even sooner. I am not suggesting that I expect a recession, or a slow recovery. I am suggesting, however, that the rapidly diminishing trust fund affords us precious little cushion for adverse events.

To prevent the rapid decline of the Social Security trust funds over the next few years, the choices are either to restrain increases in the retirement and disability benefits or to increase revenues. It is clear that we need to increase Social Security receipts.

The President has included a full cost of living increase in Social Security benefits in his Fiscal 1977 budget. To assure the future financial stability of the Social Security system, the President proposed, effective January 1, 1977, a payroll tax increase of 0.3 percent of covered wages for employees and employers.

The current Social Security tax rate is 5.85 percent for each employee and employer of covered wages. Under this proposal, in 1977 the tax rate would be 6.15 percent on a maximum wage base of $16,500. This increase will cost workers with the maximum taxable income less than $1 a week and will help stabilize the trust funds so that current and future recipients can be assured of the benefits that they have earned.

The increase is in the form of a modest rate increase as opposed to a further increase in the maximum wage base. The base is already scheduled to rise in progressive steps. Increasing the base even further to solve our short-run financial problem will lead to greater complications because of the increased benefits to which the Social Security system will be committed. Consequently, an increase in the tax rate is the responsible course of action.

Let me turn briefly to unemployment taxes.

The unemployment compensation program is no longer self-supported and the financial structure of the system at both the State and Federal levels is seriously threatened: As of March 15, 1976, 20 States have depleted their unemployment compensation funds and as many as 10 additional States will be forced to borrow from the Federal Government by the end of calendar year 1976. Also, as of March 15, $2 billion has been borrowed from the Federal Loan Fund. The Department of Labor estimates that under the present financing provisions, the State Unemployment Compensation Trust Fund will have deficits amounting to $16.5 billion in 1978, $19.3 billion in 1982, and $24.1 billion in 1984.

The Federal Unemployment Account (from which the States with depleted trust funds borrow money) and the Extended Unemployment Compensation Account (which finances the Federal share of the extended benefits program) are both depleted and borrowing Federal general revenues. The Department of Labor also projects that under the existing tax base and net Federal tax rate, the Federal Unemployment Compensation Trust Funds will have a deficit of $6.2 billion in 1978 increasing to $8.2 billion in 1982 and $9.6 billion in 1984.

To alleviate the urgent problem before us, the Administration has proposed an increase to $6,000 in the amount of wages subject to the Federal Unemployment Tax, beginning calendar year 1977. We also propose to increase the net Federal tax rate from 0.5 percent to 0.65 percent as of January 1, 1977, and reduce it to 0.45 percent in the calendar year following the year in which all advances to the Extended Unemployment Compensation Account have been repaid. Since many States tie their State unemployment taxes to the Federal rate base, State unemployment tax receipts will increase as well.

III. ENERGY POLICY AND TAX POLICY

I would like to turn now to the topic of energy and the relationship of energy policy with tax policy. Let me note at the very outset that there are four provisions in H.R. 10612 which relate to oil and gas which we believe will have a negative impact on our efforts to deal with the Nation's energy problem. It is just as important to avoid programs that aggravate the problem as it is to implement programs to resolve the problem of declining oil production in this country. It signals a return to the complacency that prevailed before 1973. Have we forgotten so quickly the effects of the embargo on the American people or the effects of OPEC's price increases on our economy?

Nature of the Problem

Let's be clear about what the problem is. Forty out of every 100 barrels of oil we consume in the United States are imported from foreign sources. Unless we take actions to increase the portion of our consumption from domestic sources, the number of imported barrels will increase as a result of increasing demand and declining domestic production.

The price of foreign oil paid by consumers is nominally about $12.50 per barrel. However, we must recognize that there are additional costs involved in each barrel of foreign oil; for we increase our dependence and vulnerability to OPEC and hurt our balance of payments.

Therefore, each barrel of domestic oil which could be produced for $12.50 is worth a premium to this Nation if it replaces a barrel of foreign oil. Tax measures which encourage domestic exploration, in effect, pay for this premium and are justifiable to the extent they make it possible to replace imported oil with domestic oil. Any provisions of the House Bill which reduce the effectiveness of those tax measures would, along with other recent actions, discourage domestic production. The cost of the resulting increased dependence on imported oil outweighs any revenue gain from those provisions.

Administration Efforts

Let's review what we've done that affects our dependence on imports since the embargo. In January, 1975, the President sent to Congress a comprehensive energy program. The thrust of that program was to limit our dependence on foreign oil by seeking both an increased domestic oil and gas supply and an elimination of wasteful demand. If the free market were permitted to work, without obstruction by government interference, thes goals could be achieved.

The major aspects of the President's package included: Immediate decontrol of oil and gas prices; an import fee on foreign crude oil; a windfall profits tax on domestic producers; a residential insulation credit; and return of the revenue from the new taxes to consumers to compensate them for higher prices. Under this program, energy would cost more, but consumers would have no reduction in their spendable income. Oil producers would have an incentive to find and produce the most costly domestic reserves that, under current world market conditions, would be competitive with expensive foreign oil. However, they would realize no windfall profits on the lower cost oil produced from pre-existing capacity.

The President's program was not accepted by the Congress. What have we achieved instead in terms of either conservation or increasing our supply of oil and gas?

Price Decontrol

In the case of natural gas, interstate sales remain subject to price regulation. Some initial steps in the right direction have been taken by the Congress with respect to small producers. Unfortunately, however, the House has voted to extend controls for large producers to cover intrastate, as well as interstate, sales. I urge the Congress to avoid this backward step and recognize the high priority of full decontrol of new natural gas.

In the case of crude oil prices, Congress agreed to a decontrol program after numerous compromise offers by the President. Last December, the President signed the Energy Policy and Conservation Act under which controls will be removed after 40 months. It is expected that such action will increase domestic production by a million barrels a day by 1985. However, production of new reserves will occur only after a 5 year lead-time for exploration and development. This means that the industry needs capital today to search for and develop the higher cost, harder to find domestic reserves that we expect to be produced 40 months from now.

Delay in decontrol will certainly have an impact on the ability of the industry to generate the needed revenues. Further, we must not forget that in March 1975, the Congress repealed percentage depletion for that sector of the oil industry which accounts for 75 to 80 percent of expenditures made to discover, develop and produce from new reserves. For the small producers, percentage depletion was retained for a small, and declining, amount of production. What remains is subject to rules which are so complex that the uncertainty and confusion in some cases may outweigh the tax benefit. In any event, the repeal of percentage depletion took from the industry $1.6 billion of after-tax revenues for 1976 that could have been reinvested in exploration and development of new reserves.

H.R. 10612 Oil and Gas Provisions

Now, we have before us the proposals of H.R. 10612 which would further jeopardize sources of capital needed for exploration and development. Under this Bill, the limitations on artificial losses would be applied to all but exploratory wells on every oil and gas property. Intangible drilling cost deductions would be included as a tax preference for minimum tax purposes, along with percentage depletion which is already included under present law. The deduction for intangible drilling costs would be denied where nonrecourse loans are used to finance drilling. Finally, the tax burden would be increased on dispositions of oil and gas properties with respect to which intangible drilling costs have been deducted.

The combined effect of these measures would be a further reduction of the after-tax revenues from oil investment by almost $300 million in 1976. The problem will be compounded if outside investors, an important source of capital, become disenchanted by these actions and redirect their investments to other businesses. With the reduction of net revenues available for internal financing, the dependence on sources of outside financing becomes more acute. This is not the time to create more uncertainty or eliminate those incentives which influence potential investors in oil and gas ventures. Potential investors in a business which is inherently very risky can certainly be expected to turn to other investments if we continue to make oil investment less attractive.

We believe that your Committee should take affirmative steps to eliminate these measures from H.R. 10612, as well as the present treatment of percentage depletion as an item of tax preference, if we are to fully achieve the objectives of increased domestic oil supply and reduced dependence on imports. It was this mutual objective which, after months of give and take by the Congress and the President, led to a decontrol program. To enact these measures and dry up a significant source of capital needed today to start finding and producing those additional reserves would be patently counterproductive. Almost as detrimental is the uncertainty created by the existence of such proposals. They should be disposed of quickly.

H.R. 6860

Your Committee is now considering H.R. 6860, the energy tax bill, a product of an effort by the House to solve the energy problem with oil import quotas and tax measures to encourage conservation of oil and gas and conversion to alternative sources of energy. Although the effort was well intentioned, the result is a list of provisions which would have only a modest energy savings at the cost of significant economic distortion induced by discriminatory excise taxes, amortization, and investment credit provisions. Let me give you just a few illustrations of the problems we perceive with H.R. 6860:

The Bill includes a proposed excise tax on business use of oil and gas which is objectionable on several grounds. First it imposes the conservation burden selectively on a few members of one economic sector and only on certain kinds of uses of energy. We all need to conserve the whole barrel of oil. Second, it would produce an undesirable distortion in petroleum usage by tilting prices of products in favor of non-business uses. Third, it will be extremely difficult to administer because of the multitude of exceptions, even within the business sector.

The Bill would repeal excise taxes on radial tires and buses. This would be an unwise reshaping of the sole function of such user taxes which is to raise revenue for highway maintenance uniformly from highway users.

It also would allow tax credits for installation of insulation and solar energy equipment and the purchase of electric cars. Such credits would make some sense in the case of residential insulation, the energy saving facilities of which have been proven for use on a broad scale. However, solar energy and electric cars, early in their development, are available and useful for only a few taxpayers for whom such credits would be a windfall. Little, if any, additional use of solar energy equipment or electric cars would result from such credits at this time.

Finally, the Bill includes several provisions which employ rapid amortization or a selective increase or denial of the investment credit to induce the business sector to either conserve oil and gas or convert to alternative sources. Wherever economics are favorable, there is no need for special public subsidies to induce private business decisions. When oil is sold at a given price, energy users will convert to alternative sources which are competitive at that given price. It is wasteful to subsidize conversion to alternative sources which are not competitive at that price.

Thus, there are very few provisions of H.R. 6860 that we could support.

IV. TAX REFORM—H.R. 10612

As I stated earlier, another major item before your Committee is H.R. 10612—the Tax Reform Bill. In 1973 the Administration presented to the House Ways and Means Committee specific proposals to improve significantly the fairness, equity, simplicity and efficiency of our tax system. Our three principal proposals were:

LAL (Limitation on Artificial Losses) to deal effectively with the problems associated with tax shelters by a solution which reaches their most common feature: Bad tax accounting rules which mismatch expenses and revenues and thereby produce artificial accounting losses.

MTI (Minimum Taxable Income) which, in combination with LAL, deals with the problem of taxpayers with high economic income who pay little or no Federal income tax.

A simplification package designed to alleviate the intolerable reporting burden imposed upon the average taxpayer.

After nearly three years of labor on the House side, you now have before you H.R. 10612. In broad outline, the Bill deals with the same problems we identified in 1973. Overall, it is clearly a step in the right direction. However, in a limited number of cases, we believe that certain features should be strengthened or deleted.

Because of our crowded agenda this morning, I will limit my comments only to certain aspects of the Bill. With your permission, we will submit shortly a technical memorandum of Treasury position on the Bill. The specific areas I will address are: The limitation on artificial losses and other tax shelter amendments; the minimum taxable income proposal; the simplification provisions; the provisions affecting the taxation of foreign income and DISC; and certain administrative provisions.

Limitation on Artificial Losses and Other Shelter Provisions of the House Bill

LAL Background

LAL was first proposed by the Administration in 1973. It was designed to eliminate "tax shelters" which introduce substantial distortions into the income tax system. Under the proposal, tax accounting rules would no longer be permitted to create from a profitable enterprise an artificial tax loss to be deducted against (and shelter from tax) other unrelated income. Under present law, such losses reduce adjusted gross income and make tax shelters possible.

Artificial accounting losses limited by LAL would neither be permanently disallowed nor capitalized. Instead, they would be suspended and carried forward to be deducted in full against net related income in a future taxable year, thus more correctly matching income with the expense of earning it.

Because LAL was carefully directed at a narrow, but significant, problem under present law, it would affect relatively few taxpayers. LAL would apply only where there are artificial "losses." While such losses are frequently generated in the real estate and agricultural industries, LAL would normally not affect either the ordinary farmer or the ordinary real estate developer, but rather the outsider who buys into thos industries in search of tax "losses." Artificial "losses" from such sources as accelerated depreciation, the current deduction of pre-opening costs, and prepaid feed deals, would no longer be permitted to shelter unrelated income.

LAL would apply to individuals but not to corporations. In combination with the proposal for a Minimum Taxable Income (MTI) provision, LAL would be substituted for the present minimum tax on individuals.

The House Bill contains a modified version of the Administration's 1973 LAL proposal. In addition, the Bill also contains other provisions dealing with tax shelters. I will comment briefly on LAL and the other tax shelter provisions.

Real Estate

With respect to real estate, the House Bill applies LAL to commercial and residential real estate. The accelerated deductions subject to LAL are limited to the deductions for (1) construction period interest and taxes, and (2) accelerated depreciation in excess of straight-line depreciation. A taxpayer may aggregate all income from real estate activities in determining the accelerated deductions on real property which are currently allowable.

Although our 1973 proposals would have allowed aggregation of all income from residential real estate, and applied a property-by-property rule for commercial real estate, we favor the provision of the House Bill. Aggregation will lessen the impact of LAL on the professional real estate developer and thereby have no significant adverse effect on new construction. It will also tend to isolate the impact of LAL to the one-time passive investor. Moreover, the aggregation rule will simplify the LAL computations.

Farming Activities

Under the House Bill, LAL applies to losses generated by accelerated deductions attributable to farm operations. Subject to numerous exceptions, LAL applies to (1) pre-productive period expenses attributable to any property having a crop or yield, (2) prepaid feed, seed, fertilizer and similar farm supply expenses, and (3) accelerated depreciation on any property having a crop or yield (which may be taken after the property begins to be productive). LAL should have little impact on the ordinary farmer who works during the off season to supplement his income since farmers are permitted to deduct up to $20,000 of farm losses against nonfarm income.

Although aggregation is generally permitted for farming activities, LAL applies separately to each farm interest in the case of farming syndicates.

We generally support the application of LAL to farming activities but do not favor the application of more stringent rules to farm syndicates. Instead, we propose that syndicates be required to use the accrual and inventory method of accounting. In this way, the tax shelter abuses resulting from the cash method of accounting are dealt with directly. These syndicates should be treated in the same manner as farm corporations (other than family corporations) which, under the House Bill, are required to use the accrual method of accounting. Existing income tax regulations have long exempted farmers from the accrual method of accounting because of the difficulty of maintaining the books and records required for accrual accounting. However, today's non-family farm corporations and syndicates are sophisticated business ventures with ready access to the necessary expertise to maintain these records.

Oil and Gas

Under the House Bill, LAL does not apply to exploratory wells but it does apply to development welss. The House Bill also provides that gain on the disposition of oil and gas interests will be treated as ordinary income to the extent of the excess intangible drilling cost deductions over the amount that would be allowed had the costs been capitalized.

We strongly oppose the application of LAL to any oil and gas activities. We also strongly oppose the recapture of intangible drilling cost deductions. Admittedly, our position on LAL is a change from our 1973 proposal. However, the situation has changed markedly. We have witnessed a sharp decline in domestic sources of oil and gas. We have experienced the painful dislocations caused by our dependence on foreign sources for oil. Energy exploration and development activities have already been severely hampered by the repeal of percentage depletion, the limitations on the foreign tax credit, and the continuation of price controls. For reasons I spelled out earlier, the existence of government-imposed controls will prevent the market incentives from increasing domestic energy supplies. Surely, now is not the time to erect further impediments by increasing the tax burden on oil and gas.

Sports Franchises

The House Bill applies LAL to sports franchises. While LAL is a sound concept, this is an unwarranted extension of the rules the Administration proposed in 1973. These rules did not contemplate that LAL would apply to sports franchises.

The Internal Revenue Code contains no special tax benefits for sports franchises. In this area, abuses arise only when too high a value is placed on player contracts, or when they are written off over too short a period of time. However, abuses of this type are possible in the case of any business property amortized or depreciated. These abuses can be dealt with adequately by the Internal Revenue Service. Although the disputes surrounding the value and life of player contracts are the subject of litigation, resolution of these disputes should eliminate the tax controversies in this area.

The House Bill also applies special rules for the allocation of the purchase price on the purchase and sale of sports franchises. It also provides that single sale of a player contract will trigger depreciation recapture on previously unrecaptured depreciation and abandonment losses taken on all other player contracts.

These proposals are arbitrary since they apply only to sports franchises. Allocating the purchase price among the assets of a sports franchise is no different from allocating the purchase price among the assets of any other business. Applying special rules to sports franchises to deal with a problem that the Internal Revenue Service can handle adequately is not warranted. Further, the unique depreciation recapture rule goes far beyond the usual asset-by-asset depreciation recapture rules in the Code. Here, too, there is no apparent reason to isolate sports franchises for special treatment.

Limitation on Nonbusiness Interest

The House Bill imposes a $12,000 a year limitation on the amount of personal interest, and investment interest in excess of investment income, that an individual may deduct. Unused investment interest, but not unused personal interest, would be available as a carryforward and be deductible in future years to the extent of related investment income in those years.

We oppose the $12,000 limitation since it is an arbitrary limit on the interest deduction. It would deter individuals from purchasing assets with borrowed funds. Moreover, the $12,000 limitation can have the effect of disallowing permanently deductions for home mortgage interest. This is a fundamental change from current law since home mortgage interest will be subject for the first time to a dollar limitation, and in some cases, will be disallowed permanently. The permanent disallowance can occur because of the absence of a carryover for unused personal interest.

We believe that the problem presented by taxpayers who use the interest deduction and other itemized deductions to reduce their tax liability will be handled adequately by treating the amount of itemized deductions in excess of 70 percent of adjusted gross income as an item of tax preference includable in the minimum taxable income base. I will discuss this point in detail shortly.

"At Risk" Limitation

The House Bill limits deductions to the amount of capital which a taxpayer has "at risk" in a venture in the case of motion picture films, livestock, certain one-year crops (grain, oil seed, fiber and others) and oil and gas wells. The "at risk" limitation is intended to prevent a taxpayer from deducting losses where the deductions are attributable to property acquired with borrowed funds for which he has no personal liability, that is, nonrecourse financing. The losses would be suspended and become deductible only in the future as the taxpayer increases his "at risk" capital.

The "at risk" limitation is premised on the assumption that the present tax treatment of nonrecourse financing is unsound. The present law is based on the Supreme Court's decision in *Crane* v. *United States*, 331 U.S. 1 (1947), which held that nonrecourse financing is treated in the same manner, for tax purposes, as financing for which taxpayers are personally liable. The Supreme Court's decision in *Crane* recognizes that nonrecourse financing is an accepted financing medium in many industries. It is a valuable method of encouraging individuals to invest in ventures with a high degree of risk. An "at risk" limitation would overturn more than 20 years of established commercial practice, and adversely affect the general business community as well as passive investors.

We believe that LAL is a better remedy to the tax shelter problem than the "at risk" limitation. The limitation—applicable to corporations as well as to individuals—can result in distortions of income. Taxpayers would include income from ventures but would not have the benefit of offsetting deductions. Moreover, taxpayers will be able to control the timing of their deductions merely by electing to increase their capital "at risk" in those years in which the deductions yield the greatest tax benefit. Further, the scope of the definition of "at risk" is not clear. The House Ways and Means Committee Report accompanying H.R. 10612 adopted an expansive definition of the term which would include within its scope many types of insurance arrangements obtained in the normal course of business. Thus, the reach of "at risk" may be far greater and affect far more transactions than necessary or desirable to cure the potential abuse of nonrecourse financing.

Minimum Taxable Income

In 1973 the Administration recommended a proposal which would require each individual to pay tax at regular rates on a minimum amount of taxable income. Last July, in testimony before the House Ways and Means Committee, I recommended that the House follow our 1973 proposal with some modifications. Today, I am renewing our MTI proposal.

MTI was formulated with a view to balancing two competing considerations. First, Congress has provided various tax incentives designed to encourage specific economic activities. Second, excessive use of these tax incentives by some taxpayers with large economic incomes enables them to avoid paying a reasonable amount of tax, or in some cases, any tax at all. This conflicts directly with the basic tenets of equity and fairness—the income tax should be based on ability to pay; the income tax should be fair and should be perceived as such by all taxpayers.

The House did not adopt MTI. Instead, it perpetuates the minimum tax. Let me review briefly the defects of the minimum tax.

Defects of Present Minimum Tax

The minimum tax is a flat 10 percent tax on certain preference items, such as the excluded portion of capital gains, accelerated depreciation on real property, and the excess percentage over cost depletion. An exemption for the first $30,000 of preferences and a full offset for regular income taxes paid are applied to reduce the amount subject to the minimum tax.

The minimum tax is defective in two critical respects:

First, since it is an additional tax, it penalizes the use of preferences, or incentives, even where an individual has paid significant amounts of regular tax. By contrast, MTI comes into play only if the taxpayer's taxable income is not sufficiently large, in relation to his economic income, to assure that he is paying his fair share of taxes.

Second, because minimum tax is imposed at a flat rate, it serves merely to "slap the wrist" of those taxpayers who are able to shelter large amounts of income from regular tax. By contrast MTI is predicated on the proposition that taxpayers should not be permitted to avoid the graduated rates through exclusion preferences, itemized deductions or the payment of a 10 percent surcharge.

Previous Proposals

Because of the deficiencies of the current minimum tax, the Administration proposed in 1973, and again in 1975, repeal of the minimum tax and the substitution of MTI and LAL. MTI would prevent individuals from avoiding tax on high economic income by the use of exclusions or large itemized deductions. LAL would prevent individuals from deducting artificial losses against unrelated salary or investment income.

The prior MTI proposal called for taxing an individual at regular rates on one-half of an expanded income base if the expanded base exceeded his regular taxable income. The expanded base consisted of adjusted gross income plus the excluded half of net long-term capital gains, the bargain element in stock options, the excess of percentage over cost depletion, and excludible income earned abroad. The expanded income base was then reduced by personal exemptions, certain deductions, and a $10,000 exemption.

House Action

Instead of adopting MTI, the House merely restructured the minimum tax. The rate of tax is increased from 10 to 14 percent, the $30,000 exemption is reduced to $20,000 and is subject to a phase-out. Moreover, new items of tax preference are added. A most serious consequence of the House action is the denial of any offset for regular income taxes paid. This means that individuals who have paid significant amounts of regular tax will now be subject for the first time to an additional minimum tax.

The House Bill also treats as preferences certain accelerated deductions which result in deferral of tax rather than a permanent exemption from tax. To illustrate, as an incentive for real estate development, taxpayers may elect to deduct taxes and interest during the construction period. To prevent the mismatching of income and deductions the House adopted the Administration's LAL proposal, which allows these deductions only to the extent of related real estate income. Having closed the potential abuse, the House proceeded to treat construction period interest and taxes not limited by LAL as items of tax preference for minimum tax purposes. We believe this action is conceptually unsound since the deductions, when allowed, are offsetting income from a related activity. Furthermore, HUD and Treasury are convinced that this treatment can have no adverse affect on real estate development.

Revised MTI Proposal

We are convinced that neither the current minimum tax nor the amendments made by the House Bill properly deal with the problem of high economic income taxpayers who pay little or no income tax. We propose that your Committee repeal the minimum tax and adopt an alternative tax along the lines of our prior MTI proposal. We have modified our MTI proposal somewhat in light of concerns expressed since it was first proposed in 1973.

Adjusted gross income was the starting point for computations under the original MTI proposal. A taxpayer with large, but legitimate, itemized deductions and little taxable income might have been taxable under MTI. We have reconsidered this aspect of the proposal and have concluded that this result is not warranted. We recommend, therefore, that the starting point for MTI calculations should be taxable income.

Permit me to review how MTI will work. MTI will be an alternative tax. Under MTI, a taxpayer will pay tax at the regular rates on the larger of his taxable income or on his MTI base. The MTI base is calculated by (1) adding items of tax preference to a taxpayer's taxable income, and (2) taking 60 percent of that expanded base. A $10,000 exclusion is allowed (before applying the 60 percent factor) to assure that MTI does not affect either low income taxpayers or taxpayers with only a small amount of tax preferences. For MTI purposes, there are only two tax preferences: (1) the excluded portion of the net long-term capital gains, and (2) itemized deductions (other than charitable contributions) to the extent that they exceed 70 percent of the taxpayer's adjusted gross income (AGI).

There are several preference items which are included under the present minimum tax which are not included as preference items under our MTI proposal. Our tax shelter program consists of two parts: LAL takes care of some shelters; MTI will take care of others. Thus, to the extent that LAL deals with an item of preference, there is no reason to include it under MTI. Most of the preference items under the minimum tax are handled under LAL. We have not included percentage depletion in excess of basis as an item of tax preference since percentage depletion has been virtually eliminated. The remaining preferences are excessive itemized deductions and capital gains. Therefore, they are the only two included under MTI.

Under our present proposal, the alternative tax will be computed on 60 percent of the MTI base instead of the 50 percent which the Administration recommended in 1973. The increase from 50 to 60 percent will make MTI more effective in insuring that individuals with large economic incomes pay a tax which is significant in relation to that income.

Charitable Contributions Under MTI

In 1974, when the House Ways and Means Committee in its tentative decisions adopted the MTI concept one of the controversial issues was the impact of MTI on charitable contributions. After considerable discussion, the Committee decided to put charitable deductions entirely outside the scope of MTI. In view of the dire financial position in which inflation has left so many private charities, we became persuaded that the Committee decision was appropriate and we supported it in our July 1975 testimony.

Accordingly, we have carefully structured our present MTI proposal to avoid completely all impact on charitable contributions. Under our proposal, charitable contributions, no matter how large, will not be an item of preference. We will exclude contributions in computing the extent to which itemized deductions will be a preference item.

In short, we have treated charitable contributions very generously. Under no circumstances can MTI adversely affect contributions.

Overall, we believe that MTI is superior to the minimum tax as a way of dealing with the problems of taxpayers who make excessive use of tax preferences. MTI will not affect taxpayers who use tax preferences—which the Congress has provided to encourage various economic activities—and who otherwise pay substantial ordinary tax. At the same time MTI will assure that every taxpayer bears a fair share of the tax burden. The idea of "fair share" is related to the taxpayer's ability to pay. Whereas the minimum tax is an additional tax at a flat rate, our minimum taxable income proposal involves an alternative tax, at progressive rates, based directly on a measure of ability to pay. Not only is this in itself a desirable feature, it is compatible with long-term tax reform in the direction of a more inclusive definition of income, taxed at a lower structure of rates.

Simplification Provisions

As I mentioned earlier, simplification of the tax law must be a major objective of any meaningful tax reform.

Much of the complexity faced by the average taxpayer is in itemizing deductions. Expansion and revision of the standard deduction under the Administration's current tax proposal will result in substantial tax simplification by increasing the number of taxpayers who will use the standard deduction. However, it is also necessary to simplify the tax law directly, and thereby enhance its fairness, through the elimination or restructuring of certain provisions which require complex recordkeeping by taxpayers.

In 1973, the Administration made specific proposals to achieve simplification. H.R. 10612 generally follows our proposals by expanding the optional tax tables and by revising the sick pay exclusion, the retirement income credit and the child care deduction. Overall, the changes are in the right direction. However, the House did not adopt the Miscellaneous Deduction Allowance proposal recommended by the Administration in 1978. We believe that further action is required and that certain aspects of H.R. 10612 relating to simplification should be revised.

Miscellaneous Deduction Allowance

The Administration recommends the adoption of a Miscellaneous Deduction Allowance of $400 ($200 in the case of a married individual filing a separate return) for taxpayers who itemize their deductions. This "simplification" deduction will replace or modify the following hard-to-itemize deductions: The deduction for state and local gasoline taxes; medical expenses and casualty losses; and certain miscellaneous investment expenses and employee business expenses.

These deductions are sources of complexity in the present tax law. While they are used by many taxpayers, they generally do not significantly affect a taxpayer's ability to pay or provide substantial incentives. They require taxpayers to keep track of numerous small bills and receipts which are difficult to classify, summarize, and correctly reflect on the tax return. These items also cause substantial problems on the administrative side at the audit level.

Let me discuss briefly some of the specific deductions which will be affected by our proposal.

First, we propose repeal of the deduction for state and local gasoline taxes. The gasoline tax deduction involves complications out of proportion to any benefit to the taxpayer. There is a substantial amount of guessing in the computation of the deduction (where the tax tables are not utilized) and the amount of the tax saving to the average taxpayer is generally small.

In addition, state and local gasoline taxes, like the nondeductible federal gasoline tax, are in essence charged by the state for the use of its highways. They are in the nature of personal expenses for automobile travel rather than a tax, and therefore, like such expenses they should not be deductible. Further, their deductibility is inconsistent with the character of the taxes as use charges since they serve to shift part of the cost of the highway user to the general taxpayer.

The gasoline tax deduction is also inconsistent with our current national energy policy. The deduction lowers the price of gasoline to taxpayers who itemize deductions. Repeal of this provision should result in the reduction of gasoline consumption.

Second, we propose to revise the medical expense and casualty loss deductions. Under current law, there is a complex three-tier system for determining allowable medical expense deductions. First, a medical expense deduction is allowed for one-half of medical insurance premiums (up to $150) without regard to a 3 percent floor applicable to other medical expenses. Second, a taxpayer must compute amounts paid for medicine and drugs to the extent they exceed 1 percent of his adjusted gross income. This excess is then added to the remainder of the cost of his medical insurance (which was not deductible in the manner described above) and to general medical expenses not otherwise compensated by insurance. If the total of these items exceeds 3 percent of the taxpayer's adjusted gross income. then that excess is deductible as a medical expense.

Nonbusiness casualty and theft losses are deductible under present law only to the extent that the loss in each case exceeds $100.

We propose to apply a floor of 5 percent of adjusted gross income on medical expenses and casualty losses. Further, we proposed repeal of the deduction for one-half of medical insurance premiums (up to $150) allowable without regard to the current 3 percent floor. The 1 percent floor with respect to medicine and drugs would also be eliminated. Expenses for drugs would be covered under the proposed 5 percent floor, but the deduction would apply only to prescription drugs.

Aggregation of medical and casualty deductions is desirable because they are quite similar. Both are based on the theory that they reduce a taxpayer's ability to pay because of unfortunate circumstances generally beyond his control. The 5 percent level is where these expenses become extraordinary and affect substantially a taxpayer's ability to pay taxes.

Third, we propose a $200 floor on the deduction of the following expenses: Employee business expenses such as union dues, work clothes, small tools, educational expenses and home office expenses; and, expenses such as tax return preparation expenses, and investment expenses such as the cost of financial newspapers, financial periodicals, investment advisory services and safe deposit boxes.

We propose a $200 floor on these expenses because of the considerable difficulty experienced by taxpayers in keeping records of a number of relatively small items. By limiting these deductions to cases where a taxpayer incurs a significant amount of such expenditures, some difficulty in completing tax returns will be eliminated for many taxpayers.

We propose the adoption of a "Miscellaneous Deduction Allowance" of $400 ($200 in the case of a married individual filing a separate return) for taxpayers who itemize their deductions to replace the itemized deductions eliminated or restructured by our proposal. This deduction would be in addition to a taxpayer's other itemized deductions which are unaffected by this proposal.

Child Care Provision

The child care provision of H.R. 10612 converts the current treatment of household and dependent care expenses from an itemized deduction to a nonrefundable tax credit. The revenue loss from adoption of a credit is estimated to be $325 million for 1976, $355 million for 1977, and $393 million for 1978, with the amounts projected to increase substantially for the years 1979–1981. Such high cost for the child care credit is entirely unjustified in terms of the resultant benefits.

Simplification and expansion of the provision can be provided adequately by retaining the existing deduction without substantial revenue loss. We continue to emphasize that the child care deduction should be made available only to low and moderate income taxpayers whose economic situation is such that it compels both spouses to work and who thus have no spouse at home to care for dependents. There can be no justification for allowing the tax system to subsidize high-income taxpayers in discharging a personal obligation to care for dependents and thereby depart from what is the proper basis for the provision.

We generally support the other revisions of the child care deduction made by H.R. 10612. Thus, we support those measures which make it fairer and simpler such as its extension to married couples where the husband or wife, or both, work part time, or where one is a full-time student and the other works. Similarly, we support elimination of the monthly limitation on the deduction in favor of an annual deduction.

We also support elimination of the current distinction between care outside the home and care in the home, making the deduction available to a divorced or separated parent with custody of a child, and to a deserted spouse.

Sick Pay Exclusion

Another prime candidate for simplification is the sick pay exclusion provisions of the Code. Under present law, sick pay is excluded from gross income and, therefore, not subject to tax. However, these provisions are complicated by special rules turning on the amount of the weekly sick pay, the number of days the employee has been absent from work, the relationship between the sick pay and the employee's regular wages, and whether the taxpayer has been hospitalized.

H.R. 10612 repeals the present sick pay exclusion and the complicated time and percentage rules. A maximum annual exclusion of $5,200 ($100 a week) is provided only for taxpayers under age 65 who are permanently and totally disabled. After age 65, these individuals are eligible for a retirement income credit. The provision requires a reduction of the exclusion on a dollar-for-dollar basis by the amount of the taxpayer's income, including disability income, in excess of $15,000.

While the House modifications of the sick pay provisions are a step in the right direction, we believe that complete repeal of these provisions is essential to the goal of simplification and equity. The sick pay provisions were enacted with worthwhile objectives in mind. However, limitations, conditions, and exceptions had to be grafted onto them to prevent abuses and substantial revenue losses. As a result, these provisions are now incomprehensible to the average taxpayer. More fundamentally, no justification exists for treating sick pay any differently than other wages. Taxpayers who have comparable ability to pay should be taxed in a similar manner.

Retirement Income Credit

There is a need to redesign the present retirement income credit for several basic reasons:

First, the complexity of the present retirement income credit prevents it from providing the full measure of relief it was intended to grant to elderly people. Individuals who receive little or no social security benefits should be subject to a tax treatment roughly comparable to that accorded those who receive tax-exempt social security benefits. However, difficult compliance burdens have been imposed on large numbers of elderly people, many of whom are not skillful in preparing tax returns. These individuals must now compute their retirement income credit on a separate schedule which involves 19 separate items, some of which require computations in three separate columns. Further, the special provisions for public retirees under age 65 also add substantially to this complexity.

It is these complexities which undoubtedly account for the fact that some of the organizations representing retired people have estimated that as many as one-half of all elderly individuals eligible to use the retirement income credit do not claim this credit on their tax returns.

Second, the credit needs revision because most of its basic features have not been revised since 1962 when the maximum level of income and the current earnings limits were established. Since that time, social security benefits have been substantially liberalized. As a result, the present maximum amount of income eligible for the credit is considerably below the average social security primary and supplementary benefits received by retired workers.

Third, the present credit discriminates among individuals with modest incomes, depending on the source of their income. The credit is available only to those with retirement income—that is, some form of investment or pension income in the taxable year. Elderly individuals who must support themselves by earning modest wages, and who have no investment or pension income, are not eligible for any relief under the present credit.

This feature of present law is unfair. Elderly individuals who rely on earned income should be allowed the same retirement income credit as those who live on investment income.

In 1973, we recommended a revision of the retirement income credit. With one exception, H.R. 10612 follows our recommendations. The retirement credit is converted to an age credit, available to all taxpayers age 65 or over regardless of whether they have retirement income or earned income. Further, the maximum amount on which the credit is computed was increased and much of the complexity reduced or eliminated.

One further step is necessary. The separate treatment of the retirement income of public employees under age 65 should be eliminated. The continuation of this treatment perpetuates the extraordinary complexity of this provision. This would be contrary to the goal of simplification and fairness which was the major purpose of amending the existing retirement income credit in the first instance.

Foreign Income Provisions

The House Bill has several provisions dealing with the taxation of foreign income. I would like to comment briefly on a few of these provisions.

Foreign Tax Credit

The United States employs a foreign tax credit to avoid double taxation of income. The basic concept of a foreign tax credit system is that, when an enterprise of one country does business in another country, the country in which the business is carried on has the first right to tax the income of the business. The home country also taxes the income, but only to the extent that the home tax does not duplicate the tax of the country where the income is earned. The duplication is eliminated by the foreign tax credit.

The basic concept of the foreign tax credit is sound, and has the full support of the Administration. The foreign tax credit is neither a tax loophole nor an incentive to invest abroad. It is merely part of a system of allocating primary taxing jurisdiction to the country within whose borders the income is earned. U.S. companies are taxable on their worldwide income. Our tax credit system does not reduce the total tax bill of U.S. companies below the amount they would have paid if the income had been earned here. The effect is that the total tax is limited to the higher of the U.S. tax or the foreign tax.

Despite the basic soundness of the foreign tax credit, there are technical problems with our present system. H.R. 10612 contains several provisions which deal with these problems.

At present, taxpayers may compute their foreign tax credit under either the per-country limitation or the overall limitation. Under the per-country limitation, the foreign tax credit is applied to the taxes and the income of each country separately. Where taxes in a given foreign country exceed the U.S. tax on the income from that country, that excess is not creditable. Where another foreign country's taxes are less than the U.S. tax on the foreign income from that other country, the taxpayer will have additional tax to pay to the United States. When there is a loss in a particular country, that loss can reduce U.S. taxes on U.S. income, even if there is income in other countries with respect to which no U.S. tax is payable because of the foreign tax credit.

Under the overall limitation, the taxpayer aggregates all his foreign income and all his foreign taxes. If the foreign taxes do not exceed the U.S. tax on the foreign income, then the entire amount of foreign tax may be taken as a credit. The overall limitation permits the taxpayer to average out high foreign taxes with low foreign taxes, but does not allow foreign losses to reduce U.S. taxes on U.S. income, unless there is an overall foreign loss.

The opportunity that taxpayers now have either to offset foreign losses against domestic income or to average high and low foreign taxes has given rise to demands for revision of our foreign tax credit system. In response to these demands, the House bill eliminates the per-country limitation.

The Ways and Means Committee Report explains that the elimination of the per-country limitation is necessary to prevent foreign losses from offsetting domestic income, except in the case of an overall foreign loss. In addition, the per-country limitation creates difficult administrative problems. The primary problem is the difficulty of providing adequate source rules. Because of these problems with the per-country limitation, the Administration has not objected to its repeal.

The House Bill also includes a foreign loss recapture provision. This provision was proposed by Treasury in slightly different form in 1973, but we support it in its present form. We view this as a technical change to eliminate an unintended benefit. Under present law, a U.S. taxpayer can use foreign start-up losses to reduce U.S. tax and then pay no U.S. tax on subsequent foreign gains because of the foreign tax credit. In such a case it is only fair for the U.S. to recapture the tax lost during the start-up period.

The House Bill provides a capital gain adjustment to the foreign tax credit. We view this as a technical improvement, and we support it. Capital gains are subject to lower U.S. tax, and it is logical that foreign capital gains should receive a correspondingly lower foreign tax credit limitation. Similarly, we view the full gross-up for less developed country dividends as a desirable simplification, eliminating an inefficient preference in our tax laws.

DISC

The House Bill has introduced an incremental export rule for United States exporters through DISC and has provided that certain goods are not eligible for DISC benefits. The Administration supports DISC and opposes the House cut-backs in the program.

DISC stimulates exports. During the time DISC has been in existence, United States exports have grown from $44 billion in 1971 to some $118 billion in

1975. Obviously, all of this growth cannot be attributed to DISC. The growth reflects worldwide trade expansion, exchange rate adjustments, varying inflationary movements, and so on. But part of the growth is due to the incentive of DISC. Most estimates of the DISC part of the growth range between $4 billion and $6 billion per year.

DISC creates jobs. With more goods exported, more goods must be produced, and more people are employed to produce them. DISC tends to neutralize the provisions in foreign tax laws which encourage United States businesses to establish plants abroad or encourage foreign export efforts in competition with U.S. exports.

Any curtailment of DISC would be particularly unfortunate at this time, when the economy is in the midst of a recovery. It would increase our present problem of capital formation by raising the taxes on capital at a time when they should be lowered. It would hit hardest those companies who have been doing the most to help our export efforts. We shouldn't alter DISC until there is agreement in the multilateral trade negotiations concerning uniform rules for taxation of exports.

The House moved to restrict DISC benefits in two ways:

First, the bill takes away DISC benefits for the export of certain goods. The Tax Reduction Act of 1975 has already made natural resources ineligible for DISC. The current bill would add to the disqualified list agricultural products not in excess supply and military equipment.

Second, for companies with profits in excess of $100,000, the House Bill restricts DISC benefits to income on sales in excess of 75 percent of average sales during a base period.

The first change, the disqualification of certain items from DISC, reflects a desire to remove the export stimulus from the export of goods believed to be undeserving of stimulus. This effort produces hardship for companies exporting those items. The hardship is made particularly difficult by the lack of adequate transitional rules for those companies previously exporting the now-disqualified items.

The second change, the incremental approach, was considered seriously during the development of the DISC legislation in 1971, at a time when income on incremental DISC sales would have been 100 percent deferred, rather than 50 percent deferrd. This Committee judged an incremental approach unsatisfactory and the legislation emerged with an alternative of a 50 percent deferral. The reasons valid in 1971 for rejecting an incremental approach remain valid today. The problem is similar to that posed by excess profits tax legislation. Inevitably, any base period will lead to unfairness. The new entrant will have an undue advantage, and the company with declining sales will have no incentive to slow the trend. An already complex statute will be rendered increasingly unworkable to the detriment of U.S. exports and jobs.

DISC has been in place for only a short time. And, it is working. Many companies have made significant investments in reliance on it, but the legislative tinkering with the DISC can only weaken the program. DISC, like the investment credit, should not be turned on and off depending on the whim of the moment. We must resist the temptation to adopt stop and go policies, which create a climate of great uncertainty for business planning.

Other Foreign Income Items

The House Bill contains a number of other changes in the tax treatment of foreign income. In general, we either support, or do not oppose, these changes. I would like to mention in particular only two of these items.

First the foreign trust provision. The House Bill would end the tax loophole whereby many wealthy individuals avoid U.S. tax through the creation of foreign trusts. We strongly support this provision and, in particular, would oppose any attempt to weaken the provision or to postpone its effective date.

Second, the changes in the ruling requirements with respect to tax-free reorganizations of foreign corporations. These changes are very technical, but in general would allow taxpayers either to determine the effects of a transaction from the regulations rather than applying for a ruling or to apply for a ruling after the event takes place rather than being required, as under present law, to obtain an advance ruling. We strongly support this provision.

Administrative Provisions

The House Bill contains numerous changes affecting the administrative provisions of the Code. Most of these provisions would directly benefit the cause of sound tax administration and the Treasury welcomes their enactment. For example, the provisions dealing with income tax return preparers, declaratory judgments in section 501(c)(3) cases, assessments in the cases of mathematical or clerical errors, and minimum exemptions from levy for wages, etc., would all have the effect of improving our tax system and we hope these provisions, with certain minor drafting changes, will be enacted into law.

Jeopardy and Termination Assessments; Administrative Summons

We believe, however, that extensive revisions are required in two provisions of the House Bill, those dealing with jeopardy and termination assessments and with administrative summons. Whenever the Congress makes changes in the area of the capability of the Service to perform its tax administration responsibilities, great care must be taken to provide that such changes do not diminish the ability of the Service to effectively and fairly carry out these responsibilities. While we share fully the concern underlying the House Bill for the protection of taxpayers' rights, we believe these provisions go too far in imposing burdensome administrative procedures on the Service that unduly handicap its ability to collect taxes.

For example, the Internal Revenue Service uses administrative summons to obtain needed information from third parties concerning the tax liability of taxpayers. This important investigatory tool, which has been provided by modern revenue laws since at least 1926, is essential to investigating cases in which there is a substantial probability of serious noncompliance with the revenue laws. Although the Department believes that legislative review of the entire administrative summons procedure is desirable at this time, it opposes the particular amendments passed by the House. If enacted, they would enable a taxpayer, by simple notice, to prevent a third party from giving the IRS information from the third party's records relevant to the liability of the taxpayer and compel the government to institute a court action (to which the taxpayer will be a party) for the release of that information. This will mean that in every case in which there is a high probability of noncompliance with the tax laws, IRS investigations will, from their inception, be frequently tied up for extended periods of time without any investigatory progress.

As regards jeopardy and termination assessments, the *Laing* case, decided by the Supreme Court after the House Bill was passed, will plainly alter procedures which the Service must follow in termination assessment cases, and the effect of this decision should be taken into account when your Committee considers these provisions.

Employment Taxes

There are two important areas affecting tax administration which are not dealt with in the House Bill that we would hope the Committee will give its serious consideration. The first deals with the Service's administration of the employment tax area. Despite vigorous actions by the Internal Revenue Service, the tools available under present law are simply not adequate to cope with mounting delinquencies in unpaid employment taxes. Our experience shows that this overall deterioration in compliance requires a thorough revision of the basic definition of the employer-employee relationship and the penalty structure for failures to file, collect, withhold, account for, and pay over employment taxes. Accordingly, we would like to work with your Committee in developing clearer and more uniform statutory guidelines with respect to when an employer-employee relationship exists. Such guidelines would have the beneficial effect of making clear the types of relationships that would be subject to the various employment taxes. This would provide greater certainty for taxpayers and eliminate the necessity for the Service to devote a vast amount of administrative time and resources to determining responsibility for payment of employment taxes.

Interest on Delinquent Taxes

The second area relates to the amount of interest charged and paid by the Service on underpayments and overpayments of tax. Under present law (enacted last year), the rate of interest for tax purposes is to be fixed, not more frequently than every two years, at 90 percent of the average predominant prime rate quoted by commercial banks as determined by the Board of Governors of the Federal Reserve System. To make the tax rate of interest more realistic when compared with interest rates in the money markets, we recommend that it be raised from 90 percent to 125 percent of the prime interest rate charged by commercial banks. With this revision, the interest rate on underpayments and overpayments of tax would conform more nearly to the interest rates that the average taxpayer could obtain in the money markets and, thus, make it less attractive for taxpayers to "borrow" from the Government by being delinquent in their tax payments. In addition, we recommend that provision be made for an annual, rather than a biennial, adjustment in the tax interest rate.

I would like to comment, now, on two other administrative provisions in more detail.

Disclosure of Private Letter Rulings

The House Bill contains a detailed set of rules providing for public disclosure of the substance of private letter rulings issued by the Internal Revenue Service to taxpayers and of National Office technical advice memoranda issued to district directors, if disclosed to the taxpayer involved. We enthusiastically endorse this basic concept of making public what has come to be considered a body of "secret law."

While the structure of the section is elaborate in describing what must be disclosed under its terms, it fails to provide sufficient safeguards for the legitimate confidentiality of materials involved. This deficiency results from the fact that the section does not provide that it is the exclusive means of public access to the material encompassed in its scope. Thus, the section leaves unresolved the basic issue as to what information contained in a ruling or a technical advice memorandum, or the related background file, is subject to public disclosure under other provisions of the law, principally the Freedom of Information Act. Nor does the section resolve the issue of what portions of such information are protected from disclosure by the confidentiality principles underlying our self-assessment tax system.

The section also provides that, in general, the identity of the recipient of a private letter ruling will be made public as part of the ruling itself. As a result, it is likely that a complicated and cumbersome procedure will have to be established by the Service to insure that other significant information will be deleted from the public text of the ruling in order to protect the confidential affairs of the taxpayer.

We believe that the "secret law" is best understood when disclosure includes as many of the relevant facts as possible and, moreover, that broadscale disclosure of the identity of ruling recipients serves no useful public function particularly when compared to the potential damage it may do to the basic confidentiality of the tax system. We urge the committee, therefore, to attempt to find a method under which identities of ruling recipients would be disclosed when there is compelling cause for the disclosure but under which, as a general rule, such identities would remain confidential. If a successful solution to this problem is found, the need to delete other information from the ruling in order to protect a taxpayer's personal or financial privacy would be reduced.

Certainly it will remain necessary for a procedure to exist to permit the taxpayer and the Internal Revenue Service to agree, before the issuance of a ruling, as to what information may be disclosed. The taxpeyer should be entitled to protect trade secrets and other sensitive material, even if his identity will not be disclosed, by withdrawing his ruling request. But so long as his identity will not be disclosed, this agreement procedure should be facilitated; and public disclosure should not interfere with the basic ruling and technical advice issuance programs.

I do want to emphasize, amid these comments, our basic support of many concepts embodied in the House Bill. It preserves the confidentiality principles of the Freedom of Information Act; it recognizes the repetitiveness of certain rulings by permitting disclosures of certain rulings in summary form; it acknowledges the need of the Service for judicial uniformity on the scope of disclosure by limiting disclosure and confidentiality actions to the Tax

Court and the District Court for the District of Columbia with appeal to the Court of Appeals for the District of Columbia Circuit; and it permits delay of disclosure when premature disclosure would interfere with a pending transaction.

We also believe it critical to have an effective date for disclosure of future rulings to commence upon the expiration of a reasonable time, say 90 days, after enactment of the precise statutory rules governing disclosure. The taxpayer has a right to know, at the time he requests his ruling the degree of publicity to which has affairs may be subject; and the Internal Revenue Service will have a massive gearing-up task to face.

In addition, consideration should be given as to the best manner in which to make public rulings requested in the past. First, we think that the most recent rulings are likely to be the most informative to the public so that a last-in-first-out (LIFO) order should be used. And, the Service for its own internal purposes as important, or "reference," rulings will be the most useful and should be disclosed prior to any past "routine" rulings.

Most important in your consideration of this issue is the preservation of the concept in the House Bill that the process of disclosure of past rulings is expensive and should not be required without additional appropriation of funds by Congress for this specific purpose.

Confidentiality of Tax Returns

As you are well aware, another matter related to the confidentiality of our tax system has been the subject of recent Congressional concern, that is, the degree to which tax returns and tax return information are made available to governmental agencies outside the Treasury Department. Several members of Congress, including Senators Weicker, Bentsen, Montoya, and Dole, have introduced legislation to make section 6103, the section governing tax return confidentiality, more specific and restrictive—replacing the present broad grant of authority to the President to authorize disclosure by Executive Order.

In this Congress and the last, the Administration sent to the Congress a bill which, in our view, constitutes an appropriate statutory balancing of the need for confidentiality in the self-assessment tax system and privacy for the taxpayer with the legitimate needs of relevant governmental agencies for access to a data source of unparalleled detail and completeness. At the end of January of this year, the General Counsel of the Treasury, Mr. Albrecht, and the Commissioner of Internal Revenue, Mr. Alexander, presented the Treasury Department's and the Service's views on this subject to the House Ways and Means Committee. Such a complete discussion would be inappropriate in the general context of my remarks and this hearing; but we are ready and eager to meet with your Committee to review in detail the factors which we believe must be taken into consideration in the legislative resolution of this complex issue.

Let me, nonetheless, raise a few of the most pressing issues for your review.

First, there is substantial similarity among the majority of the proposals presently before the Congress on the basic issues. There must be a comprehensive set of statutory rules to replace the open ended Executive Order system of present law. This system should cover not only the tax return itself but also other tax data concerning a taxpayer gathered by the Service.

There are entities outside the Treasury Department which most proposals agree have legitimate need for access to tax return information. These include the Justice Department when it acts as the Internal Revenue Service's attorney in litigating tax cases; the staff of the Congressional Joint Committee on Internal Revenue Taxation and the tax-writing committees of the Congress, themselves, when considering the changes in the tax laws or performing their oversight function; the President and his specifically designated assistants when he is acting in his capacity as the Constitutional Chief Executive; and state tax administrators when trying to verify the correctness of income reported on a state income tax return. On most of these issues, there is almost unanimous agreement.

Second, the principal area of contention seems to relate to the use of tax data in nontax law enforcement investigations and court proceedings. We believe that the Internal Revenue Service has all the necessary incentive to protect the confidentiality of returns if given a set of statutory rules permitting it to resist demands for disclosure. The Administration's Bill requires that the Service be satisfied that the information sought for nontax law enforcement use "cannot reasonably be obtained from another source" and that the disclosure of the information will not "seriously impair the administration of the Federal tax law."

A further requirement that the information have a "direct bearing" on the investigation or proceeding applies in the case of so-called "third party" returns. We strongly feel that such a system of administrative control should be tested in use before a cumbersome court order or search warrant procedure is established to govern access by non-Treasury personnel to tax returns.

Third, we believe that analysis of the degree of publicity involved in a disclosure and the relationship of the taxpayer to the matter under investigation or litigation is necessary to determine the standards for disclosure. Thus, a public courtroom disclosure must be justified by a stronger showing of necessity or relevance than must a disclosure within the federal government. And the disclosure of a third-party's return should be permitted only on a showing of a degree of directness of relevance specified in the statute.

Fourth, we have concluded, based primarily on the absence of past abuse and on convincing claims of need, that the statistical agencies of the Federal Government—specifically the Census Bureau, the Bureau of Economic Affairs, and the Federal Trade Commission's Bureau of Economics—should have access to individualized tax data for statistical purposes under strict confidentiality controls.

Fifth, any amendment should permit the taxpayer to designate agents to inspect his own tax information and to consent to any otherwise unauthorized disclosure of information by the Internal Revenue Service.

Finally, we believe that nontax-writing Congressional committees should have access to returns if authorized by a specific resolution of the appropriate house and that the President, similarly, should not be limited to "tax-administration-only" access to tax data. There should, however, be a written record of accountability for each disclosure (in the form of the resolution on one hand and a personally signed request on the other), and a specification of the staff assistants who are to be entitled to act as agents for the President and the Congress in carrying out their constitutional functions.

Clearly, there are many detailed provisions to be worked out. But we are optimistic that there is a solid foundation of agreement on which a final and practical structure can be erected which will protect the privacy of taxpayers and enable the government to function effectively.

Conclusion

In this testimony I have addressed long and seemingly disparate list of tax provisions. As the members of this Committee well know, when we attempt to embody policy in concrete provisions of the law, it is difficult to avoid becoming entangled in a web of complexity. But let us keep before us the long-term objectives of this Administration and, I believe, of all of you. The tax system should be fair. The tax system should be simple. The tax system should promote efficient use of resources.

Inevitably we are going to take some steps backward as we take other steps forward and often we are going to move sideways. I believe that the positions I have urged upon you today represent the direction of improvement. However, I must candidly say to you that I see a vast potential for further improvement. As I have said earlier and as I have said many times elsewhere, I believe that the extraordinary complexity of our tax system has begun to threaten public confidence in it, and I do not believe that this complexity is required to serve the objectives of fairness and efficiency. Quite to the contrary.

Let us then, by all means, take the steps I have urged upon you in the direction of a better income tax Code, but let us not stop there. Let us have these steps represent a part of a process of continuing true tax reform which will take us eventually to a tax system which looks as though someone had constructed it on purpose, a simple progressive tax on a broad base which adequately reflects individual taxpayer's ability to pay. That is the tax break all Americans are waiting for.

Thank you.

Table 1

Real Gross National Product

Billions of 1972 dollars, seasonally adjusted at annual rates

Period		Real GNP
1970		1075.3
1971		1107.5
1972		1171.1
1973	I	1227.7
	II	1228.4
	III	1236.5
	IV	1240.9
1974	I	1228.7
	II	1217.2
	III	1210.2
	IV	1186.8
1975	I	1158.6
	II	1168.1
	III	1201.5
	IV	1215.9

Office of the Secretary of the Treasury
Office of Tax Analysis

March 11, 1976

Table 2

Consumer Price Index

Seasonally Adjusted

Period	Level (1967=100)	Percent Change From Last Period (Annual Rates)
1970	116.3	5.9
1971	121.3	4.3
1972	125.3	3.3
1973 I	128.8	6.0
II	131.6	8.7
III	134.3	8.2
IV	137.5	9.5
1974 I	141.6	11.9
II	145.5	11.0
III	149.7	11.5
IV	154.1	11.8
1975 I	157.2	8.0
II	159.6	6.1
III	162.8	8.0
IV	165.5	6.6
October	164.5	7.3
November	165.5	7.3
December	166.4	6.5
1976 January	167.1	5.0

Office of the Secretary of the Treasury
Office of Tax Analysis

March 11, 1976

Table 3

Productivity Growth, 1960-1973
(Average Annual Rate)

	Gross Domestic Product per employed person	Manufacturing output per manhour
United States	2.1	3.3
Japan	9.2	10.5
West Germany	5.4	5.8
France	5.2	6.0
Canada	2.4	4.3
Italy	5.7	6.4
United Kingdom	2.8	4.0
11 OECD Nations	5.2*	6.1

*Average for 6 OECD countries listed.

Source: Department of the Treasury

Table 4

ACTUAL AND PROJECTED INVESTMENT AS A PERCENT OF GNP

	Average 1965-1974	NYSE 1/	Bosworth Duesenberry Carron 2/	Friedman 3/	G.E. 4/	DRI 5/	Chase Econometrics 6/
Gross private domestic investment	15.1	16.4	15.5	15.8	15.8	15.7	15.9
Non-residential fixed	10.4	12.1	11.3	11.5	11.4	11.0	11.8
Inventory	1.0	0.3	0.8	0.8	0.4	0.8	0.8
Residential	3.8	3.9	3.5	3.5	4.0	3.8	3.3

1/ The New York Stock Exchange, The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985, September 1974. Figures shown are based on cumulative projections in current dollars, 1974-1985.

2/ Barry Bosworth, James S. Duesenberry, and Andrew S. Carron, Capital Needs in the Seventies, The Brookings Institution, 1975. Figures shown are based on estimates for 1980 in current dollars from Table 2-12, p. 39 (note the constant dollar 1980 figures in Table 2-11 project gross private domestic investment as 15.8 percent of GNP).

3/ Benjamin M. Friedman, "Financing the Next Five Years of Fixed Investment" in President's Authority to Adjust Imports of Petroleum, Public Debt Ceiling Increase; and Emergency Tax Proposals; Hearings before the Committee on Ways and Means, House of Representatives, January 1975, pp. 710-726. Figures shown are based on 1975-79 averages of current dollar projections.

4/ Reginald H. Jones, "Capital Requirements of Business, 1974-85," Testimony submitted to Subcommittee on Economic Growth, Joint Economic Committee, May 8, 1974. Figures shown are based on cumulative projections in current dollars, 1974-1985.

5/ Data Resources, Inc., Summer 1975, "Special Study: The Capital Shortage." Summary table on inside cover. 1985 data only, current dollars, standard forecast.

6/ Chase Econometrics August 1975. "The Next Ten Years: Inflation, Recession and Capital Shortage." 1984 data only, current dollars. Table, page #1 of 14. No recession run.

Table 5

Debt-Equity Ratios for Selected Industries 1/

Fourth Quarter of Year	All Manufacturing	Durable Goods	Motor Vehicles & Equipment	Electrical & Electronics Equipment	Primary Iron & Steel	Non-Durable Goods	Textile Mill Products	Industrial Chemicals	Petroleum and Coal Products
1956	.249	.224	.147	.316	.191	.254	.243	.263	.200
1957	.242	.233	.150	.290	.188	.251	.251	.276	.197
1958	.239	.233	.136	.260	.208	.246	.236	.306	.198
1959	.237	.235	.132	.284	.216	.239	.237	.289	.180
1960	.246	.248	.126	.282	.231	.244	.242	.283	.178
1961	.250	.255	.135	.273	.272	.245	.257	.280	.172
1962	.253	.256	.122	.299	.257	.248	.270	.299	.166
1963	.253	.253	.113	.296	.239	.253	.313	.338	.168
1964	.258	.253	.110	.293	.249	.262	.310	.368	.165
1965	.282	.275	.120	.330	.262	.289	.337	.426	.186
1966	.321	.321	.141	.403	.309	.319	.364	.426	.211
1967	.350	.353	.155	.446	.330	.347	.392	.452	.233
1968	.377	.375	.158	.444	.358	.382	.408	.465	.268
1969	.412	.420	.194	.498	.407	.403	.448	.474	.271
1970	.444	.463	.215	.546	.472	.427	.463	.505	.287
1971	.444	.459	.255	.518	.498	.429	.457	.495	.309
1972	.431	.442	.232	.505	.500	.420	.526	.485	.292
1973	.437	.455	.264	.549	.500	.417	.559	.463	.282
1974	.433	.448	.230	.508	.370	.415	.556	.446	.221
1975	.431	.450	.287	.467	.422	.412	.535	.503	.238

Office of the Secretary of the Treasury
Office of Tax Analysis

March 11, 1976

1/ Total stockholder equity divided by total short-term bank loans, installments due on one-year or less on long-term debt and long-term debt due in more than one year.

Source: Federal Trade Commission "Quarterly Financial Report for Manufacturing Corporations," Fourth Quarter of Year. Not adjusted for changes in sample or methods of reporting.

Table 6

The President's Tax Cut Proposals

(1975 Levels of Income)

($ billions)

	President's Tax Cut Proposals
Individual	21.2
Increase personal exemption	10.1
Standard deduction changes	4.0
Tax rate reductions	6.6
Investment tax credit 1/	0.5
Corporate	6.7
Surtax exemption and normal rates	1.5
Surtax rate	2.2
Investment tax credit 1/	2.5
Utility relief	0.6
Total	27.9

Office of the Secretary of the Treasury
Office of Tax Analysis

March 15, 1976

1/ The investment tax credit changes do not affect tax liabilities until 1977, since these exact changes were already included in the Tax Reduction Act of 1975 and extended through 1976.

Note: Figures may not add to totals due to rounding.

Table 7

Tax Rate Schedule for President's
Tax Reduction Proposals
(Single Taxpayers)

Taxable income bracket		Present rates	Proposed rates for 1976	Proposed rates for 1977
$ 0	$ 500	14 %	13 %	12 %
500	1,000	15	14	13
1,000	1,500	16	15.5	15
1,500	2,000	17	16	15
2,000	3,000	19	17.5	16
3,000	4,000	19	18	17
4,000	5,000	21	19.5	18
5,000	6,000	21	20	19
6,000	8,000	24	22.5	21
8,000	10,000	25	24.5	24
10,000	12,000	27	27	27
12,000	14,000	29	29	29
14,000	16,000	31	31	31
16,000	18,000	34	34	34
18,000	20,000	36	36	36
20,000	22,000	38	38	38
22,000	26,000	40	40	40
26,000	32,000	45	45	45
32,000	38,000	50	50	50
38,000	44,000	55	55	55
44,000	50,000	60	60	60
50,000	60,000	62	62	62
60,000	70,000	64	64	64
70,000	80,000	66	66	66
80,000	90,000	68	68	68
90,000	100,000	69	69	69
100,000	--	70	70	70

Office of the Secretary of the Treasury
Office of Tax Analysis

January 12, 1976

Table 8

Tax Rate Schedule for President's Tax Reduction Proposals (Married Taxpayers Filing Jointly)

Taxable income bracket		Present rates	Proposed rates for 1976	Proposed rates for 1977
$ 0	$ 1,000	14 %	13 %	12 %
1,000	2,000	15	14.5	14
2,000	3,000	16	15.5	15
3,000	4,000	17	16	15
4,000	6,000	19	17.5	16
6,000	8,000	19	18	17
8,000	10,000	22	21.5	21
10,000	12,000	22	22	22
12,000	16,000	25	25	25
16,000	20,000	28	28.5 1/	29 1/
20,000	24,000	32	33 1/	34 1/
24,000	28,000	36	36	36
28,000	32,000	39	39	39
32,000	36,000	42	42	42
36,000	40,000	45	45	45
40,000	44,000	48	48	48
44,000	52,000	50	50	50
52,000	64,000	53	53	53
64,000	76,000	55	55	55
76,000	88,000	58	58	58
88,000	100,000	60	60	60
100,000	120,000	62	62	62
120,000	140,000	64	64	64
140,000	160,000	66	66	66
160,000	180,000	68	68	68
180,000	200,000	69	69	69
200,000	---	70	70	70

Office of the Secretary of the Treasury
Office of Tax Analysis

January 12, 1976

1/ While two rates are increased in the higher brackets, taxpayers with income taxed in those brackets will benefit from rate reductions in the lower brackets so that on balance the changes in rates reduce taxes even for those affected by the increased rates.

Table 9

Tax Liabilities Under Various Tax Laws for Single Person Without Dependents, With Itemized Deductions of 16 Percent of Adjusted Gross Income 1/

Adjusted gross income class	Tax Liability					
	1972-74 law	1975 law 2/	Revenue Adjustment Act	Revenue Adjustment Act extended	Proposed 1976 law	Proposed 1977 law
$ 5,000	$ 490	$ 404	$ 425	$ 364	$ 334	$ 307
7,000	889	796	800	715	677	643
10,000	1,506	1,476	1,430	1,331	1,278	1,227
15,000	2,589	2,559	2,500	2,410	2,358	2,307
20,000	3,847	3,817	3,757	3,667	3,609	3,553
25,000	5,325	5,295	5,235	5,145	5,080	5,015
30,000	6,970	6,940	6,880	6,790	6,722	6,655
40,000	10,715	10,685	10,625	10,535	10,455	10,375
50,000	15,078	15,048	14,988	14,898	14,811	14,725

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

1/ If standard deduction exceeds itemized deduction, uses standard deduction.

2/ Assumes that taxpayer is not eligible for the Home Purchase Credit.

Table 10

Tax Liabilities Under Various Tax Laws for Family with No Dependents, Filing Jointly with Itemized Deductions of 16 Percent of Adjusted Gross Income 1/
(Dollars)

Adjusted gross income class	Tax Liability					
	1972-74 law	1975 law 2/	Revenue Adjustment Act	Revenue Adjustment Act: extended	Proposed 1976 law	Proposed 1977 law
$ 5,000	$ 322	$ 170	$ 225	$ 130	$ 88	60
7,000	658	492	548	448	387	335
10,000	1,171	1,054	1,084	948	872	800
15,000	2,062	2,002	1,972	1,862	1,827	1,750
20,000	3,085	3,025	2,995	2,905	2,842	2,780
25,000	4,240	4,180	4,150	4,060	4,006	3,950
30,000	5,564	5,504	5,474	5,384	5,358	5,328
40,000	8,702	8,642	8,612	8,522	8,481	8,444
50,000	12,380	12,320	12,290	12,200	12,140	12,080

Office of the Secretary of the Treasury
Office of Tax Analysis
March 12, 1976

1/ If standard deduction exceeds itemized deduction, family uses standard deduction.

2/ Assumes that taxpayer is not eligible for the Home Purchase Credit.

Table 11

Tax Liabilities Under Various Tax Laws for Family with 1 Dependent, Filing Jointly with Itemized Deductions of 16 Percent of Adjusted Gross Income 1/

(Dollars)

Adjusted gross income class	Tax Liability					
	1972-74 law	1975 law 2/	Revenue Adjustment Act	Revenue Adjustment Act: extended	Proposed 1976 law	Proposed 1977 law
$ 5,000	$ 208	$ 29	$ 95	$ 0	$ 0	$ 0
7,000	527	336	406	289	234	190
10,000	1,029	882	949	821	726	640
15,000	1,897	1,807	1,807	1,717	1,635	1,535
20,000	2,898	2,808	2,808	2,718	2,624	2,530
25,000	4,030	3,940	3,940	3,850	3,757	3,660
30,000	5,324	5,234	5,234	5,144	5,070	4,938
40,000	8,407	8,317	8,317	8,227	8,140	8,054
50,000	12,028	11,938	11,938	11,848	11,739	11,630

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

1/ If standard deduction exceeds itemized deduction, family uses standard deduction.

2/ Assumes that taxpayer is not eligible for the Home Purchase Credit. Also assumes that taxpayer is not eligible for the Earned Income Credit. Taxpayers maintaining a home in the United States for a dependent child are eligible for the Earned Income Credit (EIC) if they earn less than $8,000. If the effects of the EIC were included, the table would have these entries (negative entries represent direct payments to the taxpayer):

AGI	1975 Law	Revenue Adjustment Act	Revenue Adjustment Act Extended	Proposed 1976 Law
$5,000	- $271	-$55	-$300	- $150
$7,000	+ $236	$356	$189	+ $184

Table 12

Tax Liabilities Under Various Tax Laws for Family
with 2 Dependents, Filing Jointly with Itemized Deductions
of 16 Percent of Adjusted Gross Income 1/
(Dollars)

Adjusted gross income class	Tax Liability: 1972-74 law	1975 law 2/	Revenue Adjustment Act	Revenue Adjustment Act extended	Proposed 1976 law	Proposed 1977 law
$ 5,000	$ 98	$ 0	0	0	$ 0	$ 0
7,000	402	186	$ 268	$ 135	89	60
10,000	886	709	797	651	555	485
15,000	1,732	1,612	1,642	1,552	1,446	1,325
20,000	2,710	2,590	2,620	2,530	2,405	2,280
25,000	3,820	3,700	3,730	3,640	3,507	3,370
30,000	5,084	4,964	4,994	4,904	4,781	4,648
40,000	8,114	7,994	8,024	7,934	7,799	7,664
50,000	11,690	11,570	11,600	11,510	11,345	11,180

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

1/ If standard deduction exceeds itemized deduction, family uses standard deduction.

2/ Assumes that taxpayer is not eligible for the Home Purchase Credit. Also assumes that taxpayer is not eligible for the Earned Income Credit. Taxpayers maintaining a home in the United States for a dependent child are eligible for the Earned Income Credit (EIC) if they earn less than $8,000. If the effects of the EIC were included, the table would have these entries (negative entries represent direct payments to the taxpayer):

AGI	1975 Law	Revenue Adjustment Act	Revenue Adjustment Act Extended	Proposed 1976 Law
$5,000	- $300	-$150	-$300	- $150
$7,000	+ $ 86	$218	$35	+ $ 39

Table 13

Tax Liabilities Under Various Tax Laws for Family with 4 Dependents, Filing Jointly with Itemized Deductions of 16 Percent of Adjusted Gross Income 1/
(Dollars)

Adjusted gross income class	Tax Liability					
	1972-74 law	1975 law 2/	Revenue Adjustment Act	Revenue Adjustment Act extended	Proposed 1976 law	Proposed 1977 law
$ 5,000	$ 0	$ 0	0	0	$ 0	$ 0
7,000	170	0	7	0	0	0
10,000	603	372	$ 481	$ 308	240	190
15,000	1,402	1,222	1,297	1,192	1,078	965
20,000	2,335	2,155	2,230	2,125	1,966	1,816
25,000	3,400	3,220	3,295	3,190	3,003	2,830
30,000	4,604	4,424	4,499	4,394	4,191	4,008
40,000	7,529	7,349	7,424	7,319	7,102	6,896
50,000	11,015	10,835	10,910	10,805	10,543	10,280

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

1/ If standard deduction exceeds itemized deduction, family uses standard deduction.

2/ Assumes that taxpayer is not eligible for the Home Purchase Credit. Also assumes that taxpayer is not eligible for the Earned Income Credit. Taxpayers maintaining a home in the United States for a dependent child are eligible for the Earned Income Credit (EIC) if they earn less than $8,000. If the effects of the EIC were included, the table would have these entries (negative entries represent direct payments to the taxpayer):

AGI	1975 Law	Revenue Adjustment Act	Revenue Adjustment Act Extended	Proposed 1976 Law
$5,000	- $300	-$150	-$300	- $150
$7,000	- $100	-$43	-$100	- $ 50

69-460 O - 76 - pt.1 - 9

Table 14

Comparison of Individual Income Tax Provisions

	1974 Law	1975 Law	Revenue Adjustment Act - unextended 1/	Revenue Adjustment Act extended 2/	President's proposal for 1976	President's proposal for 1977
1. Standard Deduction						
(a) Minimum standard						
Single returns	$1,300	$1,600	$1,500	$1,700	$1,750	$1,800
Joint returns	$1,300	$1,900	$1,700	$2,100	$2,300	$2,500
(b) Percentage standard	15%	16%	16%	16%	16%	-
(c) Maximum standard						
Single returns	$2,000	$2,300	$2,200	$2,400	$2,100	$1,800
Joint returns	$2,000	$2,600	$2,400	$2,800	$2,650	$2,500
2. Personal Exemption Deduction	$750	$750	$750	$750	$675	$1,000
3. Tax Credit						
(a) Per capita	None	$30	$17.50	$35	$17.50	None
(b) Percent of taxable income	None	None	1% up to $90	2% up to $180	1% up to $90	None
4. Rate Reductions	None	None	None	None	See Annex	See Annex
5. Earned Income Credit	None	10% up to $400	5% up to $200	10% up to $400	5% up to $200	None
6. Home purchase credit	None	5% of value up to $2,000	None	None	None	None

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

1/ Full-year tax liability change enacted by Revenue Adjustment Act of 1975.
2/ Extension of Revenue Adjustment Act changes to permit continued use of present withholding tax tables through 1976. These provisions are actually contained in the Act but will be inoperative without further legislation.

Table 15

Revenue Losses of Individual Income Tax Reduction Compared to 1974 Law

(1976 Levels of Income)

($ billions)

	Revenue Adjustment Act unextended	Revenue Adjustment Act extended	Combination of President's program and Revenue Adjustment Act for 1976	President's proposal for 1977
1. Standard Deduction	-1.8	-3.9	-3.9	-4.2
2. Personal Exemption Deduction	-	-	-5.4	-10.6
3. Per Capita Exemption/ Taxable Income Tax Credit	-4.9	-9.5	-4.9	-
4. Rate Reductions	-	-	-3.6	-6.8
5. Earned Income Credit 1/ ..	-0.7	-1.4	-0.7	-
Total	-7.4	-14.9	-18.5	-21.6
Total excluding outlay portion of earned income credit 2/	-6.8	-13.8	-17.9	-21.6

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

1/ Includes outlay portion.

2/ Revenue loss of tax liability changes that affect withholding tax tables.

Table 16

Total Tax Liability Under Various Tax Laws

(1975 Levels of Income)

($ millions)

Adjusted gross income class	1974 law	1975 law 1/	Revenue Adjustment Act unextended	Revenue Adjustment Act extended	President's proposed 1976 law	President's proposed 1977 law
($000)						
Up to 0	44	44	44	44	44	44
0 - 5	2,000	1,165	1,430	998	872	775
5 - 10	14,069	11,514	12,247	10,391	9,702	9,102
10 - 15	23,122	21,099	21,536	19,818	18,653	17,609
15 - 20	23,706	21,944	22,381	21,066	20,264	19,520
20 - 30	28,022	26,782	27,148	26,216	25,470	24,714
30 - 50	16,950	16,579	16,696	16,430	16,174	15,913
50 - 100	12,064	11,962	11,995	11,923	11,803	11,681
100 or over	9,445	9,425	9,431	9,416	9,385	9,354
TOTAL	129,422	120,514	122,906	116,303	112,366	108,711

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

Note: Estimates exclude net refunds under E.I.C.; they are treated as expenditures.

1/ Includes effect of home purchase credit.

Table 17

Distribution of Tax Liabilities Under President's Proposal for 1976 Compared with Revenue Adjustment Act Extended by Size of Adjusted Gross Income

(1975 Levels of Income)

Adjusted gross income class	Total tax liability		Tax cut caused by the President's proposal for 1976		
	Revenue Adjustment Act Extended	President's proposal for 1976	Amount	Percent distribution	As percent of tax under Revenue Adjustment Act Extended
($000)	(............... $ billions		...............)	(.................. percent	........................)
Up to 5	1.0	0.9	0.1	3.2%	12.1%
5 - 10	10.4	9.7	0.7	17.5	6.6
10 - 15	19.8	18.7	1.2	29.6	5.9
15 - 20	21.1	20.3	0.8	20.4	3.8
20 - 30	26.2	25.5	0.7	18.9	2.8
30 - 50	16.4	16.2	0.3	6.5	1.6
50 - 100	11.9	11.8	0.1	3.0	1.0
100 +	9.4	9.4	0.03	0.8	0.3
TOTAL	116.3	112.4	3.9	100.0	3.4

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

Note: Estimates exclude net refunds under E.I.C.; they are treated as expenditures.

Table 18

Distribution of Tax Liabilities Under President's Proposal
for 1977 Compared with Revenue Adjustment Act Extended
by Size of Adjusted Gross Income
(1975 Level of Income)

Adjusted gross income class	Total tax liability		Tax cut caused by the President's proposal for 1977		
	Revenue Adjustment Act extended	President's proposal for 1977	Amount	Percent distribution	As percent of tax under Revenue Adjustment Act extended
($000)	(.................$ billions	................)	(..................	percent	......................)
Up to 5	1.0	0.8	.2	2.9%	21.4%
5 - 10	10.4	9.1	1.3	17.0	12.4
10 - 15	19.8	17.6	2.2	29.1	11.1
15 - 20	21.1	19.5	1.5	20.4	7.3
20 - 30	26.2	24.7	1.5	19.8	5.7
30 - 50	16.4	15.9	0.5	6.8	3.1
50 - 100	11.9	11.7	0.2	3.2	2.0
100 +	9.4	9.4	0.1	0.8	0.7
TOTAL	116.3	108.7	7.6	100.0	6.5

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

Note: Estimates exclude net refunds under E.I.C.; they are treated as expenditures.

Table 19

Distribution of Tax Liabilities Under President's Proposal for 1976 Compared with Revenue Adjustment Act Unextended by Size of Adjusted Gross Income

(1975 Levels of Income)

Adjusted gross income class	Total tax liability		Tax cut caused by President's proposal for 1976		
	Revenue Adjustment Act unextended	Proposed 1976 law	Amount	Percent distribution	As percent of tax under Revenue Adjustment Act unextended
($000)	(........... $ billions		..............................)(	... percent	.....................)
Up to 5	1.5	0.9	0.6	5.3%	37.9%
5 - 10	12.2	9.7	2.5	24.1	20.8
10 - 15	21.5	18.7	2.9	27.4	13.4
15 - 20	22.4	20.3	2.1	20.1	9.5
20 - 30	27.1	25.5	1.7	15.9	6.2
30 - 50	16.7	16.2	0.5	5.0	3.1
50 - 100	12.0	11.8	0.2	1.8	1.6
100 +	9.4	9.4	0.05	0.4	0.5
TOTAL	122.9	112.4	10.5	100.0	8.6

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

Note: Estimates exclude net refunds of E.I.C.; they are treated as expenditures.

Table 20

Income Distribution of Liability Under President's Proposal for 1977 Compared with Revenue Adjustment Act Unextended

(1975 Levels of Income)

Adjusted gross income class	Total of tax liability: Revenue Adjustment Act unextended	Total of tax liability: President's proposal for 1977	Tax cut caused by the President's proposal for 1977: Amount	Tax cut caused by the President's proposal for 1977: Percent distribution	Tax cut caused by the President's proposal for 1977: As percent of tax under Revenue Adjustment Act unextended
($000)	(.......... $ billions	....	.......)	(.percent.................	..........)
Up to 5	1.5	0.8	0.7	4.6%	44.4%
5 - 10	12.2	9.1	3.1	22.2	25.7
10 - 15	21.5	17.6	3.9	27.7	18.2
15 - 20	22.4	19.5	2.9	20.2	12.8
20 - 30	27.1	24.7	2.4	17.1	9.0
30 - 50	16.7	15.9	0.8	5.5	4.7
50 - 100	12.0	11.7	0.3	2.2	2.6
100 +	9.4	9.4	0.1	0.5	0.8
TOTAL	122.9	108.7	14.2	100.0	11.5

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

Note: Estimates exclude net refunds under E.I.C.; they are treated as expenditures.

Table 21

Income Distribution of Liability Under
President's Proposal for 1977 Compared with
President's Proposal for 1976

(1975 Levels of Income)

AGI class ($000)	Total tax liability: President's Proposal for 1976	Total tax liability: President's Proposal for 1977	Tax cut caused by the President's Proposal for 1977: Amount	Tax cut caused by the President's Proposal for 1977: Percent distribution	Tax cut caused by the President's Proposal for 1977: As percent of tax under President's Proposal for 1976
	(..........$ billions	....	...................)	(..percent	....................)
Up to 5	0.9	0.8	0.1	2.7	10.6
5 - 10	9.7	9.1	0.6	16.4	6.2
10 - 15	18.7	17.6	1.0	28.6	5.6
15 - 20	20.3	19.5	0.7	20.4	3.7
20 - 30	25.5	24.7	0.8	20.7	3.0
30 - 50	16.2	15.9	0.3	7.1	1.6
50 - 100	11.8	11.7	0.1	3.3	1.0
100 +	9.4	9.4	0.03	0.8	0.3
TOTAL	112.4	108.7	3.7	100.0	3.3

Office of the Secretary of the Treasury
Office of Tax Analysis

March 12, 1976

Note: Estimates exclude net refunds under E.I.C; they are treated as expenditures.

Table 22

Revenue Losses of Corporate Income Tax Reduction Compared to 1974 Law

(1976 Levels of Income)

($ billions)

	Revenue Adjustment Act unextended	Revenue Adjustment Act extended	Combination of President's program and Revenue Adjustment Act for 1976	President's proposal for 1977
1. Reduce basic corporate rate and increase surtax exemption.........	-1.0	-1.9	-1.9	-1.9
2. Reduce corporate surtax rate......	--	--	-1.2	-2.5
3. Six-point utilities program 1/....	--	--	-0.6	-0.6
Total.	-1.0	-1.9	-3.8	-5.0

Office of the Secretary of the Treasury
Office of Tax Analysis

March 15, 1976

1/ Assumes program effective July 1, 1976.

Note: Figures may not add to totals due to rounding.

Table 23

Annual Costs and Benefits of Taxable Municipal Bond

Plan with 30 Percent Subsidy

(millions of dollars)

Year	1	2	3	4	5	10
Gross subsidy cost	39	79	122	166	213	486
Revenues generated	32	66	102	139	178	405
Net subsidy cost	7	13	20	27	35	81
Reduction in state and local interest costs	69	141	218	297	381	868

Office of the Secretary of the Treasury
Office of Tax Analysis

January 20, 1976

Effects of Tax Proposals on Fiscal Year 1977 Receipts

($ billions)

Proposals	Effect on fiscal year 1977 receipts
ADMINISTRATION PROPOSALS IN 1977 BUDGET:	
President's Tax Cut Proposals Effective July 1, 1976:	
Individual:	
Personal exemption	-10.8
Standard deduction	-4.5
Tax rate changes	-7.0
Investment tax credit	-0.1
Total individual	-22.4
Corporate:	
Two percentage point surtax reduction	-2.0
Change in rate and surtax exemption	-1.7
Extension of investment credit	-1.2
Utility relief	-0.8
Total corporate	-5.7
Total individual and corporate	-28.1
Other Proposals:	
Social security tax rate increase from 11.7% to 12.3% effective January 1, 1977	+3.3
Unemployment tax rate and base increase January 1, 1977	+2.1
Stock ownership incentives	-0.3
Accelerated depreciation on investment in high unemployment areas	-0.3
Miscellaneous 1/	-0.1
Total Administration Proposals in 1977 Budget	-23.4

1/ Miscellaneous consists of Financial Institutions Act; Airport and Airway Trust Fund; estate taxes; and miscellaneous receipts.

- 2 -

Proposals ($ billions)	Effect on fiscal year 1977 receipts
PROPOSED TAX REFORM: H.R. 10612 TOGETHER WITH NEW INITIATIVES NOT SPECIFIED IN THE PRESIDENT'S BUDGET	
H.R. 10612 modified to delete certain provisions but retaining general effective date of January 1, 1976 1/	-0.1
Replace the retirement income credit with a tax credit for the elderly (as in H.R. 10612, section 503) but eliminate the credit for individuals under age 65	-0.3
Restructure the tax treatment of certain disability pensions (as in H.R. 10612, section 505) but repeal the sick pay exclusion	+0.3
Repeal 30 percent foreign withholding on portfolio dividends and interest	-0.2
Repeal alternative tax on capital gains	+0.1
Replace 10 percent minimum tax on individuals with minimum taxable income	+0.4
Sliding scale additional capital gains exclusion	*
Allow 30 percent optional subsidy for taxable municipal bonds .	*
Home insulation credit	-0.3
Simplification package with $400 allowance	*
Total proposed tax reform	*
TOTAL ADMINISTRATION PROPOSALS IN 1977 BUDGET AND TOTAL PROPOSED TAX REFORM	-23.4

Office of the Secretary of the Treasury
Office of Tax Analysis

March 16, 1976

1/ Delete the following sections of H.R. 10612: 101 (as pertains to oil and gas property and sports franchise property), 202, 206, 209, 301, 503, 504, 505, 1101, 1401, 1402, 1701, and 1801.

* Less than $50 million.

Note: Figures may not add to totals due to rounding.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10 a.m., on Thursday, March 18, 1976.]

TAX REFORM ACT OF 1976

THURSDAY, MARCH 18, 1976

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

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

Present: Senators Long, Talmadge, Byrd, Jr., of Virginia, and Curtis.

The CHAIRMAN. This hearing will come to order.

The first witness this morning will be the Senator from Massachusetts, the Honorable Edward M. Kennedy. Is Senator Kennedy here?

We are also scheduled to hear from Senator Mathias. The Senate is in session. Senator Mathias is not here either.

I will call Mr. Walker Winter, member of the board of directors, chairman, Taxation Committee, Chamber of Commerce of the United States, accompanied by Robert R. Statham, director, tax and finance section.

We are limiting witnesses to 10 minutes for oral presentation.

I will ask that each Senator confine himself to 7 minutes for the first round of questions.

I want to assure all witnesses and anyone else who does not know this that we will endeavor to read every word of these statements if we have already failed to do so. We have two good staffs, the joint committee staff and the committee staff, who will study everything that the witnesses have to present. The fact that they are not able to present everything in their statement does not mean that it will not all be considered. It will all be considered.

For example, the first witness talks about employee stock ownership in his statement, and that will definitely have the attention of the chairman, the committee, and the staffs.

STATEMENT OF WALKER WINTER, MEMBER OF THE BOARD OF DIRECTORS, CHAIRMAN, TAXATION COMMITTEE, CHAMBER OF COMMERCE OF THE UNITED STATES; ACCOMPANIED BY ROBERT R. STATHAM, DIRECTOR, TAX AND FINANCE SECTION; AND WALTER A. SLOWINSKI, MEMBER OF THE CHAMBER'S TAXATION AND INTERNATIONAL COMMITTEES

Mr. WINTER. My name is Walker Winter. I am a member of the Board of Directors of the Chamber of Commerce of the United States and chairman of its taxation committee. I am also a partner in the Chicago law firm of Ross, Hardies, O'Keefe, Babcock & Parsons.

I am accompanied by Walter A. Slowinski, a member of the chamber's taxation and international committees and a partner in the Washington, D.C., law firm of Baker & McKenzie, and Robert R. Statham, director of the taxation and finance section of the national chamber.

Mr. Chairman, the chamber appreciates this opportunity to present its views on tax revision and the extension of expiring tax reduction provisions. The American business community is concerned with the burden of taxation and its effects on the economy.

There should be a continuing and thorough consideration of the entire Federal tax system, with particular emphasis on the rate structure, other revenue sources, and amendments needed to remove the ambiguities and the unintended hardships and the inequities in the Internal Revenue Code.

The thrust of tax revision should be to encourage job-creating capital investment. Our present tax policy favors consumption and discourages savings and investment. The existing corporate tax discourages equity investment and encourages debt financing. Present depreciation provisions are grossly inadequate, still tied to an outmoded system of useful lives, and need major overhaul. And the rates of taxation for both individuals and corporations are too high—so that they discourage savings, investment and risk taking and promote inefficiency.

To encourage modernization and expansion of productive facilities in order to make American industry fully competitive and capable of meeting the added demands of our economy, the concept of prompt capital recovery allowances designed to encourage replacement and expansion should take the place of outmoded concepts of useful lives, which have been used unsuccessfully in the attempt to measure depreciation and obsolescence.

ASSET DEPRECIATION RANGE

As a first step, the Asset Depreciation Range system should provide for a 40-percent variable capital cost recovery period applied to the 1962 Treasury guidelines. The goal should be a complete capital cost recovery system that groups assets in a few general classes, to which a capital cost recovery percentage is applied to assets as a class.

INVESTMENT TAX CREDIT

A permanent 12-percent investment tax credit would help stimulate the economy, reduce unemployment, increase capital investment, encourage productivity, stimulate new orders for materials, combat industrial obsolescence, and improve the climate for capital formation.

The corporate form of business enterprise is the premier form of business organization in the United States. It allows for the efficient concentration of the capital of large numbers of investors, and provides limited liability for investors. However, it is the only form of business enterprise whose owners are subject to double taxation. Double taxation discriminates against the corporate form of doing business. This inequity should be removed.

TAX REDUCTIONS

We urge that an across-the-board tax reduction for individuals and corporations be made a major part of tax reform legislation. Tax rates should be reduced to permit and encourage the reinvestment of earnings in sufficient amounts to promote economic progress and provide jobs.

CAPITAL GAINS TAX

We support modification of the rate of taxation of capital gains by providing for reduced taxation of capital gains proportionate to the length of time a capital asset is held, with the reduction of being gradual and continuous. Current law provides for a deduction from gross income of 50 percent of the excess of net long-term capital gains over net short-term capital losses for individuals.

TAXATION OF FOREIGN INCOME

The national chamber opposes legislation that would increase the tax burden on U.S. businesses doing business abroad, either directly or indirectly. There are sound reasons for the present tax law relating to the foreign tax credit, DISC and deferral for certain foreign subsidiaries of U.S. companies. Any adverse change almost certainly would result in curtailing American foreign operations, with an attendant loss of jobs both here and abroad.

WITHHOLDING TAX ON PORTFOLIO INVESTMENTS IN THE UNITED STATES

We support elimination of the current 30-percent withholding tax on portfolio investments in the United States of nonresident aliens and foreign corporations and the elimination of the estate tax on such investments. The United States is facing a critical capital shortage. One way to alleviate this shortage would be to encourage investment in U.S. businesses by foreign persons. The current 30-percent withholding tax and the estate tax is a discouragement to this investment and should be eliminated.

ESTATE AND GIFT TAXES

It is time to reexamine Federal estate and gift taxes in terms of equity, inflation, and the adverse effects on family-owned and small closely-held businesses. These tax laws and their high rates have been virtually unchanged since 1942.

We support an increase in the Federal estate tax exemption from $60,000 to $200,000.

We support an increase in the Federal gift tax annual exclusion to $6,000.

We support an increase in the Federal gift tax lifetime specific exemption to $60,000.

CORPORATE SURTAX EXEMPTION

Substantial further corporate tax reduction is necessary to permit and encourage reinvestment of earnings in sufficient amounts to promote healthy economic progress. Prior to the Tax Reduction Act of

1975, the $25,000 surtax exemption had been in the tax law for 25 years. Clearly, the current exemption is not worth what it was in 1950. We urge that the corporate surtax exemption be increased to $100,000, with a 20-percent normal tax on the full amount subject to the surtax exemption.

DEDUCTION FOR NONBUSINESS INTEREST

We oppose any changes in the tax law that would eliminate or abridge the present deduction for nonbusiness interest. H.R. 10612 would put a fixed dollar limit on the deduction for nonbusiness interest, including investment interest and interest on home mortgages, to $12,000 per year. This provision could provide a devastating restriction in the long run on the deduction of nonbusiness interest.

Nonbusiness interest would include interest on home loans, auto and home appliance loans, personal loans, vacation and student loans, and transactions involving loans for installment purchases.

We are opposed to this provision in H.R. 10612 which would place a limit on nonbusiness interest. There already are sufficient limitations in the law to prevent any possible abuse in this area. We urge that this provision be eliminated from the bill.

DEADWOOD

In previous Congresses, legislation designed to remove the "deadwood" from the code was introduced. This proposed legislation—commonly referred to as the Deadwood bill—provides for repeal of approximately 150 obsolete sections and changes in over 850 others. These provisions are included in H.R. 10612. The stated purpose of the Deadwood bill is to achieve simplification, but not through making any policy or substantive changes in existing law. We endorse the concept of the Deadwood statute. It is one step toward simplification that should be welcomed by all taxpayers. We hope it will be considered in the course of this committee's deliberations on tax reform, and made a part of the proposed legislation.

TAX LAW SIMPLIFICATION

We hope that as a result of these hearings, Congress will simplify the tax laws, rewrite inequitable provisions in the law, and develop a program of tax reduction. As we have pointed out in the past, the complexity of the Internal Revenue Code may be the real "loophole" in our tax system. It should be pointed out that the current legislation under consideration by this committee—H.R. 10612—is over 650 pages long, contains over 90 sections and is accompanied by 475 pages of explanatory material.

The uncertainty of the tax system adds to its complexity. A new round of tax reform has been a matter of discussion since 1972. Uncertainty as to the future of major tax legislation breeds uncertainty in investment decisions. Taxpayers become reluctant to invest in ventures that could produce jobs and improve economic conditions, because they are uncertain as to the impact of possible new income tax changes on profits. Uncertainty in the tax system discourages economic growth.

Constant changes in the tax system add to the uncertainty and to the complexity for the average individual taxpayer. Constant changes in the tax law require constant changes by the Internal Revenue Service in the individual income tax return forms. Every year the taxpayer must familiarize himself all over again with a new Form 1040. Unable to keep up with these annual changes, the taxpayer often grudgingly pays for assistance in the preparation of his return. As you know, we have seen an increase of that year after year.

Tax reform rhetoric forecasting major overhauls of the Federal tax system, constant changes in the tax system that cause inconvenience and return compliance problems for the taxpayer, the proposals of changes in the tax laws—so complex they are often difficult even for most of the Members of Congress to fathom—are causing major problems for the average taxpayer and discouraging more job-producing investment.

ESOP

Now, a word on the ESOP. What I have in mind is the investment credit ESOP, Mr. Chairman. We are, of course, very interested in the investment tax credit. There is a problem in the investment credit ESOP which was administered by the Tax Reduction Act of 1975; that is, that when you have a corporation issuing stock and you have a second and third tier corporation, you have a big corporate setup and you want to use the parent company stock. You do not want to use the stock of the second or third subsidiary.

If you have a subsidiary with nonvoting stock, which is not owned by the parent, you do not want to use the stock of that subsidiary, you want to use the stock of the holding company. We cannot do that now because the definition of control for this purpose is under section 368(c). It is in subchapter C. So that you knock out the second and third subsidiaries and subsidiaries with nonvoting preferred stock.

On behalf of the national chamber, I wish to thank you, Mr. Chairman, and the members of the committee, for this opportunity to testify on the subject of tax reform. We hope we have been helpful in presenting the views of American business, and we again thank you for the opportunity to appear and be heard.

The CHAIRMAN. Thank you very much. I especially welcome your suggestion on employee stock ownership. If this Senator has any influence on this committee, we are going to do everything we can to make employee stock ownership more and more the order of the day, and so far as I can see, I think that everybody agrees that it helps the rank and file to come to own an equity interest in the company for which he works.

It improves labor relations when employees have a substantial interest; it increases productivity; it increases an employee's interest in the firm for which he is working. To put it another way, it tends to get rid of the "don't-give-a-damn" attitude that is altogether too prevalent in some areas, and I think it tends also to help spread the wealth of our country somewhat more evenly among the people.

So I think it is most important.

Now, I would be the first to agree that it was written altogether too tightly, and that is the case because our dedicated staff does not want to see any one of these things become a big loophole where somebody could get some money not intended to be a benefit. But I would be the first to agree that in the areas that you are discussing we should carefully study it to see that it achieves what we want it to achieve and, at the same time, has the flexibility to permit the companies to do what best fits their situation.

The definition of control you have had in mind is a good example.

Mr. WINTER. When you take a look at a group, you look at the affiliation rules and you will include more participation for all the companies, but when you are looking at the investment credit ESOP, you do not look to the same rules, whether they are in consolidation. One of the changes corporations look at, and this is a very narrow definition of section 368(c), indirect control is not direct control for purposes of the subchapter C.

So that is the very technical problem that needs to be corrected.

The CHAIRMAN. I hope that the staff will take note of this, because that is one of the things that we should discuss.

It should not be a requirement that a company own 80 percent of the stock of a subsidiary in order for the subsidiary to participate to have an employee stock ownership plan in which the parent company would encourage or participate directly or indirectly. We ought to find ways to do that so that the employee stock would not, for control purposes, be kind of against the rights of a company that uses a consolidated tax return.

Mr. WINTER. The important thing is a parent company that is a company listed on the big board that is publicly owned, that is the stock you have to use if you are going to use the investment credit ESOP.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Thank you very much, gentlemen. I want to assure you again that we will study this very fine presentation that you have made for us.

[The two statements of Mr. Winter follow. Oral testimony continues on p. 180.]

STATEMENT BY WALKER WINTER, CHAMBER OF COMMERCE OF THE UNITED STATES

SUMMARY

There is a need to evaluate the tax laws and their impact upon taxpayers and the economy. The entire Federal tax system should be examined with particular emphasis given to the rate structure, revenue sources, and amendments needed to remove ambiguities and unintended hardships and inequities from the Internal Revenue Code. We endorse the concept of the deadwood statute. It is one step toward simplification that should be welcomed by all taxpayers.

The American economy is faced with a major capital shortage. To encourage the growth of capital formation, the following changes should be made in the tax laws:

1. To encourage modernization and expansion of productive facilities so as to make American industry fully capable of meeting its new demands, the concept of prompt capital recovery allowances designed to encourage replacement and expansion should take the place of outmoded concepts of useful lives which have been used unsuccessfully as a measure of depreciation and obsolescence. As a first step, the Asset Depreciation Range system should provide for a 40 percent variable capital cost recovery period applied to the 1962 Treasury guidelines. The goal should be a complete capital cost recovery system that

groups assets in a few general classes to which a capital cost recovery percentage is applied to assets as a class.

2. A permanent full 12 percent investment tax credit should be provided, on an expenditure basis, uniformly applied to all business, and without limitations based on tax liability in order to encourage job producing investment.

3. Tax rates should be reduced to permit and encourage reinvestment of earnings in sufficient amounts to promote economic progress and provide jobs.

4. High tax rates have emphasized the unfairness and unsoundness of the double taxation of equity capital resulting from the taxation of corporate earnings and of corporate dividends received by individuals. This inequity should be removed.

5. The rate of taxation for capital gains should be reduced proportionate to the length of time an asset is held, with the reduction being gradual and continuous.

We urge that the corporate surtax exemption be increased to $100,000, with a 20 percent normal tax on the full amount subject to the surtax exemption.

There are sound reasons for the present tax law relating to the foreign tax credit, DISC and deferral for certain foreign subsidiaries of United States companies. Any adverse change almost certainly would result in curtailing American foreign operations, with an attendant loss of jobs both here and abroad.

It is time to reexamine federal estate and gift taxes in terms of equity, inflation, and the adverse effects on family-owned and small closely-held businesses. These tax laws have been virtually unchanged since 1942. We support an increase in the federal estate tax exemption to $200,000.

STATEMENT

My name is Walker Winter. I am a member of the Board of Directors of the Chamber of Commerce of the United States and Chairman of its Taxation Committee. I am also a partner in the Chicago law firm Ross, Hardies, O'Keefe, Babcock and Parsons.

I am accompanied by Robert R. Statham, Director of the Tax and Finance Section of the National Chamber.

Mr. Chairman, the Chamber appreciates this opportunity to present its views on tax revision and the extension of expiring tax reduction provisions. The American business community is concerned with the burden of taxation and its effects on the economy. There should be a continuing and thorough consideration of the entire federal tax system, with particular emphasis on the rate structure, other revenue sources, and amendments needed to remove the ambiguities and the unintended hardships and inequities in the Internal Revenue Code.

The main thrust of major tax revision should be on capital formation and job creation for long-term economic growth. With energy and environmental requirements that are certain to increase, the legislation should encourage capital investment in more productive, energy-saving and environmentally sound machinery and equipment.

The legislation under consideration by this Committee will play a major role in the course of the Nation's economy, and every segment of the American enterprise system is certain to be affected by its provisions. It is in the best interests of the country that this legislation be used to provide equity in the tax laws and simplify compliance for the taxpayer. It should not be used as an instrument to quash individual initiative to save, invest and provide jobs and a better standard of living for our citizens.

Ours is a self-assessment system of compliance with the tax laws. Taxpayer confidence is necessary or those administering the tax law will have problems obtaining the revenue required for necessary government operations. It is important that we guard against constant changes in the tax laws lest this in itself have a demoralizing effect. It is important that adequate consideration be given to proposed changes to make sure that what is being enacted will provide lasting solutions rather than temporary confusion.

The tax system should not restrict investment necessary for capital formation and the growth of job opportunities. Taxes on income from foreign sources should be imposed with due regard for the necessity of keeping United States enterprises fully competitive in their operations abroad.

In keeping with these remarks, we enumerate our recommendations on the issues of tax revision and tax reduction.

The Need for Capital Formation

If we are to meet our economic goals, reduce unemployment to a minimum, bring inflation under control, and meet our energy and environmental protection needs of the future, it is critical that we allocate more of our resources to capital spending and less to consumption. Our tax system should encourage more business investment in the tools of production.

A study for the Council of Economic Advisers indicates there will be a needed shift in business fixed investment as a share of Gross National Product from an annual average of 10.4 percent from 1965 to 1970 and from 1971 to 1974 to an annual average of 12 percent during the period 1975 to 1980. Since investment from 1975 to 1976 is expected to be less than 10 percent of GNP, a ratio in excess of 12 percent may be needed over the next four years. This necessary shift in emphasis in business fixed investment may not appear large in percentage terms, but—when considered in terms of the multi-trillion dollar economy of the future—huge dollar amounts will be needed. To achieve our employment, environmental, and energy goals, our tax policies must be revised to encourage more capital formation.

We must apply those principles to our taxing system that promote the modernization and expansion of our productive facilities. Other highly industrialized nations understand these principles and are applying them. If we are to continue to improve our standard of living, reduce unemployment and solve our inflation problem and remain competitive internationally, we must balance our tax policy in favor of capital formation.

The thrust of tax revision should be to encourage job-creating capital investment. Our present tax policy favors consumption and discourages savings and investment. The existing corporate tax discourages equity investment and encourages debt financing. Present depreciation provisions are grossly inadequate, still tied to an outmoded system of useful lives, and need major overhaul. And the rates of taxation for both individuals and corporations are too high—so that they discourage savings, investment and risk taking and promote inefficiency.

Capital Cost Recovery and Depreciation

Depreciation practices in this country are grossly inadequate. Although the codification of the Asset Depreciation Range system has eased the situation, it is far from being corrected. The Chamber supported the Asset Depreciation Range (ADR) system when it was codified in the Revenue Act of 1971. We continue to support the full retention of the ADR system and urge that it be liberalized to insure the continued modernization of American industry and to enable American business to compete more effectively in world markets. At the same time, we reaffirm our long-standing preference for a permanent and flexible capital cost recovery allowance system.

For many years, we have called for meaningful changes in our capital cost recovery system. We have asked for a permanent capital cost recovery allowance system along the lines set forth in the 1970 *Report of the President's Task Force on Business Taxation* as a first step toward the adoption of a full capital cost recovery system. Those recommendations include substituting a capital cost recovery allowance system for the present system based on useful life of property, and allowing full recovery of cost, unreduced by salvage value, in a period 40 percent shorter than would be allowed under the 1962 Treasury guidelines for determining useful lives. The Task Force recommendations should be adopted for their long-range, permanent effect.

We believe that the ADR system is an important step in encouraging investment and replacement of obsolete and inefficient machinery and equipment, increasing productivity, fighting inflation, encouraging economic growth to provide jobs and maintaining American leadership in the world marketplace.

American business is at a distinct disadvantage with regard to replacing its obsolete machinery and equipment. Prior to ADR, a piece of equipment which might be written off for tax purposes in the United States in 13 years typically could be written off in 10 years or less in most of the highly industrialized nations of the world. ADR now allows the depreciation of such a piece of equipment in about 10 years.

Even with ADR, American business is at a disadvantage. The table in Appendix A illustrates comparative figures on capital recovery in 12 industrial nations and shows that, without ADR and the investment credit, the United States requires substantially longer depreciation periods than each of the other major trading nations.

The table in Appendix B illustrates the comparative costs of manufacturing machinery and equipment as influenced by income tax policies in major industrial countries in 1971. The chart shows that, without ADR and the investment credit, capital costs in the United States would surpass every other country listed. Even with ADR and the investment credit, our capital costs are still above most of the other countries listed. It is important to note that American capital costs are substantially higher than Japan and West Germany, our strongest competitors.

Seventeen percent of the plant and equipment of American business is at least 20 years old according to a McGraw-Hill survey released in November of 1974. The survey also reports that 61 percent of the Nation's plant and equipment is less than 11 years old. In addition, according to the survey, business considers 11 percent of its plant and equipment outmoded.

The March, 1975, *International Economic Report of the President* notes that the average age of capital equipment is older in the United States than in most of the other industrialized nations, which replaced their equipment after World War II. This report states that it is estimated that 30 to 40 percent of American productive capital was in existence before 1960 as compared to 15 to 25 percent in these other developed countries. This report also concludes that because of the age of U.S. capital equipment, a greater portion of investment must go to replacement, rather than to additional equipment, compared to these other countries.

We cannot afford to fall further behind our major trade competitors and still hope to recover from our precarious balance-of-payments position. Until the time the United States can close the gap between the systems of capital recovery used by our competitors and that which is allowed by our own tax system, there will be little chance for increasing exports.

With wage increases outpacing productivity gains, there can be only one practical course of adjustment. Since wages cannot be lowered, productivity must be increased. This requires that an adequate permanent capital recovery system be worked into our tax structure. By using more modern and efficient production facilities, more goods can be produced at a lower cost per unit. By encouraging American industry to invest in the most modern machinery and equipment available, inflation can be reduced.

A piece of equipment is often depreciated at its cost over a long period of time. When the time comes to replace that piece of equipment, the cost of replacing it has greatly increased due to inflation. As a result, the increased cost of replacement must be paid for primarily from earnings.

For example, assume a $20,000 asset is depreciated using the straight-line method over a period of 12 years, and an inflation rate of seven percent is compounded annually. By the time that asset is depreciated and replaced, the cost of replacement will have risen to approximately $45,000. Twenty thousand dollars of this amount can be accounted for by depreciation, but the additional $25,000 must come from the taxpayer's earnings or from new, after-tax, invested capital. Had the asset been depreciated over a shorter and more realistic period of time, the effect of inflation would have been reduced and the increase in replacement cost would be less. This story has been repeated over and over again.

In actuality, American business has been paying taxes on its capital. A number of businesses in this country have been paying to the Internal Revenue Service what purports to be a tax on earnings but what, in reality, is a contribution of business capital. In order to lessen the effects of inflation on replacement costs, a shorter period for computing depreciation should be permitted.

Since the enactment of the ADR provisions in the Internal Revenue Code, there have been those who have sought to have them terminated. Any such termination would further handicap American business at a time when modernization and expansion of production facilities are essential to the achievement of national goals.

It is important that the Congress adopt a tax policy that encourages the replacement of obsolete and inefficient plant machinery and equipment so that American enterprise will outproduce its rivals, continue to provide jobs at the highest wages on earth, and maintain American leadership in the world marketplace.

To encourage modernization and expansion of productive facilities in order to make American industry fully competitive and capable of meeting the added demands of our economy, the concept of prompt capital recovery allowances designed to encourage replacement and expansion should take the place of outmoded concepts of useful lives, which have been used unsuccessfully in the attempt to measure depreciation and obsolescence. As a first step, the Asset Depreciation Range system should provide for a 40 percent variable capital cost recovery period applied to the 1962 Treasury guidelines. The goal should be a complete capital cost recovery system that groups assets in a few general classes, to which a capital cost recovery percentage is applied to assets as a class.

Investment Tax Credit

The Congress restored the investment tax credit in 1971. The Tax Reduction Act of 1975 temporarily increased the amount of the investment tax credit through 1976. We favor enactment of a permanent 12 percent investment tax credit, on an expenditure basis, uniformly applied to all business, without limitations based on tax liability, and without any corresponding reduction in depreciation allowances.

A permanent 12 percent investment tax credit would help stimulate the economy, reduce unemployment, increase capital investment, encourage productivity, stimulate new orders for materials, combat industrial obsolescence, and improve the climate for capital formation.

The Tax Reduction Act of 1975 increased the investment tax credit from 7 to 10 percent and 4 to 10 percent for public utilities, and to 11 percent if the extra one percent is invested in an employee stock ownership plan. Under the 1975 law, 10 percent of the cost of qualifying property—generally tangible personal property used in a trade or business—may be offset directly against income tax liability. The increase in the credit applies to property acquired and placed in service after January 21, 1975, and before January 1, 1977. In the case of property acquired after December 31, 1976, the seven percent investment credit, and four percent credit for public utility property applies even if the property is ordered by the taxpayer before 1977. There are additional limitations with regard to qualifying property with less than a seven-year useful life. Except for most public utilities, the maximum amount of the credit is $25,000, plus one-half of tax liability over $25,000. However, excess credits may be carried back for three years and forward for seven years, after which they expire if unused.

Property becomes eligible for the credit under present law when it is placed in service. The 1975 Act provided for a new Code provision whereby a taxpayer could make an irrevocable election to have the investment tax credit apply to qualified progress expenditures for long leadtime property. It is our view that this progress payments provision should go even further by providing that the credit would be available for all investments in qualified property in the year that the expenditure is made, rather than in the year that the property is placed in service.

A brief history of the investment tax credit is helpful in understanding its full effect. The investment tax credit was originally enacted by Congress in 1962 at the recommendation of President Kennedy. At the time of its adoption, the Nation was experiencing a period of high unemployment, economic recession, and idle industrial plant capacity. In proposing the investment tax credit in 1961, President Kennedy said:

"The history of our economy has been one of rising productivity, based on improvement in skills, advances in technology, and a growing supply of more efficient tools and equipment. This rise has been reflected in rising wages and standards of living for our workers, as well as a healthy rate of growth for the economy as a whole. It has also been the foundation of our leadership in world markets, even as we enjoyed the highest wage rates in the world."

Secretary of the Treasury Dillon in his opening statement to the House Ways and Means Committee in support of the investment tax credit on May 3, 1961, said:

"All of our citizens will benefit from modernization of our industry. A basic fact of economic life is that modernization and expansion are essential to higher productivity. Rising productivity will provide us with a rising level of per capita income, with resultant and widely shared benefits in the form of rising real wages and rising investment incomes. Rising productivity will also permit us to hold prices down."

Four and a half years after its enactment, on September 8, 1966, President Johnson asked Congress to suspend the operation of the credit temporarily. Congress responded by suspending the investment credit for a period of 15 months, from October 10, 1966, to December 31, 1967. However, the suspension never ran its full course. Faced with an economic downturn in the first quarter of 1967, President Johnson asked Congress, on March 9, 1967, to restore the credit. The credit was reinstated as of March 9.

Two years later, on April 21, 1969, President Nixon asked Congress to shift national priorities and repeal the investment tax credit. In his message President Nixon said:

"In the early 60's, America's productive capacity needed prompt modernization to enable it to compete with industry abroad. Accordingly, Government gave high priority to providing tax incentives for this modernization.

"Since that time, American business has invested close to $400 billion in new plant and equipment, bringing the American economy to new levels of productivity and efficiency."

Congress responded by repealing the credit. Two years later, in the midst of a new recession, President Nixon asked Congress, on August 15, 1971, to reenact the investment tax credit. In his message President Nixon said:

"The time has come for American industry, which has produced more jobs at higher real wages than any other industrial system in history to embark on a bold program of new investment in production for peace.

"To give that system a powerful new stimulus, I shall ask the Congress, when it reconvenes after its summer recess, to consider as its first priority the enactment of the Job Development Act of 1971."

Congress subsequently enacted the Revenue Act of 1971, restoring the investment tax credit as of August 15, 1971.

President Ford, in his State of the Union message on January 15, 1975, asked the Congress to increase the investment tax credit for all business to 12 percent for a one-year period. He said:

"Let us mobilize the most powerful and creative industrial nation that ever existed on this earth to put all our people to work. The emphasis of our economic efforts must now shift from inflation to jobs.

"To bolster business and industry and to create new jobs, I propose a one-year tax reduction of $16 billion. Three-quarters would go to individuals and one-quarter to promote business investment."

The Tax Reduction Act of 1975, was passed by the House on February 27, the Senate on March 22, and was approved by the President on March 29, 1975. The fundamental reasons for the increase in the credit were well stated in the Senate Finance Committee report on H.R. 2166:

". . . The investment (tax credit) not only creates jobs both directly and through the multiplier effect, but it also increases productivity. This is anti-inflationary because it increases the amount of output available to meet future consumer demands and because it results in lower production costs which means that money wage increases will not exert the same degree of upward pressure on product prices that they would in the absence of growing productivity. Increased productivity also has favorable implications for our balance of payments and the exchange rate of the dollar. Finally, unless in the future the stock of capital is increased significantly, there will be serious problems in providing enough jobs for those entering the labor force."

Senate Report No. 94–36, p. 12,
94th Congress, 1st Session (1975)

H.R. 10612 as passed by the House of Representatives, would extend the 10 percent investment tax credit through 1980. Such a temporary extension of the increased credit provision creates uncertainties as to the future of the credit and the rate to be available to businessmen. It makes future investment planning more difficult, and it reduces the impact of the credit on long-range capital investment. A permanent credit would be far more stimulating.

A 12 percent investment tax credit should become a permanent part of the law. The economy cannot afford the on-again off-again approach to the investment credit absent a modern capital cost recovery system equal to our foreign competitors. We must continue to stimulate, rather than stifle, the mighty productive forces of American industry in order that we may fight inflation, provide more jobs, and increase the standard of living of the American people.

The tax policy of the United States toward the energy companies could determine the outcome of the energy crisis. The President's Labor-Management Committee has recommended that the investment tax credit be increased to 12 percent for electric utilities. The Congress should take action on this report. We favor a full 12 percent credit, not only for electric utilities—but for all business.

An increase in the investment tax credit to 12 percent would help to stimulate the economy further. The economy is recovering from a recession but is still in difficulty. Unemployment was 7.6 percent for the month of February.

The investment tax credit has been a proven stimulus to the economy. When the credit was repealed in 1969, the country went into a period of increased unemployment and reduced business activity. When the investment tax credit was reenacted in 1971, there followed a period of increased investment and a decline in unemployment. New investment increased by nine percent in 1972 and 13 percent in 1973. The stimulus needed now is enactment of a permanent 12 percent investment tax credit.

An increase in the investment tax credit would help reduce unemployment. We must encourage the private sector to create jobs. The ability of business to create jobs and reduce unemployment depends on its ability to equip workers with the tools of production. To equip new workers requires new investment in machinery and equipment. According to the 1975 *Fortune* survey of the "First 500," some industry medians of assets per employee are:

Petroleum refining	$177, 680
Mining	147, 852
Metal manufacturing	50, 101
Chemicals	44, 753
Motor vehicles and parts	28, 473
Metal products	25, 112
Appliances, electronics	22, 531
The median for all industries was	33, 658

A comparison with the 1974 *Fortune* survey is most revealing in that the median for all industries was $28,639. This reflects a substantial increase in the amount of new investment in machinery and equipment that will be needed to keep high levels of employment.

As the labor force in the country increases, we must meet employment needs with huge investments in the capital base. Projections of the Bureau of Labor Statistics indicate that during this decade the total labor force will expand by 15.9 million, with the labor force reaching 101.8 million by 1980. Only with the investment of thousands of dollars can a job be created for even one worker. Well-paying jobs require tremendous capital investment in capital intensive industries.

We cannot expect to improve the economic well-being of all Americans unless we are able to produce more goods at lower prices and provide for the employment needs of our society. Stimulating capital investment through an increase in the investment tax credit will assist efforts to meet a national goal of prosperity and a high standard of living for all of our citizens.

An increase in the investment tax credit would help increase capital investment. We believe that the investment tax credit and the Asset Depreciation Range system are significant factors in encouraging investment in new plant and equipment. These new outlays for plant and equipment will stimulate construction, increase orders for materials, and result in increased employment.

An increase in the investment tax credit would help improve productivity. It is this growth in productivity that can determine the living standards Americans can expect to enjoy in the future. Unfortunately, since 1965, the United States has the worst record among the major free-world nations in productivity gains. During the sixties and early seventies, the annual growth in productivity averaged more than 10 percent in Japan and almost six percent in France and Germany. As illustrated in the table in Appendix C, the annual growth in productivity averaged only 3.3 percent in the United States for the same period.

Because a large proportion of Gross National Product was devoted to the replacement of obsolete plant, machinery and equipment, productivity rose rapidly in the United States after World War II. Bolstered by the new investment tax credit and the liberalization of depreciation allowances in 1962, the trend continued through 1968, when output per man hour increased 2.8 percent over the 1967 level. However, with the elimination of the investment tax credit in 1969, productivity in the private economy as measured by output per man-hour increased by only 0.4 percent in 1969 and 0.8 percent in 1970. With the adoption of the Asset Depreciation Range system and the restoration of the investment tax credit in 1971, the productivity figure jumped by four percent. According to U.S. Department of Labor's Bureau of Labor Statistics, productivity in the private economy, as measured by output per man-hour, fell by 2.7 percent in 1974—the first annual decline since the series began in 1947. For 1975, private sector productivity increased only 1.3 percent.

An example of how the investment credit can affect productivity in the United States can be seen from the apparent impact of the previous credit on new orders for domestically produced machine tools. These orders are viewed as an important indicator of the future capital spending plans of business.

The enactment of the investment tax credit in 1962, along with the reduction in depreciation lives, marked the beginning of a sharp rise in machine tool orders. After a slight decline in machine tool orders in 1964, new orders increased strongly until October of 1966 when the old seven percent investment credit was temporarily suspended. During the period of the suspension, orders dropped more than 25 percent. When the investment credit was restored in 1967, orders began increasing, reaching a peak in April of 1969, when the credit was terminated. After the termination, new orders for machine tools decreased tremendously. In the first quarter of 1971, orders were over 70 percent less than the all-time high in 1969. The investment credit was reinstated in August of 1971, and total orders rose 67 percent, from $747.3 million in 1971 to $1.25 billion in 1972. Due to the recession, orders for new machine tools dropped off sharply in 1974 to levels below those at the time of the reenactment of the credit in 1971. In 1975, with the increase in rate of the investment tax credit to 10 percent, machine tool orders began to rebound.

An increase in the investment tax credit would help combat industrial obsolescence. We must consider the relative obsolescence of United States plant and equipment as compared with our foreign counterparts. The investment credit was designed to close the obsolescence gap. Stanley S. Surrey, former Assistant Secretary of the Treasury, acknowledged this in a speech on March 12, 1962:

"The investment credit, coupled with realistic depreciable lives will make the tax treatment of investment in the United States comparable with that offered by our major competitors in Western Europe, Canada and Japan. The investment credit thus takes its place along with the variety of western European devices such as the incentive allowances afforded in addition to depreciation in the United Kingdom, Belgium and the Netherlands, or the first year additional depreciation allowances permitted in the United Kingdom, France, Italy and the Netherlands."

It is time to reaffirm Mr. Surrey's statement in the light of the fact that the Canadian government allows a two-year write-off on costs of equipment for manufacturing and processing. This means that 50 percent of the costs can be written off in the first year and the rest in any subsequent year. Also, the United Kingdom allows a write-off in the first year of 100 percent of the cost of new capital equipment.

With the Common Market countries adopting the value-added tax, there are increased pressures on our tax system to offer incentives to capital investment. The type of value-added tax which is being adopted in Europe is the "consumption" variety, by which the cost of capital equipment may be deducted in the first year of purchase, thereby encouraging new capital investment by our business competitors.

On the other hand, the United States places a greater reliance on income taxes, which in turn places a premium on high-cost production and inefficiency and discourages modernization of American plant and equipment. Unlike the value-added tax, the income tax, as it applies to exports, cannot be rebated. The United States is thereby at a further disadvantage in international trade.

Stringent environmental standards necessitating new abatement equipment have cut into productivity-increasing capital investment. Abatement procedures generally do not directly increase productivity or efficiency of operations. The investment credit and ADR will assist in meeting new demands to clean up the environment, and at the same time assist in meeting capital spending demands to assure continued economic growth.

We urge enactment of a permanent full 12 percent investment tax credit. on an expenditure basis, uniformly applied to all business, without limitations based on tax liability, and without any corresponding reduction in depreciation allowances.

Double Taxation of Corporate Income

High tax rates have emphasized the unfairness and unsoundness of the double taxation of equity capital resulting from the taxation of corporate earnings and corporate dividends received by individuals. We oppose the double taxation of corporate income. Corporate income is the only form of income that is subject to two federal income taxes. It is subject to a 48 percent income tax at the corporate level and again subject to tax when paid out to an individual shareholder. This double taxation of corporate income is wholly contrary to the equitable concepts on which a tax system should be based.

From 1913 to 1936 there was no income tax on dividends. There was only a surtax that fell on a few shareholders. Corporations were subject to tax—but in 1913, the corporate tax rate was only one percent.

During the Great Depression, the House proposed a tax on undistributed corporate income. It hoped to pressure corporations to pay out more dividends to pump more money into the economy. These dividends were to be made taxable to the individual shareholder. The House had intended to eliminate the prior tax on corporate income and prevent double taxation. However, as finally enacted, a graduated surtax was imposed on top of the corporate income tax. There was no allowance for a deduction for dividends paid. Full double taxation of corporate income was a reality.

The experiment with a corporate surtax was unworkable and was repealed after three years in 1939. A full corporate income tax was imposed. The previous exemption for dividends was not reinstated. Full double taxation was to persist until 1954. What irony that double taxation should result from a plan to eliminate it.

In 1954, in an effort to mitigate double taxation, Congress passed a $50 dividend exclusion coupled with a tax credit equal to four percent of dividends received in excess of $50. In 1964, the $50 exclusion was raised to $100, but the tax credit was eliminated.

We oppose any proposal that would repeal the dividends received exclusion on the grounds that such repeal would be wholly contrary to the equitable concepts on which a tax system should be based. Rather than eliminate this provision, consideration should be given to an enlargement of the existing exclusion in order to attract additional venture capital.

Double taxation of corporate income dramatically increases individual income tax rates. An individual in the 20 percent tax bracket in effect pays 48 percent at the corporate level and then an additional 20 percent on what is left for a total tax burden of 58.4 percent. This is nearly three times his individual rate.

The double taxation of corporate income creates additional pressures on already scarce equity capital. When a potential investor assesses the attractiveness of the variety of investments available to him, he must consider the potential after-tax return on his investment. Double taxation, therefore, means that the rate of profit on the actual investment must be higher than that required where there is no double taxation.

When a corporation seeks additional financing, it may sell new shares of stock or it may borrow money through debt financing. Since the interest on debt is tax deductible, and dividends are subject to double taxation, there is a bias toward debt financing.

The corporate form of business enterprise is the premier form of business organization in the United States. It allows for the efficient concentration of the capital of large numbers of investors, and provides limited liability for investors. However, it is the only form of business enterprise whose owners are subject to double taxation. Double taxation discriminates against the corporate form of doing business. This inequity should be removed.

Need for Tax Reduction

We favor corporate tax reduction to permit and encourage reinvestment of earnings in sufficient amounts to promote healthy economic progress. The present corporate income tax deters business expansion, diminishes sources of equity funds, and discourages new investment by reducing profit incentives. A reduction in corporate taxes would help provide the Nation with the new capital necessary to produce a better life for all.

We also favor lower and less steeply graduated tax rates on personal income. The maximum rate should be under 50 percent. Steeply graduated income tax rates make the government the principal beneficiary from the generation of additional income. This discourages individual initiative, leads to inefficiency, diverts attention from efforts to reduce taxes, and impedes economic progress.

We urge that an across-the-board tax reduction for individuals and corporations be made a major part of tax reform legislation. Tax rates should be reduced to permit and encourage the reinvestment of earnings in sufficient amounts to promote economic progress and provide jobs.

Fast Depreciation Methods

Present law provides for depreciation methods other than straight-line. We support the retention of the existing provisions in the tax law and oppose changes that would eliminate or abridge the present methods of fast depreciation. We also oppose limiting depreciation of property located outside the United States to the straight-line method. We oppose those provisions in H.R. 10612 which limit, in certain circumstances, the current deduction for depreciation in excess of straight-line depreciation.

When the Internal Revenue Code was adopted in 1913, the law provided for a "reasonable allowance for depreciation, by use, wear and tear of property, if any." Taxpayers were left to determine their own rates of depreciation on the basis of original or historical costs of the asset. The Treasury Department published figures on the "useful lives" of certain assets in 1931 and these guidelines were updated in 1942.

For many years prior to 1954, there was much criticism of these guidelines on the basis they were outdated and biased, since the Depression resulted in unusually prolonged service lives. Also, they failed to reflect post-war technological advances, inflation, and other economic changes. In light of these criticisms, the Internal Revenue Code of 1954 explicitly authorized the use of double-declining balance, sum of the years-digits and other means of accelerated depreciation.

Straight-line depreciation provides for a ratable write-off over the asset's useful life. Accelerated depreciation methods permit a greater write-off in the earlier years of an asset's life. Of course, taking larger deductions for depreciation in early years means higher allowable costs and therefore lower taxes. But later, with the deductions used up, allowable costs decrease and there are higher taxes.

The same reasons for Congressional recognition of accelerated depreciation allowances that existed in 1953 are present today. There is a necessity to stimulate capital investment as well as to reflect the realities of the actual practice of business taxpayers. The straight-line method understates depreciation in the early years of an asset's useful life. Fast depreciation methods take into account this factor and permit the timing of allowances more in accord with the actual pattern of loss of economic usefulness.

Fast methods of depreciation are needed to encourage capital expenditures for expansion and for replacement of obsolete equipment. A more rapid recovery of costs increases the rate of return on plant investment. This accelerated depreciation permits smaller cash outflow for taxes in early years and facilitates repayment of loans that financed capital acquisitions.

Accelerated depreciation is often a critical factor for new or small businesses which may have difficulty in obtaining financing for capital expenditures. The Committee Reports on H.R. 8300, which became the 1954 Code, stated:

"Small business and farmers particularly have a vital stake in a more liberal and constructive depreciation policy. They are especially dependent on their current earnings or short-term loans to obtain funds for expansion. The faster recovery of capital investment provided by this bill will permit them to secure short-term loans which would otherwise not be available."

House Report No. 1337, p. 24, 83rd Cong., 2d Session (1954);
Senate Report No. 1622, p. 26, 83rd Cong., 2d Session (1954).

Liberal capital cost allowances stimulate the modernization and expansion of the Nation's productive plants—especially in the case of small or new businesses which have difficulty in obtaining capital for long-lived property.

Additional First Year Depreciation

In addition to the regular deduction for depreciation taken in the first year of an asset's life, the Internal Revenue Code provides an election to taxpayers to take an initial deduction of 20 percent of the cost of tangible personal property. Total deductions for depreciation cannot exceed 100 percent of the cost of the asset. This extra 20 percent deduction applies only to the first $10,000 of investment. This provision was introduced in the Small Business Tax Revision Act of 1958 to stimulate investment and expansion of small businesses.

There is no question that an asset loses much of its value during the early years of its life. The additional first year depreciation allowance takes into account this factor. We urge that the useful life the asset must have to qualify for additional first year depreciation be reduced and the dollar limit of property that qualifies be increased.

Special Five-Year Amortization Provisions

There are four provisions in the Internal Revenue Code that provide for five-year amortization of capital investments in: pollution control facilities, certain coal mine safety equipment, railroad rolling stock, and rehabilitation of low and moderate income rental housing. These four provisions for five-year amortization were enacted only for a five-year period in the Tax Reform Act of 1969. These provisions were extended through 1975 by Public Law 93-625. We support the continuance of these provisions.

H.R. 6860 would extend the five-year amortization provision with respect to railroad rolling stock until January 1, 1980. H.R. 10612 would extend for two more years the present provisions providing five-year amortization for the rehabilitation of low and moderate income rental housing.

We urge that a more rapid amortization period be provided for pollution control facilities. McGraw-Hill economists estimate that it would take over $34 billion to bring existing U.S. business facilities into compliance with present pollution control standards. We urge that this five-year period for pollution control facilities be shortened to provide additional encouragement for this important task.

Amortization of Railroad Grading and Tunnel Bores

The Tax Reform Act of 1969 added to the Internal Revenue Code the provision for allowing a domestic railroad to elect to amortize over 50 years the adjusted basis of qualified railroad grading and tunnel bores placed in service after 1968. This provision only provides limited recovery since it is inapplicable to railroad grading and tunnel bores placed in service before January 1, 1969. The deduction is in lieu of any depreciation deduction or other amortization deduction. It was put into the Code because railroads, though required to capitalize these costs, were not able to depreciate them because of uncertainties as to the length of their useful lives. The same problem would exist today without this provision in the law.

H.R. 10612 would allow railroad grading and tunnel bores in service before 1969 to be amortized over a 50-year period. We support the retention of existing law regarding the 50-year amortization of railroad grading and tunnel bores and support its extension to grading and tunnel bores placed in service before January 1, 1969.

Capital Gains Deduction

We support modification of the rate of taxation of capital gains by providing for reduced taxation of capital gains proportionate to the length of time a capital asset is held, with the reduction being gradual and continuous. Current law provides for a deduction from gross income of 50 percent of the excess of net long-term capital gains over net short-term capital losses for individuals.

Capital gains treatment in the Internal Revenue Code has existed since the Revenue Act of 1921. From 1921 until 1933, capital assets were defined as property held for more than two years, and individuals could elect to be taxed at the alternative rate of 12.5 percent on net capital gains. With the Revenue Act of 1934, the two-year holding period was repealed along with the alternative tax rate, and a sliding scale system was substituted. Under this sliding scale system, from 30 percent to 100 percent of the net capital gain was included in income, depending on the holding period.

The Revenue Act of 1938 simplified the sliding scale and provided for three rates. Assets held for less than 18 months were taxed as short-term gains at 100 percent; assets held between 18 and 24 months were considered long-term gains and taxed at 66 percent; and assets held for more than 24 months were taxed at 50 percent. The capital gains provisions in the present Code began with the Revenue Act of 1942, which divided long and short-term gains by a six-month holding period and provided that only 50 percent of long-term capital gains would be taxable.

A strong argument favoring the expansion of the capital gains deduction is inflation. In many instances capital gains merely reflect the inflationary spiral of our economy. What appears to be a gain in the amount of dollars over a given period of time is merely a reflection of the decreasing value of the dollar invested. This is a monetary gain which does not represent an actual gain, and should not be taxed.

The rate of capital gains taxation should be reduced proportionate to the length of time a capital asset is held, with the reduction being gradual and continuous. Expansion of the capital gains deduction would encourage greater capital formation through equity investment.

Capital Gains Holding Period

We recommend no lengthening in the holding period required to qualify for long-term capital gains treatment. Such a change in the holding period before long-term capital gains rates apply would serve to discourage capital investment and make it immobile, as well as cause a reduction in the availability of risk capital. H.R. 10612 would increase the present six-month holding period after which gains from sales of capital assets become long-term gains to eight months in 1976, 10 months in 1977, and 12 months in 1978 and following years.

The holding period in the present Internal Revenue Code began with the Revenue Act of 1942, which divided long and short-term gains by a six-month holding period. The present statute relating to the definition of long-term capital gain goes back more than 30 years. To extend the holding period for long-term capital gains could have serious long-range effects on the industrial and technological growth of the United States. The financing of new plant and equipment is in large measure dependent on funds provided from the issuance of corporate securities. If the holding period were to be extended, the effect could well be to discourage investment in such securities and to increase financing costs.

It is also important that the tax laws not discourage the free flow of capital from one investment to another. Any extension of the holding period would have the effect of discouraging the shifting of capital among investments. Investors would find their capital frozen into investments and be deterred from switching into better opportunities during an extended period. Instead of placing less emphasis on the tax consequences of business transactions, investors would have to be made fully aware of the tax results of a more lengthy holding period.

We believe that a lengthening of the holding period beyond the present six-month limitation is not in the national interest. Such a change would certainly reduce the availability of venture capital and inhibit economic growth. Investors are now willing to put their savings in high risk ventures envisioning capital gains treatment of any gains after a reasonable period of time. A lengthening of the holding period would make them reluctant to make such investments.

The present six-month holding period carries out the intent of Congress to provide different tax treatment for investment as distinguished from speculative gains. This period is ample to deny capital gains treatment to those who earn a livelihood from short-term sales and those engaged in highly speculative short-term ventures.

It is true that there is some bunching of transactions at the end of six months, but this is to be expected from any holding period providing in the law. Extension of the holding period would place a much greater tax burden on the investor. An extended holding period as a condition precedent to capital gains treatment inevitably would become a roadblock to the free transfer of assets which are not held for the entire period.

Alternative Tax on Capital Gains

The existing Internal Revenue Code provisions providing an alternative tax on long-term capital gains of individuals and corporations should be retained. Subject to the provisions of the minimum tax, the alternative tax taxes capital gains of individual taxpayers at a maximum of 25 percent up to the first $50,000 and the capital gains of corporations at a maximum of 30 percent. The Tax Reform Act of 1969 eliminated the 25 percent alternative tax for individuals except for the first $50,000 of long-term capital gains. This limitation increased the effective tax on high-income individuals who had been using the alternative tax rate. After transition rules prior to 1972, the maximum rate applicable to capital gains is one-half of the 70 percent maximum individual income tax rate or 35 percent.

While it is true that the alternative rate for capital gains primarily affects a relatively small number of taxpayers in the higher brackets, it must be recognized that it is this group of taxpayers that provides much of the risk capital that keeps our economy growing. Any changes in the alternative rate for capital gains would have the effect of discouraging the free flow of capital among investments and could severely limit the availability of venture capital, thereby limiting our economic growth.

Any higher alternative capital gains rate for corporations would be unwarranted. Moderate taxation of capital gains for corporations has the same purpose as moderate taxation of capital gains for individuals—to assure that investors of risk capital are not discouraged by the tax laws from undertaking investments leading to the establishment of new business enterprises or the expansion of existing enterprises. Further, a capital gains tax on corporations is but another example of double taxation of corporate income. A higher alternative capital gains tax on corporations can only serve to increase this inequity.

Recapture of Depreciation on Sale at Gain of Certain Real Property

The Internal Revenue Code provides that upon the disposition of real property that has been depreciated, any depreciation in excess of that which would have been allowed under the straight-line method is recaptured and treated as ordinary income to the extent of any gain realized at the time of sale. The balance of the gain is treated as capital gain. The Code also provides for the recapture of prior depreciation on the disposition at a gain of machinery, equipment and other depreciable personal property. This recapture is for the full amount of the depreciation after 1962, to the extent of the gain, whether it is taken on the straight-line method or by use of a fast depreciation method.

Under existing law, the amount of depreciation allowed on residential real property which must be recaptured is reduced after the property has been held for certain periods of time. H.R. 10612 would eliminate the reduction in recapturable depreciation on residential real estate and provide for the recapture of all post-1975 depreciation in excess of straight-line to the extent of any gain realized at the time of sale.

In order not to hamper construction so necessary for the growing population of the United States, we recommend that capital gains treatment on the sale of depreciable real estate be retained as under present law and that only depreciation in excess of straight-line depreciation taken by the use of an accelerated depreciation method be includable as ordinary income. In the event the present capital gains treatment on the sale of depreciable real estate is eliminated from the law, we urge that depreciable real estate be subject to the provisions of the ADR system so that there can be an adequate recovery of the investment to provide for reinvestment and continued growth and productivity in this country.

Ordinary Income Offset by Capital Losses

Existing tax law provides that up to $1,000 of ordinary income may be offset by net capital losses. We support an increase in this amount. H.R. 10612 would increase the present $1,000 limitation by which ordinary income may be offset by capital losses to $2,000 in 1976, to $3,000 in 1977, and to $4,000 in 1978 and following years.

It is important that we remove from our tax laws impediments to the free movement of capital. It is vital that we provide measures that allow taxpayers to eliminate unprofitable investments and shift to job producing profitable ventures. The current limitation of $1,000 of ordinary income that may be offset by capital losses increases the "lock-in" effect.

In 1974, Merrill Lynch, Pierce, Fenner and Smith, Inc. commissioned a survey to discover what changes in the tax laws would tend to influence people to increase their stock market investments. Over half of those surveyed indicated that they would increase their investment if there was an increase in the amount of ordinary income that could be offset by capital losses. Such increases in investment are necessary if we are to solve the capital formation problem.

Capital Loss Carryback for Individuals

Current tax law provides that individuals may carry forward capital losses to future taxable years. Corportions are limited to a five-year carryforward of capital losses, but may carry back capital losses for three years. We support a carryback as well as carryforward of capital losses for individuals.

The projected capital needs of America are going to be difficult to meet. We must provide measures that would tend to eliminate the "lock-in" of capital investment. The ability to carry back capital losses would tend to eliminate the "lock-in" effect by allowing the taxpayers immediate reductions in the tax through the offset of prior years capital gains. Without such a carryback provision, a taxpayer could have a tendency to hold unrealized capital losses until he had capital gains to offset against his losses.

The 1974 survey commissioned by Merrill Lynch, Pierce, Fenner and Smith, Inc. indicated that 66 percent of those surveyed would increase their investments if capital losses could be carried back against the capital gains in the preceding three years. This would provide an immediate benefit to the shareholders. They would receive a refund of prior taxes on the amount of income offset by the loss carryback. This would encourage them to "unlock" their investments.

Wash Sales

The 30-day period governing the wash sale provision has been a part of the tax law for over 85 years. It was intended to prevent the sale of securities solely to take a loss for tax purposes. This provision has served this purpose well for many years and any change would only add to the complexities caused by continual changes in the tax laws. We recommend there be no change in the wash sale provision, which provides that the purchase of a security within 30 days of the sale of the same security will disallow any loss with respect to the sale.

Capital Gains on Sale or Exchange of Patents

We support retention of existing law with regard to capital gains on the sale or exchange of patents and oppose any changes in the tax law in this area. Under present law, a transfer of property consisting of all substantial rights to a patent is considered as the sale or exchange of a capital asset held for more than six months and thereby treated as a long-term capital gain.

In 1954, Congress assured capital gains treatment on the disposition of a patent in order to encourage the work of inventors. The applicability of this provision is restricted under present law. It applies only to individual inventors, whether amateur or professional. Also, it applies only to unrelated persons who have financed their research, at a very substantial risk, before the invention is reduced to practice, i.e., prior to the time the invention has been tested and operated successfully.

The same reasoning for retaining the present treatment for patents exists today as in 1954, namely to provide the incentive to inventors to contribute to the welfare of the Nation. Any alternative proposal for income averaging, and thereby taxing small inventors and their financial backers at ordinary income rates, could seriously curtail individual resourcefulness in the fields of science and technology at a time when the Nation can ill-afford to lose contributions of this kind.

Taxation of Foreign Source Income—Introduction

The National Chamber opposes legislation that would increase the tax burden on United States businesses doing business abroad, either directly or indirectly. There are sound reasons for the present tax law relating to the foreign tax credit, DISC and deferral for certain foreign subsidiaries of United States companies. Any adverse change almost certainly would result in curtailing American foreign operations, with an attendant loss of jobs both here and abroad.

U.S. multinational companies have made a substantial contribution to export development and to the growth of American employment. These companies have contributed substantially to the worldwide improvement of living standards, the rapid generation of employment opportunities, and the more effective use of advanced technology. Sound and expanding international commerce is essential to the continued expansion of the economy of the United States and to the achievement of greater prosperity and strength of all nations. Mutually beneficial trade raises standards of living by providing people with more goods at less real cost, raising productivity, and by increasing economic efficiency through competition.

Federal income tax laws already hamper participation of United States businesses in world competition and additional tax burdens would further aggravate this problem. It is to the mutual advantage of all countries that the exchange of goods, capital, and services in international trade not be discouragd by taxation. Even if other conditions are favorable, excessive taxation by a single country or multiple taxation by two or more countries of the same property or income will leave inadequate incentives for incurring the risks involved. The following discussion relates to specific foreign tax provisions under consideration by this Committee.

Foreign Tax Credit

Under present law, when a dividend is paid by a foreign subsidiary of a United States corporation, the parent company can take a credit against its United States tax liability for the total of the direct foreign taxes paid on the dividend and the tax incurred by the foreign subsidiary on its earnings which produced the dividend. We oppose legislation that would increase the tax burden on United States businesses doing business abroad, either directly or indirectly, including legislation that would repeal or modify the foreign tax credit currently allowed to United States corporations for the payment of foreign taxes paid both by the United States parent corporations and their foreign subsidiaries.

The foreign tax credit was substantially modified by the Tax Reduction Act of 1975, which provided for a 52.8 percent limitation on foreign tax credits for creditable foreign taxes from foreign oil and gas extraction income in 1975, reduced to 50.4 percent in 1976 and to 50 percent in 1977 and thereafter.

Prior to 1918, foreign taxes paid were allowed as a deduction from taxable income. In 1918, the foreign tax credit was adopted to provide relief from the severe burden of multiple taxation of business operations abroad. It was recognized that the foreign tax credit was needed to avoid the double taxation of foreign earnings of United States corporations and to maintain competitiveness of American business in foreign countries.

Adoption of the foreign tax credit affirmed a policy decision to tax United States citizens and corporations on worldwide income. It was argued, however, that United States corporations were at a disadvantage in foreign markets because they also had to pay a United States tax, but this was rejected in favor of recognition of the foreign tax credit to eliminate the burden of double taxation. Adoption of the credit also reaffirmed the policy of source jurisdiction, i.e., the United States recognizes the tax burdens of taxpayers with fiscal responsibilities to two national jurisdictions. As a matter of tax neutrality, it cannot be said that the foreign tax credit violates the equities of American taxpayers because United States companies must pay a tax rate on their foreign earnings at least equal to the United States rate of income tax, irrespective of the country from which the income was derived.

The immediate effect of substituting a deduction for the foreign tax credit for foreign taxes paid would be to increase the total tax burden unfairly and force a foreign subsidiary to pay a substantially higher dividend in order for the United States parent to receive the same after-tax dividend it receives under present law. As a result, a subsidiary which needed to retain in the business all or a major part of its earnings for the year to finance plant expansion or to carry inventories, receivables, etc., would be under a severe financial burden.

An example can best illustrate the inequity that would result to United States companies operating abroad. If $100 of pretax profit of a subsidiary in a foreign country is subject to $45 of income tax there, the United States tax would be assessed on the remaining $55, leaving an after-tax profit of less than $29. Few American companies could continue to compete abroad if they were forced to pay, on the average, an effective tax rate on foreign earnings of over 70 percent. The foreign tax credit is essential to prevent the taxation of foreign source income at confiscatory rates.

It is often argued by opponents of the foreign tax credit that because only a deduction is given for domestic state and municipal income taxes, a credit should not be given for foreign income taxes. Unfortunately, the question of permitting only a deduction assumes an analogy between the jurisdiction of a state and a sovereign to levy taxes. The foreign tax credit recognizes that two sovereign nations have the right to levy taxes. The proper analogy for states is to look to see how corporate income is treated that is earned in two or more states. A survey of state taxation in 1972 showed that 41 out of 44 states levying income taxes permitted a credit for income taxes paid to other states to avoid double taxation. Furthermore, the average corporate income tax rates for all states was less than six percent, as compared with many nations that have tax rates of over 40 percent, such as West Germany, France, and the Netherlands.

Repeal of the foreign tax credit would result in less domestic employment, and have a negative effect on the United States balance-of-payments over the long run. Export sales would probably decline. Tax treaties would have to be renegotiated. Host countries might take retaliatory measures.

Foreign direct investment has had a favorable effect on the United States balance of payments. Income from trade coupled with dividends, fees, royalties, interest and other income from foreign affiliates has contributed favorably to our balance-of-payments position. Foreign investment by United States companies contributes to job growth in this country. Jobs are provided in the home offices of such companies, and at the same time exports of capital equipment, materials, and component parts provide employment for American workers in this country.

Professor Robert B. Stobaugh of the Harvard Business School said in the September–October, 1972, issue of *Harvard Business Review:*

"What effect does direct foreign investment have on the balance of payments? Undeniably, it is positive. The net inflows due to the trade effects, together with dividends, royalties, and management fees from this investment, total at least $3 billion more annually than would be the case if there were no investment.

"In addition, U.S. economic strength abroad is growing at an annual book-value rate of $8 billion. While this buildup makes no immediate contribution to the balance of payments, it must be included in any survey of our economic picture, since the increasing value of investment abroad will result in larger future returns in dividends, loan repayments, and fees to the parent corporations."

The foreign tax credit is essential for American industry to compete abroad. There are over 22 international treaties to avoid double taxation and discriminatory practices against foreign direct earnings. Repeal of the foreign tax credit would thus have an adverse effect on the entire United States economy.

We consistently have emphasized the need for a foreign tax credit giving greater relief for foreign taxes paid which are not strictly "income" taxes. It must be remembered that a substantial percentage of the total tax burden in Europe is collected in the form of sales taxes, turnover taxes, transmission taxes, trade taxes, excise taxes, taxes on capitalization, privilege and franchise taxes, and property taxes—none of which are creditable under the present United States income tax system. As in the past, we advocate that section 903 be amended to achieve equality for taxpayers who pay substantial foreign taxes not specifically designated "income" taxes, and for those who lose even the benefits of the "in lieu of" provisions of section 903.

Foreign Tax Credit—Per-Country and Overall Limitations

We oppose elimination or fragmentation of either the overall limitation method or the per-country limitation method of computing the foreign tax credit. Both methods must be retained for American business to compete with foreign-owned competition. Under H.R. 10612, the per-country limitation on the foreign tax credit would be repealed in general for taxable years ending after December 31, 1975.

Originally, there was no limit on the amount of foreign tax credit which could be used to offset United States tax liability on domestic income. In 1921, an "overall" limitation was added. It provides that the total foreign taxes used as a credit in any year cannot exceed the United States tax attributable to the foreign source income for the same year. In 1932, a "per-country" limitation was added whereby the foreign tax credit on taxes paid to any one country in a year cannot exceed the United States tax liability on the income earned in that country in that year.

Between 1932 and 1954, the credit was limited to the lesser of the overall or the sum of the per-country limitations. In 1954, the overall limitation was removed. Since 1960, the taxpayer has had the option of using either the per-country or the overall limitation. However, the Tax Reduction Act of 1975 provided that, for the 1976 taxable year, and thereafter, the per-country limitation would not apply to foreign oil related income and therefore the amount of creditable foreign taxes with respect to such income could be computed only on the overall basis.

Since the per-country limitation requires computation of income and taxes from each country, rather than in the aggregate, this limitation is important where a loss is sustained in one country and a profit achieved in another. The overall limitation is important because it permits a taxpayer to average foreign taxes paid.

It should be remembered that the availability of both an overall and a per-country limitation is basically a recognition of different foreign operating patterns among American taxpayers. In many instances, foreign operations of a United States business will be compartmentalized according to national boundaries and the per-country limitation is therefore more meaningful. In other instances, operations in different foreign countries may be fully integrated with each other, in which case it is the overall income tax burden of the operation which is most significant.

69-460—76——11

Although it is not the rule, in some cases in evaluating an investment opportunity abroad, the averaging of foreign tax burdens between countries is given significant weight in the economic review. In this connection, it must be recognized that when developing foreign countries extend tax incentives to American investors, they are very much concerned as to whether the investors or the United States Government will benefit from those incentives. In many instances, the overall limitation offers the only way such investors may secure those benefits.

Were not the overall limitation retained intact, many foreign governments could promptly determine that their tax incentives are accruing to the benefit of the United States Government. This situation could quickly be altered to the detriment of American businesses operating abroad.

On the question of further fragmentation of the overall limitation, we believe the existing law has already effectively limited the possibilities of abuse. Specifically, the overall limitation is subject to the following provisions of the Internal Revenue Code: Section 1503(b) reduces allowable foreign tax credits in consolidated returns involving Western Hemisphere Trade Corporations; Section 904(f) requires a separate computation for certain interest income and dividends received from a DISC or former DISC; and Section 901(e) reduces allowable foreign tax credits for foreign income taxes paid with respect to mineral income. Additionally, there are further limiting interrelationships with loss operations and foreign tax credit carrybacks and carryovers.

The federal income tax laws already hamper participation of United States businesses in world competition and additional tax burdens would further aggravate this problem. The overall and per-country limitation methods are important mitigating provisions and should be retained.

Recapture of Foreign Losses

We oppose any modification of the foreign tax credit which would require that any foreign losses that offset U.S. income be recaptured in future years when foreign income is earned by denying a portion of the foreign tax credit or deduction with respect to part of that income. The Tax Reduction Act of 1975 provided that for the 1976 taxable year and thereafter a foreign oil-related loss which had offset domestic income would be recaptured in a subsequent profitable year by limiting the foreign tax credits available with respect to such subsequent foreign oil-related income.

H.R. 10612 would provide that when a loss from foreign operations is used to reduce U.S. tax on U.S. source income, the resulting tax benefit is to be recaptured when the taxpayer earns income from abroad. A part of the income subsequently derived from foreign sources is treated as domestic income by denying a foreign tax credit or any deduction attributable to taxes paid on that portion of the foreign income.

We believe placing a limitation on the foreign tax credit by requiring a recapture of losses would tend to discourage companies which are less integrated from entering into foreign ventures in less-developed, relatively high-risk countries. These countries present potential markets in the future. This discouragement would result in yielding a part of these potential markets to companies which are based in countries that encourage such foreign investment.

This limitation on the foreign tax credit would make it more difficult for many companies, especially the smaller and less fully integrated companies, to engage in overseas mineral exploration and development. At a time of increasing awareness of the limitations of the currently producible mineral wealth of the United States, and at a time when the Nation is experiencing serious energy shortages, it seems especially unwise to adopt such a provision.

We believe that the recapture for foreign losses could impose unwarranted penalties on U.S. companies operating abroad. These companies are competing for overseas market opportunities through both trade and investment, and the competition they face is intense.

Earnings and Profits of Controlled Foreign Corporations

There have been proposals to tax on a current basis the earnings of certain foreign subsidiaries of United States companies referred to as controlled foreign corporations. We oppose any changes in the law that would permit taxing earnings of foreign manufacturing subsidiaries of United States corporations in the year in which they are earned, rather than when they are paid to the parent company as dividends, as at present. There are sound reasons for the present tax law and any change almost certainly would result in curtailing

U.S. foreign operations, with an attendant loss of American jobs both here and abroad.

The Tax Reduction Act of 1975 contained a number of provisions which severely limited the exceptions to the deferral of taxation of controlled foreign corporations. First, the minimum distribution exception provided in section 963 of the Internal Revenue Code is repealed effective January 1, 1976. As noted in the Ways and Means Committee's summary of this change, "The effect of repealing this exception would be to tax currently all income of foreign subsidiaries of U.S. corporations which is deemed to be tax haven income under the so-called Subpart F rules of the Code." In addition, the Act also eliminated the exception to Subpart F income for dividends reinvested in less-developed countries, limited the provision for shipping income received by a foreign subsidiary of a U.S. corporation to the extent that the profits of these corporations are reinvested in shipping operations, and modified the provision so that tax haven income would be taxed currently under the Subpart F rules to the extent that such income equals or exceeds ten percent of gross income, instead of the previous 30 percent rule. We are of the opinion that the changes were ill-advised. These provisions were originally placed in the law for sound reasons.

Prior to 1962, foreign source income of a foreign subsidiary was not subjected to United States tax until the earnings were repatriated, i.e., transmitted to the United States in the form of dividends. In 1962, the concept of current taxation of Subpart F income of controlled foreign corporations was introduced into the federal tax laws. This concept provided that those profits derived from [illegible]in categories of foreign income must be reported pro rata by the corpor[illegible]'s United States shareholders, even though not distributed to them.

Certain exceptions to the current taxation of Subpart F income were made partly because other countries did not tax their domestic subsidiaries on foreign earnings until such earnings were repatriated as dividends. If foreign subsidiaries were to be taxed on a current basis, it would require either the United States parent to pay a tax on dividends it has not received or force the foreign subsidiary to pay dividends to its United States parent to help finance the tax the parent has to pay. The effect of either of these would be highly detrimental to the financing of American operations abroad.

As a matter of tax policy, it would be unsound to tax the income currently because dividend income should not be taxed until it is received. A foreign subsidiary of a United States corporation is a separate corporation incorporated in that country. It is subject to the laws of the foreign country and must pay taxes to the host country. The earnings of the subsidiary are not a part of the earnings of the parent until they are distributed and therefore should not be taxed until received. This is in contrast to the recognized policy that a domestic corporation with branch operations abroad is taxed currently on the income received.

Increasing the total tax burden of United States companies operating abroad would put them at a disadvantage with foreign competitors who are not taxed by the mother country on the earnings of their subsidiaries overseas. It should be emphasized that no other major industrial country taxes, currently, the unremitted earnings of the foreign subsidiaries of its domestic corporations. In the long run, the only beneficiaries of a United States tax on current earnings of foreign subsidiaries would be our foreign competitors.

An underlying premise held by those who advocate the current taxation of subsidiary income is that multinational corporations are threatening domestic employment opportunities by manufacturing products abroad. The facts, however, indicate that an increase in foreign investment raises total American employment both here and abroad. Not only does new foreign investment directly create jobs for Americans abroad, it also increases the demand for domestic jobs by increasing the demand abroad for U.S. materials, equipment and know-how.

Deferral of taxation on dividends is necessary to maintain equality with foreign competition. The current taxation of income not yet received by American business could only have an adverse effect on domestic employment, and on our balance-of-payments as well as seriously weakening our competitive position abroad.

Domestic International Sales Corporation (DISC)

We again express our support for the concept of a Domestic International Sales Corporation. The DISC provisions were codified in the Revenue Act of 1971 and were effective January 1, 1972. Although this provision has been in the law for a short period of time, many companies have set up DISCs, thereby building plants in the United States and employing American workers, rather than locating production facilities abroad.

A DISC is a special type of United States corporation engaged in the business of export sales. The DISC itself is not subject to income taxes, although its shareholders are treated as receiving 50 percent of the DISC's income, and taxed currently on the amount of dividends. American exporters are permitted to defer U.S. income taxes on the other half of exporting income, but the DISC must reinvest it in its export business.

To qualify for DISC treatment, at least 95 percent of a corporation's gross receipts must arise from export activities. In addition, at least 95 percent of the corporation's assets must be export related. The recently enacted Tax Reduction Act of 1975 provided that DISC benefits would be denied in the case of income from certain export sales of natural resources and energy products after March 18, 1975.

H.R. 10612 would require a new incremental or base period method of computing DISC benefits. The DISC benefits would be allowed only to the extent that the export gross receipts of the DISC exceed 75 percent of its base period gross receipts. In addition, H.R. 10612 would eliminate DISC treatment for products sold for use as military equipment and for agricultural products not in surplus in the United States.

Reginald H. Jones, Chairman and Chief Executive Officer, General Electric Company, and a member of the President's Export Council, stated in a letter last year to the Editor of the *Wall Street Journal* on this important issue of exports and U.S. jobs:

"Consider the impact on employment. Trade-related jobs have been growing at an annual rate of 8.7% over the past nine years compared with 1.6% for the overall domestic economy. Thus, such jobs, now numbering 8.6 million, are an increasingly important element of our employment picture. Moreover, in 1974 workers employed in export-related activities average earnings of $5.20 an hour, 25 percent above the rest of the economy."

Many U.S. companies that now use DISC have substantially increased their exports and provided more U.S. jobs at a time when unemployment is a critical issue.

A Department of Labor survey reported that for 1972, more than 2.9 million U.S. jobs were directly related to production or distribution of exported merchandise. This figure does not include service industries. Furthermore, jobs related to merchandise exports rose 30 percent between 1963 and 1972, while the total United States employment in the private economy rose only 19 percent over the nine-year period. This survey noted that 72,000 jobs were associated with each billion dollars of exports in 1972. Although it cannot be assumed that each increase in billion dollars of exports will increase related jobs by that amount, certainly this 2.9 million figure of U.S. jobs related to exports is very low in the light of the fact that exports increased 100 percent between 1972 and 1974. Although it is too early to give concrete results, it is clear that the DISC provisions have significantly contributed to U.S. jobs directly and indirectly related to our exporting industry.

The fact is that in the past few years this country has experienced a substantial growth in exports. In 1972, U.S. exports rose to $48.4 billion, a 13 percent increase over 1971 exports. In 1973, exports expanded to $69.7 billion, an increase of 44 percent. In 1974, exports increased 38 percent to a high of $96.5 billion. This is representative of a worldwide phenomena of rapidly expanding trade. However, at the same time, America's share of world exports of industrialized countries declined in 1972, from 18.9 percent to 18 percent. In 1973, the U.S. share of the market recovered to 19 percent and rose in 1974 to 19.6 percent.

The Treasury Department has made two annual reports on the operation and effects of the DISC, but the latest statistics available only cover tax returns submitted for taxable periods ending between July 1972, and June 1973. For this period, the Treasury estimated about 41 percent of U.S. exports, amounting to $21.9 billion in gross receipts, were DISC related. At the same time, DISC exports increased about 33 percent, compared with a growth of 23 percent of all exports weighted to correspond to the growth of DISC exports. Based on these percentages, the Commerce Department estimated that export sales valued at about $2.6 billion would not have occurred without the encouragement from DISC.

Since the DISC legislation was enacted, we have witnessed a tremendous growth in world trade, high rates of inflation, large increases in the price of oil and other products, floating exchange rates and a recent international economic slowdown. These factors have an effect on evaluating the role of DISC in the growth of exports.

Coupled with the investment tax credit and the Asset Depreciation Range system, DISC provides employment opportunities. During the hearings on the Foreign Trade Act of 1970, the Administration estimated DISC could create new jobs for almost 80,000 Americans.

Besides promoting domestic employment, increasing exports, and contributing to the balance-of-trade, the DISC is intended to overcome two major disadvantages that faced United States domiciled exporters. First, they were not receiving the tax deferral benefits available to foreign subsidiaries of United States corporations. Second, domestic exporters were often competing against exporters based in foreign countries, who were given more liberal tax benefits by their governments. These disadvantages would exist today, were it not for the DISC provisions.

The DISC provisions provide the tax deferral opportunities for domestic exporters where previously they were available just to American exporters using foreign subsidiaries. Also, the DISC allows firms that are too small to operate through foreign subsidiaries to enter the export field. It was estimated by Treasury last year that over 7,300 elections have been made to become a DISC. The tax deferral may not be large in many cases, but the cumulative benefit provides a substantial increase of working capital for further export development.

DISC places the American exporter in a more competitive position in world trade and in the search for world markets. Foreign countries have a variety of incentives to encourage foreign trade. As mentioned in the discussion on the investment credit, the European Common Market's requirement of the use of the value-added tax permits member countries to rebate taxes paid by the exporter at the time of the export, and to impose a tax on importers. On the other hand, because the United States uses an income tax, it is precluded from giving a tax rebate on American exports. Our foreign competitors, especially Japan and members of the European Common Market, are vitally concerned with their exports. They use export incentives because they believe increased exports create fuller employment and positive trade balances.

The March 1975, *International Economic Report of the President* stated that: "Foreign competitors, all with much smaller domestic markets, have for some time devoted sizeable resources to foreign marketing programs. During the last 15 years, the United States has exported between 10 and 15 percent of the goods it produced, while major Western European countries have exported from 30 to 50 percent." This report further shows that expenditures for export marketing and information services for 1973 by the governments of Canada, France, Japan, Italy, and the United Kingdom averaged more than twice those provided by the United States Government.

It is much too early to make changes without a full evaluation. Thousands of corporations have relied on DISC. It is thus imperative that the DISC provisions be retained fully in the law to help provide more jobs and maintain equality in the tax laws for corporations that do not use foreign subsidiaries.

Less-Developed Country Corporations

We are opposed to an increase in the tax burden on U.S. enterprise doing business abroad in less-developed countries. The Tax Reduction Act of 1975 eliminated the exception to "Subpart F income" for dividends reinvested in less-developed countries. H.R. 10612 would require that dividends received by U.S. shareholders from less-developed country corporations be "grossed-up" by the amount of taxes paid to less-developed countries for purposes of computing the foreign tax credit and related foreign source taxable income. Also, H.R. 10612 would tax U.S. shareholders at ordinary income tax rates on the gain from the sale of stock in less-developed country corporations.

We favor retention of the exclusion from gross-up on dividends of less-developed country corporations. Japan, all of the Common Market countries, and most other European countries are prohibited by the Trade Act of 1974 from being designated less-developed countries. The exclusion is warranted to mitigate existing tax provisions that act as a barrier to private investment in less-developed countries because American firms must compete with firms incorporated in foreign countries which are taxed at lower rates than United States corporations. Also, treaties prevent less-developed countries from using tax rebates as a device to attract American investment.

These provisions are needed to offset the great noncommercial risks of investing in less-developed countries. Social unrest and political instability constantly pose the threat of discriminatory application of the laws, expropriation, and civil strife.

Preferential tax treatment is justified to stimulate private foreign investment, because of the United States role in foreign affairs. The success or failure of underdeveloped countries to take their place in the free world will depend to a large extent on the strength of their national economies. An orderly expansion of the economies of less-developed countries is desirable because it engenders higher standards and greater purchasing power in these countries and improved markets for United States exports.

We are opposed to the repeal of the less-developed country exception which excludes earnings accumulated while a corporation was a less-developed country corporation from those earnings and profits which are subject to tax as a dividend if there is gain from the sale or exchange of stock in the controlled foreign corporation under section 1248 of the Internal Revenue Code. Elimination of this exception also would discourage investment in these less-developed countries.

Exemption of Earned Income From Foreign Sources

The exclusion in section 911 of the Internal Revenue Code for earned income of citizens who are residents and/or employed abroad should not be reduced. Under existing tax law, United States citizens, who are bona fide residents of foreign countries for at least one full calendar year or who are physically present in foreign countries for 17 out of 18 consecutive months, may exclude from their federal income tax the first $20,000 of compensation received for services performed outside the United States. The exclusion is increased to $25,000 in the case of U.S. citizens who have been bona fide residents of foreign countries for three years or more.

Under H.R. 10612, the exclusion for income earned by U.S. citizens living abroad would be phased out over a four-year period.

The current exclusion has been a part of our tax law since 1926. This issue was fully considered by both the House and the Senate in 1962, and the present law is a result, with the exception that in 1964 the $35,000 exclusion was reduced to $25,000. The tax benefit has been reduced substantially from an unlimited exclusion to the present $20,000 and $25,000 exclusion. Furthermore, the exclusion is limited sufficiently to prevent its use as a tax avoidance device.

Critics of the exclusion assert that it entices Americans, with technical and professional skills not available in foreign countries, to work abroad by offering them tax-free earnings. This assertion completely overlooks the fact that these employees may be subjected to other foreign taxes in the place of income taxes. Foreign taxes other than income taxes, such as value-added taxes, sales taxes and custom duties, are not allowed as a credit or a deduction against United States taxes.

American citizens working abroad do not have the benefit of many services available at home that are paid for by taxes. As for the individual businessman overseas, the tax exclusion of $20,000 and $25,000 helps offset the additional costs of schooling, housing, travel, and other inconveniences. Such Americans overseas do not get the benefits of those things their taxes help pay for in the United States.

The exclusions in section 911 give some relief from this situation and represent a measure of justice for the American citizen abroad. Because of inflationary trends throughout the world, any adjustment in the exclusions should be up rather than down.

United States Government employees abroad remain subject to our income taxes on their earnings, but they are not taxed on fringe benefits such as shelter, cost of living, education, travel and other differential cost payments. On the other hand, cost-of-living allowances are taxable compensation to employees of private business.

Armed forces personnel enjoy facilities on foreign bases which provide an environment camparable to a base in the States. Civilians employed abroad must attempt to create a comparable cultural environment for their families on an individual basis. Reduction of the presently excludable portion of salary earnings would discriminate against nongovernment employees.

In order to operate on an international basis, American companies must employ some of our citizens to work in foreign subsidiaries and branches. These

American employees are necessary because local nationals, in many cases, do not possess the needed skills, experience or familiarity with American business methods.

United States citizens representing American businesses abroad often have many years of experience with the language, laws, customs, and techniques of the foreign country in which they live. They are invaluable and are as essential to companies operating abroad as American capital. It is essential to have American citizens in overseas positions to manage these investments, as well as to train local personnel.

A citizen employed abroad must receive compensation for special costs which do not represent real income. If he is given an allowance for tuition for his children to attend a private English language school, this does not represent any income to the individual, but the United States will tax such a tuition allowance.

As a revenue producing measure, the elimination of the exclusion would be largely ineffective. Corporate employers would be obliged to increase salaries or living allowances of their overseas American employees, thus diminishing corporate tax receipts. The net effect would be to make American business abroad less competitive with other foreign business, since other major industrial nations generally do not tax their overseas businessmen.

The long-range effect of any unfavorable change would be to jeopardize our competitive position abroad at a time when inflation and rising operating costs have made it increasingly difficult to compete in foreign markets. Additional costs could cut back on dividends and profits from foreign operations which assist in solving our long-range balance-of-payments problems.

Income from Sources Within the Possessions of the United States

We oppose any change that would increase the tax burden on U.S. businesses doing business abroad, including increasing taxes on the income from sources within the possessions of the United States. H.R. 10612 would provide a tax credit for possessions corporations in lieu of the exclusion provided by existing law. Income not derived from a possessions trade or business or from qualified possessions investments would be subject to U.S. tax. United States corporations receiving dividends from possessions corporations would be eligible for the 85 percent or 100 percent dividends-received deduction. Corporations could qualify as possessions corporations only if they elect to remain possessions corporations for at least 10 years.

Under present law, American citizens or domestic corporations that receive income from within a possession of the United States can exclude from gross income all the income derived from outside the United States if certain requirements are met. First, 80 percent or more of the gross income of the corporation for the three-year period immediately preceding the close of the taxable year must be derived from sources within a possession of the United States. Second, 50 percent of the gross income of the corporation for the same three-year period must be derived from the active conduct of a trade or business within a possession of the United States.

This provision has remained substantially unchanged from its enactment in 1921. While granting certain benefits, it exacts certain concessions, such as prohibiting an individual from taking the standard deduction and prohibiting a corporation from filing a consolidated return with its affiliates. Also, DISC advantages are denied to possession corporations to preclude a double benefit under these provisions. United States laws require minimum wage provisions and requirements to use U.S. flagships in transporting goods between the United States and various possessions which substantially increase the labor, transportation and other costs of establishing business operations in the possessions.

Existing provisions came into the law over 50 years ago. The original reasons for the law, to promote trade in the possessions, are still valid today. No changes should be made which would adversely affect these business activities.

Western Hemisphere Trade Corporations

We oppose elimination of the deduction allowed to Western Hemisphere Trade Corporations. H.R. 10612 would phase out, over a five-year period, the 14 percent lower tax rate for Western Hemisphere Trade Corporations.

A Western Hemisphere Trade Corporation is a domestic corporation which does all of its business in North, Central, or South America, or the West Indies, and has at least 95 percent of its gross income from sources outside the United

States and at least 90 percent of its income from the active conduct of a trade or business.

The special treatment afforded these companies is necessary to encourage the use of domestic corporations for operations in the Western Hemisphere. Beginning with the Revenue Act of 1918, which provided for credits for foreign income taxes paid by domestic corporations, there is a long history of special tax treatment for income received by domestic corporations from sources outside the United States. Special treatment for Western Hemisphere Trade Corporations was granted in 1942 to allow United States corporations to compete effectively with foreign local corporations and third-country foreign corporations doing business in the Western Hemisphere.

Today, Western Hemisphere Trade Corporations engage in export activities that provide a positive stimulus to our balance-of-trade. DISC status is denied to such corporations to preclude a double benefit. Retention of the existing provisions is necessary in order to continue the established avenues of trade with countries in the Western Hemisphere. It is essential to our domestic economy and implementation of international policies.

Foreign Corporation Investment in United States

H.R. 10612 would provide that the definition of investments in U.S. property by controlled foreign corporations, which are treated as dividends, would be limited to investments in stock or obligations of a related U.S. person, not including a subsidiary and to tangible property leased to, or used by, such a related U.S. person. We support this amendment. We urge that this Committee recognize the detrimental effect the current law has on our balance-of-payments by discouraging controlled foreign corporations from investing their profits in the U.S.

Foreign Portfolio Investments in the United States

We support elimination of the current 30 percent withholding tax on portfolio investments in the United States of nonresident aliens and foreign corporations and the elimination of the estate tax on such investments. The United States is facing a critical capital shortage. One way to alleviate this shortage would be to encourage investment in United States business by foreign persons. The current 30 percent withholding tax and the estate tax is a discouragement to this investment and should be eliminated.

H.R. 10612, as ordered reported by the House Ways and Means Committee, would have repealed the 30 percent witholding tax on dividends and interest received from the U.S. by foreign persons, except in the case of dividends and interest from investments that constitute a direct investment in U.S. securities rather than a portfolio investment. A floor amendment struck this provision from the bill. We urge this Committee to reinstate a provision which would eliminate the 30 percent withholding tax presently imposed on portfolio income paid on foreign investments in the United States.

There is a definite imbalance in today's business financing from foreign investors that favors short-term securities and bank deposits, which are presently exempt from the withholding tax. Removal of the withholding tax could redress this imbalance by improving the attractiveness of long-term investments. Eliminating the withholding tax could improve our balance-of-payments by increasing foreign investment.

There are many exceptions to the current withholding tax. The primary exceptions are contained in a series of bilateral tax treaties. The United States has followed a policy of seeking to eliminate withholding taxes on interest payments. These treaties often lead to complexities and manipulations to take advantage of favorable withholding elimination or reduction features to avoid the general 30 percent withholding tax. Elimination of the withholding tax could effectively eliminate avoidance schemes. To the extent these treaties do not apply, the mobility of United States corporate securities is lessened. This restricts the attractiveness of U.S. investment for foreign persons.

We support the elimination of the 30 percent withholding tax on foreign portfolio investments in the United States and the estate tax on such investments to encourage additional inflows of foreign capital into the United States.

Reorganizations Involving Foreign Corporations

Present law provides that when a foreign corporation is involved in certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation, tax-free treatment is not available, unless prior to the transaction the Internal Revenue Service has made a determination that the exchange does not have as one of its principal purposes the avoidance of federal income taxes. With reference to the advance ruling requirement under section 367 of the Internal Revenue Code, we believe this provision should be repealed to eliminate the unwarranted impediment to the reorganization and efficient operation of international business.

H.R. 10612 eliminates the requirement in section 367 of the Internal Revenue Code that an advance Internal Revenue Service ruling must be obtained for tax-free exchanges involving a foreign corporation related to U.S. taxpayers.

We believe that the advance ruling requirement often results in undue delay for taxpayers attempting to consummate their proper business transactions. Furthermore, the advance ruling requirements provide unnecessary barriers to perfectly legitimate business transactions. For these reasons, we support the repeal of this provision of the Code in order to facilitate efficient operations of international business.

Tax Exemption for Ships Under Foreign Flags

We favor continuation of the tax exemption for ships under foreign flags. For over 50 years, since the Revenue Act of 1921, the tax law has provided for an exemption from taxation of earnings from the operation of ships documented under the laws of a foreign country which grant an equivalent exemption to United States citizens and to corporations organized in the United States. In the absence of an equivalent exemption granted by the foreign country, these earnings are taxable in the same way as other earnings from sources partly within and partly without the United States.

The exemption was designed to encourage the international adoption of uniform tax laws affecting shipping companies and for the purpose of eliminating double taxation. Without international cooperation, there is always a possibility of discriminatory taxes such as imposing double taxation on aliens.

Present tax law, on the books since 1934, recognizes the evils of discriminatory taxation. Section 896 of the Internal Revenue Code provides that the President of the United States may retaliate by doubling the rates of tax on foreign citizens and corporations, if he finds American citizens or corporations are being subjected to discriminatory or extraterritorial taxes under foreign laws.

Elimination of this exemption could draw retaliatory taxation by the affected countries. Withdrawal of the exemption could have severe adverse effects on our international trade relations.

Depreciation on Foreign Assets

We oppose limiting depreciation on property located outside the United States to the straight-line method. There have been proposals to prevent taxpayers depreciating property located outside the United States from using an accelerated method of depreciation, such as double declining balance or sum of the years-digits. Instead a taxpayer could use the straight-line method only.

There appears to be no sound basis for discrimination between methods of depreciation based on the location of the assets, especially since foreign investments tend to carry more risk than domestic investments. Many countries—including Japan, Canada and the United Kingdom—permit much faster write-offs than does the United States. Any further prohibition on capital cost recovery for American businesses operating abroad would only curtail direct foreign investment and weaken our position in international trade.

Transfer of Patents, etc. to Foreign Corporations

We oppose any changes in the tax law to provide for taxing the gain realized on the transfer to a foreign corporation of a patent, invention, model design, copyright, secret formula, process or any other similar property. There have been proposals to tax any gain arising from a United States corporation's transfer of a patent, or similar rights to foreign corporations. Not only would such a measure seriously impair the free flow of commerce, it could lead to reciprocal actions by foreign countries which would prevent American industry from benefiting from technological advances developed abroad.

State Taxation of Foreign Source Income

We are opposed to either the apportionment or the allocation of foreign source income among the states for income tax purposes. It has been the policy of the Federal Government, through the federal tax laws and treaties with other nations, to avoid double taxation. It is the most practical approach as well as in the best interests of the Nation, for an international policy to be left to the Federal Government, not the states.

Deductibility of Expenses for Attending Conventions Outside the United States

H.R. 10612 would disallow deductions for expenses of taxpayers attending conventions, educational seminars, or similar meetings outside the U.S. incurred in attending more than two foreign conventions per year. It would limit the deduction for transportation expenses to the cost of airfare based on coach or economy class and limit subsistence expenses to the fixed amount of per diem allowed to government employees.

We oppose repeal of existing law regarding the deductibility of expenses incurred in attending conventions outside the United States, since the Treasury Department has sufficient authority under section 274 of the Internal Revenue Code to control possible abuses in this area. Under present provisions of the Code, ordinary and necessary business expenses and expenses incurred in the production of income are allowed as deductions. Expenses for attending business conventions, if they meet the tests set forth in certain sections of the Code, are generally allowed as deductions.

Under present law, if the primary purpose of the individual in going to a convention held outside the United States is a vacation, the convention is considered to be personal in nature and the expenses incurred are not deductible. Present Internal Revenue Service regulations provide that the allowance of deductions for such expenses depends upon whether there is a sufficient relationship between the taxpayer's trade or business and his attendance at the convention, so that he is benefiting or advancing the interests of his trade or business by such attendance. The regulations specifically state that if the convention is for political, social or other purposes unrelated to the taxpayer's trade or business, the expenses are not deductible.

We recognize that there have been abuses by some in this area. But those abuses are subject to correction through present law. To confine deductions for attending conventions to the United States and its possessions would be an abuse in itself. It would penalize those who are presently not abusing the law, and it could create many other inequities. For example, such a rule could disallow deductibility for a group of Detroit businessmen attending a convention across the Detroit River in Windsor, Canada, but allow expenses for attending the convention if it were held in Guam.

The real question is whether an individual should be required to pay taxes on income used for a legitimate business meeting with a legitimate business purpose. To predicate the answer on the basis of location is unreasonable and creates hardships not only for Americans but also for our neighbors in other lands.

Our neighbors in the Caribbean, Mexico and Canada would suffer materially from this new change in American policy. As a result of such action, we could anticipate similar crackdowns on business travel to the United States by nationals from those countries. American-owned hotels in other countries which depend upon American convention trade would also suffer. In addition, American-owned airlines would encounter new economic problems.

There is no reason to discriminate against deductions of legitimate business expenses for attending conventions held outside the United States. If there is any abuse in this area, the Treasury has adequate means to deal with such cases. The tax law is already too complicated and should not be further altered when many taxpayers would be denied legitimate business deductions.

Estate and Gift Taxes—Introduction

It is time to reexamine federal estate and gift taxes in terms of equity, inflation, and the adverse effects on family-owned and small closely-held businesses. These tax laws and their high rates have been virtually unchanged since 1942.

Excessively high estate tax rates disrupt the family's economic position and produce harmful effects on the private enterprise system. So far as the estate tax is concerned, much of the discussion would be inconsequential were it not for high rates which rise rapidly to 30 percent for a taxable estate of $100,000. When estate tax rates become unreasonable, every dollar of property included in the gross estate becomes important. Minor defects in the law are magnified and injustices become real problems requiring legislative solution.

The tax law should be just as concerned with the future tax base as with present revenues. Private capital is the basis of the American economic system, and a ready supply of such capital is essential to the stability and continued economic growth of the United States. According to the 1975 *Fortune* survey of industry medians of assets per employee, about $50,000 of capital is required on the average in a metal manufacturing business to employ one person. The federal estate and gift taxes are capital levies, and, as such, steadily reduce private capital available for investment. The result, but for inflation, can be a constant erosion of the tax base. If the estate tax deters the building of wealth through productive enterprise, there could come a time when comparatively little wealth would be available for capital ventures.

In the case of estates of owners of small family-owned businesses, the tax problem can be particularly acute. Few estates of this kind include large amounts of liquid assets with which to pay taxes. Typically, such an estate is primarily composed of closely-held assets of the business, making it necessary on the death of the principal shareholder to sell a substantial portion of his holdings to pay the death tax. Often, in order to meet the tax liability, stock must be sold in such amounts that the decedent's family could lose control of the business. At times, complete liquidation of the enterprise may be necessary. The consequences of the estate and gift tax can be a heavy burden on those small enterprises which have a vital role in the country's economy.

Estate Tax Exemption

We support an increase in the federal estate tax exemption from $60,000 to $200,000. The 1916 Revenue Act, which enacted the estate tax, allowed a $50,000 exemption. Because of the excessive rates, the exemption was raised to $100,000 under the 1926 Revenue Act. In response to needed revenues during the Great Depression, the exemption was reduced from $100,000 to $50,000 under the 1932 Revenue Act. In a further response to revenue needs, the $50,000 exemption was reduced to $40,000 under the 1935 Revenue Act, remaining there until 1942. During the period from 1918 to 1942, there also was a special exemption of $40,000 for life insurance payable to specific beneficiaries. In 1942, the special insurance exemption was eliminated and the present $60,000 exemption was enacted. It has not been changed in the past 34 years.

The effect of inflation on the fixed dollar amount of the $60,000 exemption is a substantial increase in estate taxes. Because of the inflated values of land and business assets, the exemption no longer provides a circuit breaker against the forced sale of closely-held businesses and family-owned farms.

The plain fact is that the $60,000 exemption is just not worth what it was in 1942. Inflation has substantially reduced the intended effect of the exemption. To maintain an equivalent amount of purchasing power in 1975 dollars, based on the Consumer Price Index, the original $60,000 estate tax exemption should be about $198,000 for 1975.

The intent of the original exemption was to allow a reasonable amount of the estate to be untaxed to insure that a surviving spouse and children could support themselves. When adopted in 1942, the present exemption would have provided sufficient capital to produce enough income to support the decedent's dependents. This is no longer true. Today in common stocks, it would provide only $2,700 to $5,400 of pretax annual income. A sufficient amount of capital should be exempted from tax to provide an annual income for the decedent's dependents. Even this test does not give full consideration to the economic status to which the family has been accustomed.

Gift Tax Annual Exclusion

We support an increase in the federal gift tax annual exclusion to $6,000. Under current law, the first $3,000 of gifts made to any one person during a calendar year is excluded for purposes of computing the tax. Gifts to third parties by a husband or wife may be treated as having been made one-half from each with the result that each spouse may claim an annual exclusion.

The first federal gift tax was imposed in 1924 but repealed in 1926. The present gift tax law dates from the 1932 Revenue Act, which included an annual gift tax exclusion of $5,000 for gifts to any person. The 1938 Revenue Act reduced the annual exclusion to $4,000. The 1942 Revenue Act reduced the annual exclusion to $3,000, where it has remained.

The exclusion is intended to allow small gifts without the administrative burden of filing gift tax returns. It must be remembered that the gift tax exclusion represents a means by which, without additional tax burden, one can provide for persons to whom the donor owes a moral duty to support and maintain.

Aged and indigent relatives, widowed daughters-in-law, disabled veterans, and the education of grandchildren come within the gift tax exclusion. In many cases it does not cover a year's tuition.

The current amount is too small and certainly not worth what it was over three decades ago. We support an increase in the gift tax annual exclusion to $6,000.

Gift Tax Lifetime Specific Exemption

We support an increase in the federal gift tax lifetime specific exemption to $60,000. Under present law, a lifetime specific exemption of $30,000 is allowed to each United States citizen or resident. This gift tax specific exemption is not an annual exemption but may be spread over the donor's lifetime at his choice. No part of the $30,000 specific exemption may be attributable to the other spouse, and once exhausted, there is no further specific exemption available. The specific exemption was $50,000 for the period 1932 to 1935 and $40,000 for the period 1936 to 1942. The current $30,000 exemption has been in effect since 1943.

We support an increase in the specific exemption for the same general reasons that the gift tax annual exclusion should be increased. The 1932 Act provided for the gift tax lifetime specific exemption to correspond to the specific exemption in the estate tax law. If the exemption were increased to $60,000, owners of small closely-held businesses and family-owned farms would be encouraged to transfer a part interest in the enterprise while still alive. This would help to encourage the retention of such operations within the family and still allow for the expertise of older and more experienced personnel to aid in its successful operation.

Installment Payments for Estates of Closely-Held Businesses

We favor a reduction in interest rates in installment payments for estates of closely-held businesses. This reduction should result in a differential of two percentage points between the interest paid on 10-year installments of estate taxes and the interest paid on other deferred taxes. Estates of closely-held businesses have experienced difficulty with the 10-year installment provisions under the Internal Revenue Code because of the increased interest rates under Public Law 93–625.

Section 6161(a)(2) gives the Internal Revenue Service the authority to extend the time for payment of estate taxes for a reasonable period not in excess of 10 years from the due date of the return, if payment of the estate tax would create an "undue hardship to the estate." Undue hardship to the estate may result where the personal representative could be forced to sell an interest in the family business to raise enough money to pay the estate tax.

Section 6166 of the Internal Revenue Code allows the estate tax to be paid in installments over as many as 10 years where the estate consists largely of an interest in a closely-held business or family farm. This provision applies only if the value of the decedent's interest in a closely-held business exceeds either 35 percent of his gross estate or 50 percent of his taxable estate. Only that portion of the tax attributable to the value of the interest in the closely-held business included in he estate is eligible for the installment payments.

Prior to July 1, 1975, the interest rate on estate tax installments was four percent per year. As a result of Public Law 93–625, signed into law in 1975, the interest rate is to be adjusted to approximately 90 percent of the commercial bank prime rate. The rate was initially set at nine percent but was adjusted to seven percent effective February 1, 1976. Before the recent change in the law, the interest charged on estate tax installment payments was two percent less than the interest charged on other deferred tax payments. The 1975 change in the law substantially reduced the intended effect of the deferral of estate tax payments for family-owned farms and closely-held businesses.

The House Ways and Means Committee Report on the Small Business Tax Revision Act of 1958 stated that the installment payments provision was primarily designed to keep together a business enterprise where the death of an owner of the business results in the imposition of a heavy estate tax.

The report stated:

"This provision is primarily designed to make it possible to keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax. Where the decedent had a substantial proportion of his estate invested in the business enterprise, under existing law this may confront the heirs with the necessity of either breaking up the business or of selling it to some larger business enterprise, in order to obtain funds to pay the Federal estate tax. Your committee believes that this result has an especially unfortunate result in the case of small businesses, which traditionally also are closely held businesses. Therefore, although not removing any Federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid for out of earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the Federal estate tax without upsetting the operation of the business. Your committee believes that this provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system."

H.R. Rep. No. 2198, 85th Cong., 2d Sess., p. 6.

The National Chamber urges an amendment to the current law to require a two percent reduction on the interest rates of these deferred estate tax payments as compared to the interest paid on other deferred taxes. This was the law prior to the amendment under Public Law 93–625.

Estate and Gift Tax Rates

We suport a reduction in estate and gift tax rates. The estate tax was adopted in its present form in 1916 in response to the government's quest for additional revenues. The quarter century between 1916 and 1941 marked a substantial climb in estate tax rates. The 1916 rates ranged from one percent on the first $50,000 of taxable assets to 10 percent on the amount over $5 million. The current rates, which have not been changed since 1942, rise rapidly from three percent of the first $5,000 of net estates to 30 percent at $100,000 and then more slowly to 77 percent on that amount over $10 million. The gift tax rates are three-fourths of the estate tax rates.

In reviewing the federal estate and gift tax laws, serious attention should be given to the adverse economic and social consequences of the present highly progressive rates. The high rates impair the incentive to continue the family business for the future generations of the family. Successful family enterprises are broken up and family ownership and control of enterprises destroyed as a result of estate and gift taxes. The estate and gift tax laws should avoid the demoralizing impact of these taxes on individual incentive, especially considering the relatively small amount of revenue derived.

Capital Gains Tax at Death

We support the current stepped-up basis rules for assets acquired from a decedent. We oppose the imposition of a tax at capital gains rates on the net gains accrued on capital assets at the time of transfer by death. We are equally opposed to carrying over the decedent's basis for property so acquired.

Under the provisions of the Internal Revenue Code, the basis of property in the hands of a person acquiring it from a decedent is generally the fair market value of the property on the date of the decedent's death or an alternative valuation date. The concept of a stepped-up basis at death has been in the tax law since the enactment of the estate tax in 1916. There have been proposals before to alter the present Code provisions on this subject by either taxing the appreciation in value of property held until death, or requiring a carryover to the heir of the decedent's basis in the property.

A tax on the appreciation of property passing at death would be a departure from the income tax concept of capital gains. An income tax on capital gains arises on the voluntary conversion of property, by a sale or exchange, into another form in a closed tax transaction so that gain is actually realized. There is no sale or exchange or voluntary conversion of property that is left by a decedent. Consequently, any such tax would constitute a new and additional capital levy on death. In effect, it would be an additional estate tax imposed specifically on those who have taken investment risks.

With regard to closely-held businesses, this type of tax would probably result in a gain determined by a highly speculative fair market value over cost—whether or not there is a market for the property or whether fair market value could be realized on the sale of the property. It could amount to a tax on the invested work of the owners. The effect could be to force many closely-held businesses to sell out to, or merge into, larger corporations whose marketable securities would provide the needed liquidity to pay heavy death taxes.

In some cases where property cannot be divided for partial sale, a tax would be due, but funds to pay the tax would not be available. In other cases, where the asset fluctuates in value, even with the sale of the asset, because the tax is based on the "paper value" of the asset, there could be insufficient funds to pay the tax. With a very low basis and a high fair market value of the asset, the imposition of an estate tax as well as an additional capital gains tax, could produce extreme hardship where stock is not readily marketable, as in the case of a closely-held corporation, or where the asset is not readily divisable. In this case, tax liability could exist without any consideration for the taxpayer's practical ability to pay the tax.

A carryover basis is complex and unworkable from a recordkeeping standpoint. In past years, taxpayers, in reliance on present law which does not require proof of the decedent's basis in property held at death, have not saved records. There are many instances where it would be impossible to determine the decedent's cost or other basis in the property. Any such determination would impose on executors and administrators the extremely difficult, if not impossible, task of determining the decedent's cost of property which may have been held for many years or transferred by gift over several generations. In addition, the problem of trying to establish fair market values of properties, even as of the date a new tax reform bill becomes law, could be fantastic. It would parallel the problem in the law for decades of determining the value of property as of March 1, 1913. It is difficult enough now to determine the fair market value at the time a person dies.

A tax on the appreciated value of property held at death could greatly add to the complexity of the federal tax laws. What would be the result with jointly owned property that is partially owned by the decedent and surviving spouse, but with the spouse receiving part of the property under the marital deduction? This problem results from the assignment of a fair market value basis of part of the property at death and a proposed carryover basis in part of the property by the surviving spouse.

Proponents of a capital gains tax at death overlook the taxes at both the federal and state levels paids at death. The alleged "loophole" is that there is an unrealized appreciation of assets which arises from the increase in value over cost, often the result of inflation, without the payment of any income tax on this increase in value. However, these proponents fail to recognize that there is a federal estate tax and a state estate or inheritance tax paid on the entire value including increase in value.

An argument is made that the current system favors holding assets until death, without paying a tax on the appreciated value, over selling before death and paying a capital gains tax. This argument overlooks the fact that this is not an area of absolutes. A sale of the asset before death, even with a tax and a resulting reduction in capital, can have a number of beneficial economic objectives. The sale of the asset prior to death assures its present gain, produces diversity for other investments, increases liquidity, and reduces the risk in holding the asset. The holder of assets until death does not obtain these economic objectives and therefore should not be forced to pay an additional tax for the greater risk of holding the asset for a longer period of time.

There is no assurance that the imposition of a capital gains tax at death would eliminate the so-called "lock-in" effect attributed to the holding of property until death to avoid a capital gains tax that would result from a sale during lifetime. Even with such an additional tax, many decedents would still prefer to hold the property until death with the estate or their decendents paying the taxes owed.

We cannot overemphasize our opposition to any change in the Code which would tax appreciation of property at death or provide for a carryover of basis. These changes could add considerable expense to the administration of estates. Any such proposals would cause additional liquidity problems, impose unwarranted hardships on the dependents and beneficiaries of those who have supplied much of the investment capital necessary for this country's economic growth, and add uncertainty, inequity and complexity to the tax system.

Transfers Involving Generation Skipping

We believe there should be no imposition of an additional tax on transfers merely because they result, or might result, in property not being subjected to a transfer tax for one or more generations.

A tax on transfers which skip a generation would probably encourage outright gifts and discourage the use of trusts. As an example, where certain family members have business acumen and others do not, it would be advisable to leave certain property outright to those who could manage it. To those who do not have the know-how to manage a business, it would be advisable to leave property in trust for them to conserve their interest in the property and provide income from it, as well as to preserve the property itself. A tax on transfers that do not violate the rule against perpetuities, but that do in fact skip a generation, such as gifts to grandchildren, could cause imprudent gift situations and discourage the use of trusts where trusts should be used.

There is no reason why gifts in trust should be subjected to a higher tax than outright gifts. Such a tax would tend to concentrate wealth in the hands of children, whereas it might be more desirable to preserve some of that property for a future generation. In addition, the overwhelming majority of trusts are created to provide income for the beneficiaries and to conserve the transferred property, rather than to avoid tax.

Congress has never expressed an intention to tax all property at least once in every generation or at periodic intervals. As part of the Powers of Appointment Act of 1951, the Congress enacted the forerunners of sections 2041(a)(3) and 2514(d) of the 1954 Code. These sections of the estate and gift tax law provide that if, through the exercise of a power of appointment, the holder of that power can create a trust which will extend for a greater period of time than that permitted by the common law rule against perpetuities, the property affected by the exercise of that power shall be included within the taxable estate or the taxable gift of the person exercising that power.

It was at that time that Congress had before it the question of how long property should be permitted to remain in a private trust without generating a second estate tax. Its response was that the property would be allowed to remain in trust for the period permitted by the rule against perpetuities and that if it went beyond that time, a second estate tax should be applicable. There is no more reason now than there was in 1951 to provide for an additional estate tax unless the rule against perpetuities is violated.

Marital Deduction

We support the present marital deduction of one-half of the adjusted gross estate for estate tax purposes and one-half of the amount transferred in the case of gifts. Under present law, in order to qualify for the marital deduction for transfers at death, the property must be transferred directly from the decedent to the surviving spouse, the value of the property must be included in the decedent's gross estate, and the surviving spouse must be given outright ownership, or its equivalent, of the property.

Proposals have been made to remove the present percentage limitations on the estate and gift tax marital deductions and allow gift-splitting between spouses to apply to both lifetime and deathtime transfers on any desired basis. In the Treasury Department proposals in 1968 on this subject, estimates were made that the current loss occasioned by an unlimited marital deduction would be approximately 13 percent of estate and gift tax revenues—declining to about 10 percent after 10 years.

With regard to the problem of equality between residents of community property states and common law states, present law alleviates this problem, even though the taxes in common law states are still not equal in all respects to those in community property states. An unlimited marital deduction would be basically unfair to unmarried persons or to those who do not leave property to their spouses. If there are revenues available that could be used for an unlimited marital deduction, whatever revenue loss that would have resulted from an unlimited marital deduction could better be spread across-the-board in the form of lower rates and increased estate and gift tax exemptions.

Separate Estate and Gift Taxes

The present separate estate and gift taxes should not be combined into a unified transfer tax. Under current law, property transferred at death is subject to a federal estate tax utilizing a progressive rate structure increasing with the size of the estate. Lifetime transfers, which are in most instances eliminated from a decedent's estate, are subject to a federal gift tax at rates 75 percent of the federal estate tax with the same progression as the estate tax. The taxes are separate so that gifts are taxed from the bottom of that schedule upwards and estates are taxed from the bottom of that schedule upwards.

We oppose unification of estate and gift taxes. Gifts are voluntary in nature as compared to involuntary transfers due to death. If the total tax will be the same whether or not the property is given away during life or at death, donors will be more inclined to hold property until their death, thereby being the victims of a new "lock-in" effect of such a unified tax. The encouragement to make lifetime gifts to avoid the lock-in effect, which is the situation under present law, would be removed. Thus, the encouragement to dispose of property by gift during life would be stifled. Family circumstances rather than the tax laws should determine when property transfers are advisable. The making of lifetime gifts that can permit younger individuals to make investments and enter business ventures should not be discouraged by the tax laws.

Even under a unified estate and gift tax system, it will be necessary to determine when a transfer is to be taxed. Where the transfer would not be covered specifically by statutory provisions, the same disputes and litigation would occur under a unified system as under the present dual system. It is unreasonable to throw out the present body of law and administrative interpretations that have developed under the estate tax statutes for 60 years and under the gift tax statutes for 44 years. The result would be long years of litigation to settle the problems arising under the new system.

In addition, a unified tax would increase the costs of administration of estates and the burden of executors and administrators, since they would have to determine not only transfers made at death but also the lifetime transfers of the transferor. This could result in liability of fiduciaries if transfers are overlooked and not accounted for in the estate tax return. For these reasons, we oppose any combination of the present separate estate and gift taxes into a unified transfer tax.

$5,000 Employee's Death Benefit Exclusion

We support the $5,000 employee's death benefit exclusion. Section 101(b) of the Code provides that amounts up to $5,000, received by the beneficiaries or the estate of an employee, paid by or on behalf of the employer by reason of the death of the employee, are excluded from gross income.

We believe the present $5,000 per employee limit is adequate to avoid any abuses that might result from an employee having two or more employers with each employer paying death benefits. This exclusion should continue to be available regardless of whether the employer has a contractual obligation to pay the benefits. This provision helps to remove any inequity in tax treatment of benefits between employers who use commercial insurance and employers who use direct-payment plans.

Corporate Surtax Exemption

Generally, corporate income is subject to a normal tax of 22 percent on the first $25,000 of taxable income and a surtax of 26 percent on taxable income in excess of $25,000. The Tax Reduction Act of 1975 temporarily increased the surtax exemption from $25,000 to $50,000 and reduced the tax on the first $25,000 of income from 22 percent to 20 percent. Taxable income in excess of $50,000 continued to be taxed at the rate of 48 percent. These reductions apply to taxable years ending in 1975. These changes were continued through June 1976, by the Revenue Adjustment Act of 1975.

Substantial further corporate tax reduction is necessary to permit and encourage reinvestment of earnings in sufficient amounts to promote healthy economic progress. Prior to the Tax Reduction Act of 1975, the $25,000 surtax exemption had been in the tax law for 25 years. Clearly, the current exemption is not worth what it was in 1950. We urge that the corporate surtax exemption be increased to $100,000, with a 20 percent normal tax on the full amount subject to the surtax exemption.

Deduction for Moving Expenses

With regard to the provisions of section 217 of the Internal Revenue Code relating to the deduction of moving expenses, we urge that the maximum allowable amounts be increased to levels which realistically reflect the inflationary changes in the economy and that the 50-mile limitation contained in the law be reduced to 20 miles.

The $2,500 maximum deduction for moving expenses allowed under section 217 was established in 1963 when that section was added to the Code. If we assume January 1964, as the base period, inflation through December of 1975 has reduced the dollar value of the deduction by over 50 percent. H.R. 10612 would increase the maximum deduction from $2,500 to $3,000. This proposed increase is not adequate to make the deduction meaningful in relation to current costs and values. The purpose of the deduction for moving expenses is to lessen the tax burden on employees who move to maintain or change their jobs. If allowable expenses are reasonable, then the actual expenses incurred could be allowed without regard to an arbitrary limit.

Prior to the Tax Reform Act of 1969, one test for qualification for moving expense deductions was that the taxpayer's new place of employment be at least 20 miles farther from his old residence than his old place of employment. The Tax Reform Act of 1969 amended this provision to make this a 50-mile test for qualification for the deduction.

According to the House report on the 1969 legislation, this change was made to eliminate deductions for inter-suburb moves within a metropolitan area. However, the inequity of such a change is that a taxpayer moving his job from Washington to Baltimore is not entitled to the deduction. It is important to consider that a number of companies are moving out of the cities and into the suburbs. The 50-mile test restricts many low income employees who live in the city and penalize them if they follow their employment.

H.R. 10612 would reduce the mileage limitation from the present 50 miles to 35 miles. This change is inadequate to resolve the inequities in the present law. However, the inequities can be ameliorated by reinstating the 20-mile test contained in the statute when it was originally enacted.

Subchapter S Corporations: Number of Shareholders

We support an increase in the number of shareholders allowable to a Subchapter S corporation. The Subchapter S provisions were added to the Internal Revenue Code by the Technical Amendments Act of 1958 to permit small corporations to be taxed as though they are partnerships. To prevent shareholder abuse of the Subchapter S provisions, Congress established requirements that were to be satisfied before a corporation would be eligible to elect Subchapter S status. To confine Subchapter S status to small businesses, Congress limited the number of shareholders to not more than ten.

To limit Subchapter S treatment to businesses with 10 or fewer shareholders overlooks the difficulties of raising investment capital from such a small group of investors. Inflation and tight money markets have made it increasingly difficult for small businesses to obtain financing. The ability to offer Subchapter S status to prospective investors could make the difference between financing and not financing a new small business. Furthermore, the rules providing for the automatic and involuntary termination of Subchapter S status may make shareholders reluctant to elect such treatment when there are close to 10 shareholders.

We support an increase in the number of shareholders allowable to a Subchapter S corporation.

Subchapter S Corporations: New Shareholders

We support a change in current law so that a new shareholder in a Subchapter S corporation must affirmatively refuse to consent to a continued Subchapter S election rather than affirmatively consent to such an election in order to terminate a corporation's Subchapter S election. Subchapter S status is elective and its inadvertent termination can cause severe hardship for all of the shareholders. Under existing law a new shareholder, no matter how small his percentage ownership, must file a consent to the election within 30 days after acquiring his interest or the Subchapter S election is automatically terminated retroactive to the beginning of the taxable year of the corporation during which the shares were acquired.

All of the shareholders of a Subchapter S corporation could suffer severe financial damage from the inadvertent termination of the Subchapter S election. We support a change in the law so that a new shareholder in a Subchapter S corporation would be required to affirmatively refuse to consent to a Subchapter S election in order to terminate such an election.

Subchapter S Corporations: Trusts as Shareholders

We support changes in current tax law to allow voting trusts, grantor trusts and temporary trusts to be shareholders in Subchapter S corporations. Under existing law a corporation may not qualify as a small business corporation eligible to elect Subchapter S status if it has a trust as a shareholder. This provision limits the usefulness of the Subchapter S corporation as a form of doing business by limiting the sources of capital available to it.

Voting trusts, grantor trusts and temporary trusts should not be prohibited from being shareholders of a Subchapter S corporation. Many small businessmen could use the voting trust where they are forced to relinquish equity to facilitate the raising of capital for their business. The voting trust would permit these businessmen to raise necessary capital and to retain control of the business with each beneficiary being counted as a shareholder for purposes of applying the number of shareholders test.

The prohibition against trusts as shareholders of Subchapter S corporations also aggravates the inadvertent termination problem with potentially serious consequences to all shareholders. For example, if, on a shareholder's death his shares become part of the corpus of a trust, the Subchapter S election is automatically terminated as to all shareholders. For these reasons, we support a change in the law to allow certain trusts be shareholders in Subchapter S corporations.

Subchapter S Corporations: Estates As Shareholders

Under present law, the death of a shareholder in a Subchapter S corporation can cause the automatic termination of the Subchapter S election. The deceased shareholder's estate is treated as a separate shareholder for purposes of applying the limitation on the number of shareholders. However, for the purpose of applying the number of shareholders limitation, spouses who own stock in the corporation jointly or as community property are treated as one shareholder. Thus, it is possible that the death of one spouse and the transfer of the deceased's shares to the estate would cause the corporation to have more than 10 shareholders, automatically terminating its Subchapter S status, and adversely affect all shareholders. We support a change in current law so that the deceased spouse's estate is not treated as a separate shareholder when the surviving spouse is also a shareholder to alleviate this problem.

Net Operating Loss Carryover

We support an increase in the period for which net operating losses may be carried forward by a new business. Current tax law generally allows net operating losses to be carried back for three years and carried forward for five years. This five-year limit creates hardships for new businesses which have early losses during start-up years and then barely break even for several years.

Although the total period for which net operating losses may be applied is technically eight years, three years back and five years forward, new businesses have no prior years to use for carryback. We support an extension of the net operating loss carryforward period for new businesses to provide a degree of equality between new businesses and established ones.

Minimum Accumulated Earnings Credit

An accumulated earnings tax has been a part of our tax laws since the Revenue Act of 1913. Currently, it is a tax imposed on accumulated or retained corporate income. There is an accumulated earnings credit equal to the amount of earnings and profits for the taxable year retained for the reasonable needs of the business. There is a minimum credit of $150,000. Prior to the Tax Reduction Act of 1975, the minimum credit was $100,000. We support an increase in the minimum accumulated earnings credit.

It is generally agreed that the accumulated earnings tax is intended to penalize corporations who retain earnings in excess of their needs to avoid paying out dividends to shareholders who would again be taxed on that income. Because this tax is not self-assessed, it often is a trap for the unwary. It is clearly a penalty tax.

The accumulated earnings tax is generally applied to small closely-held corporations. These corporations already have a difficult time raising capital. The possibility of an additional tax on earnings retained in the business could hinder raising additional capital.

Deduction for Nonbusiness Interest

We oppose any changes in the tax law that would eliminate or abridge the present deduction for nonbusiness interest. H.R. 10612 would put a fixed dollar limit on the deduction for nonbusiness interest, including investment interest and interest on home mortgages, to $12,000 per year. This provision could provide a devastating restriction in the long run on the deduction of nonbusiness interest.

Nonbusiness interest would include interest on home loans, auto and home appliance loans, personal loans, vacation and student loans, and transactions involving loans for installment purchases.

Inflation alone could eventually put a large number of individuals living in metropolitan areas up against the limit. Our society is built largely on credit. If the deduction for interest on such credit is eliminated or sharply curtailed, the general use of credit could be markedly reduced causing irreparable harm to our economy.

We are opposed to this provision in H.R. 10612 which would place a limit on nonbusiness interest. There already are sufficient limitations in the law to prevent any possible abuse in this area. We urge that this provision be eliminated from the bill.

Nonrecognition of Gain in Connection with Certain Liquidations

We oppose the elimination or any restrictive modification of section 337 of the Internal Revenue Code relating to nonrecognition of gain in connection with certain liquidations.

Under prior law, a tax was imposed, both at the corporation and shareholder level, when a corporation sold its assets and distributed the proceeds. There was a question, because of a Supreme Court case, whether the corporation or the shareholders actually sold the property. Section 337(a) was enacted to remedy this situation so that a tax is not imposed at the corporate level on the gain resulting from the liquidation. To make the necessary distinction between the corporation and the shareholder, section 337 provided for nonrecognition to the corporation of any gain or loss when it sells or exchanges its property within a 12-month period after adopting a plan of liquidation and in fact distributes all the assets of the corporation in complete liquidation.

We urge retention of the existing provisions that are necessary for all shareholders to avoid inequitable double taxation on the liquidation of a corporation. Any restrictions on this present provision could severely hamper orderly transactions under the present Code provision that has worked for over two decades with only slight modifications.

Interest on State and Municipal Obligations

We support the continuation of the exempt status of state and municipal obligations. Any change from the present tax treatment of interest on state and municipal securities would not be in the best interest of the Nation or of states and municipalities. We oppose granting states and municipalities the option of issuing taxable bonds and having the Federal Government pay any additional interest costs involved to the states and municipalities, and we oppose the use of a federal fund as a substitute for the borrowing by the states and municipalities from the general public.

The interest on state and local government securities has been exempt from Federal income tax since 1913. Congress has consistently chosen to retain the exemption despite the fact that its elimination has been discussed in almost all tax reform hearings.

Tax exempt securities are attractive primarily to those in the upper income tax brackets. One hundred dollar "minibonds" have been issued, but the small investors have not bought these tax exempt bonds. If taxable bonds are issued, they may not have appeal to those presently providing municipal and local financing. Taxpayers would have to make up the difference.

Critics of the interest exemption assert that the system is inefficient. An alternative federal subsidy system would not be any more efficient. Besides additional administrative costs, taxable bonds would not yield more revenue than the cost of the existing system. Low-marginal rate taxpayers would not pay as high taxes on the interest as upper bracket taxpayers who would not find the bonds profitable in comparison with corporate common stock.

States and municipalities place heavy reliance on bond issues to finance schools, colleges, hospitals, highways and other capital improvements. If the exempt status of state and municipal bonds is curtailed or eliminated a much greater burden could be placed on property taxpayers to finance new capital expenditures. The removal of the exemption provision would place a particular hardship on small units of local government which do not have access to national municipal bond markets.

Granting states and municipalities the option of issuing taxable or tax exempt bonds coupled with a federal subsidy is another step toward greater federal domination. The long-range effect of any such change in the law will make the states and local units of government more dependent on the Federal Government.

Industrial Development Bonds

Industrial development bonds provide many companies with the opportunity to finance new plant facilities in areas where it would otherwise be unprofitable to do so. These bonds can create jobs and improve the tax base of the community. We support an increase in the maximum face amount of industrial development bonds and a removal of period restrictions.

The interest on industrial development bonds is tax exempt on issues between $1 million and $5 million. Retaining the exemption partially depends on keeping a company's capital expenditures to less than $5 million during a six-year period beginning three years before the date of the bond issue and ending three years after issuance of the bonds.

Industrial development bonds provide an opportunity to construct facilities to reduce pollution and to increase energy. They are essential to bring industry to many areas of the country in need of employment opportunities for their citizens. The dollar limitation should be increased and the period restrictions removed to make this important provision more effective.

Research and Experimental Expenditures

To encourage research and experimentation and the development of new products, Congress has enacted in the Internal Revenue Code provisions providing that certain research and experimental expenditures can be expensed in the year incurred or amortized over a period not to exceed five years. We support extension of present tax law to permit deduction or amortization of expenditures for buildings and equipment which are used in research and development. These expenditures presently must be capitalized and cannot be expensed or amortized over a five-year period.

One of the principal reasons for America's premier position in world trade has been the overall superiority we have enjoyed in science and technology. Our advanced technology has produced one of the highest standards of living the world has known. As in the past, our future growth will depend in large measure on the ability of our research establishment to discover and develop new products that will improve the quality of life of all Americans.

We face tremendous challenges in our attempt to solve the energy problem, clear up the environment, increase productivity, improve health care, and solve other problems that we face. There should be increased stimulus for industrial research and development to enable United States industry to provide new and improved technologies needed to remain competitive in world markets and to raise the standard of living of all Americans.

It is important that those research and development expenditures that now must be capitalized be afforded the alternative of being expensed or amortized over a period not to exceed five years. There should be no discrimination between the types of research and development expenditures that are accorded expense or amortization treatment.

Employee Stock Options

We endorse the retention of existing Internal Revenue Code provisions with regard to employee stock options and urge the elimination of tax preference status on the exercise of a stock option.

Generally, under present law, an employee realizes no income when he exercises a qualified or restricted stock option. Usually, gain on the disposition of any stock acquired through an option is taxed as long-term capital gain. The Tax Reform Act of 1969 provided that tax benefits from qualified or restricted stock options are to be included as an item of tax preference for purposes of the minimum tax. On the other hand, the value of a nonqualified stock option generally constitutes ordinary income to the recipient employee if the option had a readily ascertainable fair market value when granted. If the option had no readily ascertainable fair market value when granted, ordinary income would be recognized but not until the option is exercised.

H.R. 10612 would repeal the present rules with respect to qualified stock options; and, in general, subjects qualified stock options granted after September 23, 1975, to the same ordinary income treatment now accorded to nonqualified options.

Through the use of stock options and stock purchase plans, employees are afforded a chance to acquire a proprietary interest in the corporation. Employees naturally will be more productive if they have stock options as a constant reminder that they are hired not just to perform specific services, but to contribute to the long-range profitability of the enterprise whose ownership they share.

Until stock acquired through the exercise of an option is sold, there is no financial gain. Therefore, the argument that a tax should be levied at the time the option is exercised is wrong. There should be no tax until the time the stock is sold, value is received, and a profit realized.

In effect, deferred compensation is a promise by the company to pay a sum of money in the future, under circumstances where there is not constructive receipt. Certainly to tax this income as though it were received is not in keeping with the concept of taxation of income on a cash basis.

Capital gains treatment of income was intended by Congress to compensate for the element of risk involved. In allowing stock option income to be treated as capital gains, Congress recognized the presence of a definite risk. A gain realized from a stock option very often accrues over several years. However, such gains are actually realized in one tax year and capital gains treatment helps alleviate the resulting "bunching" effect which gives rise to increased tax liability.

Under the present law, there are numerous tests that stock options must meet before they receive favorable tax treatment. The employee is not taxed until the stock is disposed of and he then receives capital gains treatment at that time if the stock option meets the following criteria: the optionee must be an employee and may not be a substantial stockholder; the option price must be 100 percent of market value of the optioned stock at the option grant date; the stock must be held at least three years; the option must be exercised within five years of its granting; and the plan must have stockholder approval.

Restricted stock is not subject to the stock option rules. The Tax Reform Act of 1969 did change prior law with respect to restricted property. Now, an employee who receives a beneficial interest in property, such as restricted stock, for reasons of his performing services, must report the value of the property as income in the taxable period received unless his interest in the property is subject to a substantial risk of forfeiture and is nontransferable.

The Revenue Act of 1964 introduced employee stock purchase plans. Unlike qualified stock options used for compensating key employees and executives, stock purchase plans give an opportunity for rank and file employees to purchase stock in their company at a discount and obtain tax advantages.

In 1963, the Chamber supported changes in the treatment of stock options. We strongly urge this Committee to retain the existing Code provision with regard to employee stock options and to remove the tax preference status on the exercise of stock options. Subjecting stock options to a minimum tax has added greater complexity to the Code. We believe any abuses should be met head-on, rather than subjecting a legitimate provision of the Code to an additional tax.

Employee Stock Ownership Plans (ESOP)

Generally, an ESOP is a qualified, deferred compensation plan which invests a large portion of its funds in the stock of the employer. ESOPs can be used as a tool to expand the ownership of the corporation to include its employees and/or as a financing technique.

The Tax Reduction Act of 1975 introduced the concept of the investment tax credit ESOP into the Internal Revenue Code. It is a special type of ESOP which permits an electing corporation to increase its maximum allowable investment tax credit from 10 percent to 11 percent if an amount equal to the additional credit is contributed to an ESOP trust. This special provision applies only to the investment tax credit attributable to qualified property added between January 22, 1975, and December 31, 1976. The investment credit ESOP is subject to certain restrictive requirements. The principal restriction is that only common stock of the employer or a corporation in control of the employer or securities convertible into such stock may be contributed to or acquired by an investment credit ESOP. However, the investment credit ESOP permits a tax credit rather than a deduction for qualified contributions.

The Employee Retirement Income Security Act participation rules, which generally require that all employees age 25 or over with more than one year of service are eligible to participate, apply to ESOPs. This means that all employees of an affiliated group, including employees of second tier subsidiaries, must be eligible to participate if the ESOP is to qualify for the additional tax credit.

Generally, under existing law, only common stock or securities convertible into common stock of the employer or a corporation in control of the employer may be contributed to an ESOP. Control is limited to direct control. The result could be that corporations with second tier subsidiaries would be required to include the employees of these subsidiaries in the plan in order to qualify for the additional credit, but could not use the stock of the corporation in effective control of the subsidiary, because of the corporation in control requirement. Thus, corporations with second tier subsidiaries would be effectively precluded from establishing an investment credit ESOP using their stock. Furthermore, as a result of the control requirements, a first tier subsidiary with nonvoting preferred stock is not considered controlled by the parent unless 80 percent of the preferred stock is owned by the parent. Here again, the participation and contribution rules may preclude the parent corporation from establishing an investment credit ESOP.

Valuation of the stock of the employer corporation may become a critical issue in the case of closely-held corporations the stock of which is not regularly traded. It is necessary to know the value of the stock in order to determine whether the value of the stock contributed to the ESOP is equal to the additional one percent tax credit. or whether, if stock is sold to the ESOP, the price paid was the fair market value of the stock. Since serious questions may arise and unintended hardships may result from the inability to value, or the innocent assignment of an incorrect value to the employer's stock, this Committee may wish to consider whether a means to determine a definitive value for the stock of a closely-held corporation should be established to remove uncertainty from transactions between the ESOP, the corporation, and persons in control of the corporation.

Another area of uncertainty results from an Internal Revenue Service interpretation of the Tax Reduction Act. The Internal Revenue Service has taken the position that the corporation must absorb the administrative expenses of managing the additional one percent tax credit held in trust for the employees, rather than having the trust bear the administrative expenses. As a result, the cost of administering the ESOP must ultimately be borne by the corporation's nonemployee shareholders. Corporations considering the establishment of an ESOP could be forced to decide whether charging these administration costs to nonemployee shareholders can be justified.

Under existing law, the amount of the offset against tax preference items is reduced by the investment tax credit, including the additional one percent credit attributable to contributions to an ESOP. This requirement could operate to discourage taxpayers, whose business generates preference income, and who might otherwise establish an ESOP, from doing so. This Committee may wish to consider whether steps should be taken to change this result.

Contributions to an investment credit ESOP must be made at the time the return claiming the investment credit is filed and be based on the amount of qualified investment claimed on the return. The law does not permit subsequent adjustments to ESOP contributions if the amount of the credit is determined to be less than originally claimed or if the property is prematurely removed from service. An employer, even one which made its ESOP contribution in good faith, could be required to recapture a portion of its investment tax credit without being able to adjust the ESOP contribution. The burden of this restriction falls on the existing shareholders of the employer whose interests in the corporation are diluted by the issuance of shares to the ESOP without a corresponding receipt of equity capital. A similar problem can arise if an audit of the corporate return results in the redetermination of the amount of property eligible for the investment tax credit. The Tax Reduction Act does not provide for an adjustment of the ESOP contribution in such a circumstance. The amount of the contribution would be subject to a deficiency assessment. As in the case of recapture of the investment credit, the interests of existing shareholders would be adversely affected.

The requirement that an ESOP be permanent in order to be qualified is difficult to reconcile with the fact that unless the tax credit is extended it will expire at the end of 1976. This raises the question of the status of the ESOP if the investment tax credit expires. Employers considering establishing an ESOP could be deterred from doing so by the possibility that the Internal Revenue Service could rule that the plan is not permanent since the investment tax credit is to expire.

Regulated utility companies required to treat all or part of the investment tax credit as a cost reduction to be flowed through to consumers may not, as a matter of practical economics, be able to use the investment credit ESOP. Such companies could be paying into the ESOP for the employees and paying out to customers in the form of rate reductions at the same time. In the long-run, the shares contributed to the ESOP would not be represented by an increase in equity and no permanent capital would be formed. Existing shareholders could suffer the dilution of their interests in the corporation.

Group-Term Life Insurance Purchased for Employees

We support retention of the present law with regard to group-term life insurance purchased for employees with modification of the existing $50,000 limit, if a limit is retained, so as to keep the limit current with the inflationary economy. Under the provisions of the Internal Revenue Code, premiums paid by an employer for group-term insurance of up to $50,000 per employee are not taxable to the employee.

The national economy benefits when employers provide group-term insurance for their employees. Group-term insurance provides economic security for large numbers of families, thus minimizing the number of people dependent on government aid.

Deduction of Development Expenditures for Mines

Under present law, after the existence of ores or minerals in commercially marketable quantities has been disclosed, all expenditures for the development of a mine or other natural deposit, other than an oil or gas well, may be deducted.

The attainment and maintenance of a sound domestic mining industry requires more ample recognition in the tax laws that mining is unique in that it exhausts its assets in the course of its operations; that exploration for, and discovery and development of, new mining deposits has continually grown more difficult, more costly and financially more hazardous; and that a recovery of capital and return on investment commensurate with the risks is essential to induce venture capital to enter this hazardous financial field.

To meet the national requirements and to assure adequate continuance of the industry by the replacement of exhausted mineral assets, the tax laws should provide that all nonrenewable natural resource industries be granted the current deduction of research, prospecting, exploration, and development costs or, at the election of the taxpayer, such deferment as the taxpayer deems most appropriate in each case, without the now existing limitations.

The tax laws must give adequate consideration to the special problems of the mining industry. Unfavorable consideration will result in an inadequate supply of minerals, increased prices, and a lower standard of living. To compete with growing demands by foreign countries for minerals, it is essential that the tax laws encourage mining investment to promote and maintain the competitive enterprise mining economy.

Capital Gains for Timber, Coal and Iron Ore Royalties

We oppose any change in existing Internal Revenue Code provisions relating to capital gains treatment for timber, coal and iron ore royalties. Under provisions of the Code, capital gains treatment is available for the cutting of standing timber, if certain requirements are met. In addition, the owner or sublessor of a coal mine who disposes of coal under a royalty contract, or disposes of iron ore under a royalty contract, generally is entitled to capital gains treatment for a gain or loss on the disposition.

The capital gains treatment accorded timber and coal under this section has been in the Code for over three decades and over a decade for iron ore royalties. These provisions should not be disturbed. The rule was adopted with respect to timber because the gain from sale was regarded as having accrued over the period during which the trees matured. The provisions of this section have been beneficial both to the industries and to the country through encouragement of orderly disposition of these assets.

In the case of timber, these provisions of the Code have encouraged forest conservation by selective cutting and proper reforestation. If timber could not be taxed at capital gains rates, timber tracts would be sold outright and this would result in complete and wasteful operations by a cutting company without any incentive to plant new trees. The future of private forestry depends on the maintenance of the present tax system.

The development of coal and iron ore through leases should be encouraged rather than penalized. Supervision of such development by the property owner conserves our natural resources by insuring a more complete recovery of the mineral product present in the property.

Percentage Depletion for Oil, Gas and Other Minerals

In order to meet the Nation's needs and to assure the continuing replacement of exhausted mineral assets, the tax laws should provide that all nonrenewable natural resource industries be granted adequate depletion allowances.

The attainment and maintenance of a sound domestic mining industry requires more recognition in the tax laws that mining is unique in that it exhausts its assets in the course of its operations; that exploration for and discovery and development of new mining deposits continually grow more difficult, more costly and financially more hazardous; and that a recovery of capital and return on investment commensurate with the risks is essential to induce venture capital to enter this hazardous financial field.

Tax laws must recognize that rising energy demands in this Nation require the constant development and maintenance of a healthy petroleum industry. Exploration and development of petroleum resources grow more difficult, more costly, and financially more hazardous. Venture Capital will continue to be attracted in this field only if the reward for success is commensurate with the risks involved. Therefore, to meet national needs and to assure replacement of oil and natural gas produced for energy use, the tax laws must provide adequate depletion allowances.

Intangible Drilling and Development Costs

Present tax law permits an oil or gas producer to deduct intangible costs of drilling when incurred as operating expenses. Intangible drilling and development costs are the intangible costs of drilling wells and preparing them for production. Examples of such costs are expenditures for labor, fuel, power, expendable materials, supplies, tool rental, and repairs of drilling equipment in connection with drilling and equipping productive wells. Tangible development costs include expenditures for such items as pipe, tanks, pumps and other equipment which are treated as capital expenditures.

The deduction for intangible drilling and devlopment costs is essential to encourage the development of the United States petroleum resources. The need for this deduction is as great today as it has been in the past if America is ever to return to a level of self-sufficiency in its oil and gas supplies. This deduction has attracted capital into high-risk petroleum exploration that would not otherwise have been available. Added taxes on oil and gas operations through the elimination of, or a limitation on, intangible drilling and development costs would not be consistent with the need to expand our domestic petroleum resources.

Deduction of Expenditures for Soil and Water Conservation

We urge retention of existing law dealing with the deduction of expenditures for soil and water conservation with respect to land used in the business of farming. The limit on the deduction is 25 percent of the gross income derived from farming during the taxable year.

This provision was first introduced in the 1954 Internal Revenue Code and adopted to clarify the existing tax treatment of soil and water conservation expenditures and to encourage sound conservation practices. The 25 percent limitation was included to prevent a current deduction for substantial investments in farm lands from being obtained from sources other than farming. Expenditures for soil and water conservation such as the leveling, grading and terracing of farms should be regarded as maintenance costs, and should therefore be deductible as a current expense. The current tax treatment for such expenditures reflects a sound conservation practice and should be encouraged.

Deduction of Expenditures for Clearing Land

We urge retention of existing provisions dealing with the deduction of expenditures for clearing land. A taxpayer engaged in the business of farming may elect to treat as a deduction, instead of as a capital expenditure, expenditures incurred by him in clearing land to make that land suitable for farming. The limitation on this deduction is the lesser of $5,000 or 25 percent of the taxable income derived from farming during the taxable year.

The election to deduct expenditures for clearing land was provided for in the Revenue Act of 1962. As with the case of expenditures for soil and water conservation, expenditures to make land suitable for farming are closely associated with the trade or business of farming and are, therefore, properly included in the category of deductible expenses.

Minimum Tax for Tax Preferences

The tax Reform Act of 1969 instituted the minimum tax. Generally, it is a flat-rate 10 percent tax on "tax preference" items in excess of $30,000 per year and the income taxes imposed for the year.

As originally passed by the House, the minimum tax did not apply to corporations. However, the Senate-passed version applied the minimum tax to corporations. This constitutes a penalty tax on corporations that have capital gains or use the percentage depletion allowance. It represents discriminatory taxation of those corporations using long-standing provisions of the tax laws.

In 1969, we appeared before this Committee and acknowledged the problem that some individuals may avoid income taxes, but urged review of those specific provisions deemed improper. We stated that new taxes such as a minimum tax often gain popular acceptance by being directed initially at a few; but, in the long run, there is a temptation to increase the burden and scope of a new tax until virtually all taxpayers come under its yoke. We warned that a new minimum tax could very well become the forerunner of a gross receipts tax on all taxpayers.

The minimum tax disregards the principle that the federal tax is based on net income. Congress has placed certain provisions in our tax laws because they were considered to be needed for reasons of fairness, because they were in the best interests of the Nation, or because there was a constitutional question involved. If Congress determines certain provisions to be improper, they should be modified. A penalty tax should not be imposed on corporations or individuals properly conforming with the provisions of those laws.

The amendments to the minimum tax in H.R. 10612 bear out our concern that the burden and the scope of the tax would be expanded. For individual taxpayers the rate would be increased from 10 percent to 14 percent, the deduction for regular taxes would be eliminated, the carryover of regular taxes would be eliminated and the $30,000 exemption would be lowered to $20,000 and phased-out so that it would vanish entirely at $40,000. H.R. 10612 would also add additional preference items for individual taxpayers including itemized deductions in excess of 70 percent of adjusted gross income.

Limitation on Artificial Accounting Losses (LAL)

H.R. 10612 provides for a new concept called Limitation on Artificial Accounting Losses (LAL). Under LAL, certain deductions may not exceed the income from the sources from which they are derived. Thus, deductions in excess of income may not be used to reduce income from other sources. Areas affected and deductions restricted include such vital segments of the economy as real estate, oil and gas and farming operations. We oppose changes in the tax laws that would disallow or postpone an otherwise allowable deduction to the extent it exceeds related income.

The LAL concept would effectively place certain investors on a transaction method of accounting. If an investment were to be made that would be subject to LAL, deductions would be allowed only to the extent they did not exceed the income from the investment. Excess deductions would have to be carried over to future years until income from the investment could be generated to offset them. A taxpayer could be in a net economic loss position for a given taxable year based on generally available tax provisions. He might have to pay taxes, however, because he could not use certain deductions against his total income.

LAL would unnecessarily complicate the tax laws. If certain provisions of the tax laws are no longer serving the function Congress intended, they should be modified or eliminated. A new layer of complex tax restrictions should not be applied.

Exemptions for Excess Deductions Account for Farm Losses

The Tax Reform Act of 1969 required a taxpayer deducting farm losses from nonfarm income to establish an "excess deduction account" if the adjusted gross income from nonfarm sources exceeds $50,000 and the net loss from farming exceeds $25,000.

H.R. 10612 deals with the issue of farm losses in the LAL provisions and provides that no additions to farm excess deductions accounts would be made for taxable years ending after December 31, 1975. LAL would restrict the extent to which certain accelerated deductions attributable to farm operations could be used to offset income from nonfarm sources. To the extent that deductions exceed the amount permitted to be deducted, they would be deferred in a "deferred deduction account" until a later taxable year. True economic losses would continue to be deductible currently. Losses from farm operations could be used to offset up to $20,000 of nonfarm income. If nonfarm income exceeds $20,000, a dollar-for-dollar reduction of the amount of nonfarm income eligible to be offset by farm losses would apply. Thus, no artificial farm losses could be deducted currently by taxpayers with incomes of $40,000 or more.

This treatment is unwarranted. There should be no discrimination between taxpayers engaged in farming activities solely on the basis of other income they earn during the year. The excess deductions account for farm losses and LAL discriminate against taxpayers with other sources of income, and discriminate between cash and accrual basis taxpayers.

The excess deductions account and LAL provisions unnecessarily complicate the Code. Abuses should be dealt with directly and not through the elimination or reduction of the exemptions from farm loss excess deductions account requirements or through the imposition of LAL. Both the existing Code provision and the LAL provision discourage farmers from diversifying into nonfarm businesses and investments. The present Code provision should be eliminated and should not be replaced by a similar LAL provision.

Limit on Deductions "at Risk"

Current law allows deductions without regard to investment except in the case of partnerships and Subchapter S corporations. In the case of partnerships, deductions are limited to a partner's basis in the partnership. For Subchapter S corporations, a shareholder's deductions for corporate net operating losses are limited to his basis in his stock and the corporation's indebtedness to him.

We oppose a limitation on deductions based on the amount the taxpayer is "at risk." Such a limitation would further complicate the tax law and would place taxpayers forced to borrow to make investments at a competitive disadvantage in relation to taxpayers not forced to borrow. The inequality of treatment could discourage taxpayers who might otherwise make leveraged investments from making those investments.

Business Use of Home

H.R. 10612 would limit deductions for business use of the home to expenses attributable to the portion of the residence used exclusively on a regular basis as the taxpayer's regular place of business, or a place of business used for patients, clients or customers in meeting or dealing with the taxpayer. A taxpayer who is an employee would be able to deduct the expenses of an office in his residence only if, in addition to meeting all of the other requirements of deductability, the use was for the convenience of his employer. The deduction allowed any taxpayer may not exceed the amount of gross income derived from the business use of the residence reduced by the deductions which are allowed without regard to whether the residence is used in business.

We oppose changes that would eliminate or abridge the methods of deducting expense attributable to the use of the home for business purposes. The provisions of H.R. 10612 ignore the fact that there are numerous occasions, including weekends and evenings, where the most efficient and productive place for an individual to work is his personal residence. The expenses incurred in connection with this work are ordinary and necessary business expenses and should be deductible under section 162 of the Code.

Deduction for Medical Expenses

The Internal Revenue Code provides for the deduction of medical and dental expenses, including medical insurance, with some modifications, in excess of three percent of a taxpayer's adjusted gross income. Medical insurance premiums are deductible without the three percent limitation for half of the first $300 of such premiums. The other half is allowed as a medical expense deduction subject to the three percent limitation. We support retention of such Code provisions.

Deductions for Charitable Giving

The tax laws should continue to allow the charitable contribution deduction without regard to any minimum contribution. The tax laws should encourage, rather than discourage, charitable giving. Caring for the needy through recognized private charities alleviates some of the need for the government to provide the financial assistance required to meet the requirements of the Nation's indigents.

We oppose any minimum contribution requirement before the charitable deduction is to apply. The use of such a minimum would result in a substantial reduction in total charitable contributions. A reduction in the number of charitable givers could mean that government would have to finance the beneficiaries of these gifts from higher taxes paid by all citizens.

In view of the need to continue encouragement of charitable giving, we recommend that the tax law continue to allow the charitable contribution deduction without regard to any minimum contribution.

Exclusion of Sick Pay

We support retention of existing Internal Revenue Code provisions relating to the exclusion of sick pay. These provisions allow the exclusion from gross income of certain amounts received under wage continuation plans during temporary absence from work. H.R. 10612 would repeal the sick pay exclusion and substitute a maximum annual exclusion of $5,200 ($100 a week) for taxpayers under the age of 65 who are permanently and totally disabled. The $100 a week maximum exclusion is reduced on a dollar-for-dollar basis by the taxpayer's income, including disability income, in excess of $15,000. Both civilians and military personnel are subject to these provisions.

Existing law helps to equalize the treatment of insured and noninsured sickness and accident benefits. We support the retention of existing Internal Revenue Code provisions relating to the exclusion of sick pay from gross income.

Deduction for Loss from Certain Noncorporate Obligations

We oppose any changes in the tax laws that would eliminate or abridge the present deduction provided in the Internal Revenue Code relating to losses from noncorporate obligations. H.R. 10612 would provide that where a taxpayer has a loss arising from the guaranty of a loan, he would receive the same treatment as where he has a loss from a loan which he makes directly. The same rule would apply to the guarantors of corporate obligations. Because trade or business reasons give rise to losses on obligations, these losses should continue to be allowed as a deduction.

Under the current provisions of section 166(f) of the Internal Revenue Code, the loss on noncorporate obligations borne by the taxpayer as a guarantor, endorser or indemnitor are allowed as a deduction if the borrower used the proceeds in his trade or business.

When this section was added as a part of the Code by the Senate Finance Committee in 1954, the reasoning stated was that in most cases debts of this type were incurred because of business relationships. That same reasoning holds true today. The Code contains an appropriate limitation on this deduction by requiring that the person who incurs the debt use the proceeds in his trade or business in order for the guaranteeing taxpayer to take a loss, if one results from his having to make good on the guarantee. Endorsers and guarantors who pay their principal's debt take over the creditor's rights against the principal debtor. If their claim against the principal debtor is or becomes worthless, they are entitled to the deduction. The deduction does not arise out of the payment itself of the principal's obligation, but because the payment gives rise to a claim that becomes a bad debt.

Deduction for Nonbusiness Taxes

We oppose any changes in the tax law that would eliminate or abridge the present deduction for nonbusiness taxes. Various state and local taxes—on real and personal property, general sales, income and the sale of gasoline—are allowed as a deduction to all taxpayers, whether or not they were paid or incurred in connection with the carrying on of a trade or business or an activity relating to the production of income. Present law recognizes that payment of state and local taxes reduces a taxpayer's ability to pay federal taxes. It also alleviates the possibility that federal, state and local taxes combined could exceed the taxpayer's gross income.

Deduction for Nonbusiness Casualty Losses

We oppose changes in the tax law that would eliminate or abridge the present deduction for nonbusiness casualty losses. Present law provides for the deduction if such losses exceed $100. The Chamber supported the casualty loss deduction and the $100 floor when it was first introduced into the Internal Revenue Code by the Revenue Act of 1964. We continue our support of the deduction for nonbusiness casualty losses on the grounds that unreimbursed casualty losses are logical and equitable items of deduction.

Miscellaneous Employee Expenses

Generally, an employee is allowed a deduction for expenses connected with his performance of services as an employee. Deductible expenses include expenses for such items as the cost of seeking employment, education, uniforms, labor union dues, and professional organization dues. We support the deduction for employee's miscellaneous business expenses and oppose changes that would eliminate or abridge the present deduction. Nor should some sort of overall deduction be substituted for the miscellaneous business expense deduction.

Miscellaneous Deductions Allowance

We oppose changes in the tax law which would provide for individual taxpayers a miscellaneous deductions allowance in place of the elimination or restriction of a number of itemized deductions. Itemized deductions serve to create a tax equity that would be diminished through a miscellaneous deductions allowance. Itemized deductions should not be replaced by an across-the-board allowance.

Retirement Income Credit

We recommend that the existing retirement income credit be retained and we urge that it be simplified. The retirement income credit provisions are designed for those elderly who do not receive tax exempt social security or similar types of tax exempt benefit payments. These provisions give a limited exemption, by means of a tax credit, for those who have other types of retirement income so that they can be on the same footing as pensioners receiving social security or other tax exempt benefits.

H.R. 10612 simplifies, restructures and increases the maximum amount of the present retirement income credit and provides for the credit to be available to taxpayers age 65 or over regardless of whether they have retirement income or earned income.

We support the simplification of the existing retirement income credit and urge its retention to help eliminate the disparity in tax treatment of different types of retirement income.

Declaratory Judgments With Respect to Exempt Organizations

We support a declaratory judgment procedure to appeal from an unfavorable Internal Revenue Service ruling with regard to the tax-exempt status of an organization under section 501(c)(3) of the Internal Revenue Code and recommend that a similar procedure be extended to chambers of commerce and trade and professional associations exempt under section 501(c)(6) of the Code. H.R. 10612 would provide a procedure whereby an organization may ask the U.S. Tax Court or a Federal district court for a declaratory judgment as to its tax-exempt status and classification under section 501(c)(3) or its charitable donee status under section 170(c)(2) of the Internal Revenue Code.

In the Employee Retirement Income Security Act of 1974, the Congress provided for a procedure for obtaining a declaratory judgment with respect to the tax-qualified status of an employee benefits plan. The remedy is available when the Internal Revenue Service has issued an adverse determination as to the status of a plan and the petitioner has exhausted his administrative remedies within the Internal Revenue Service.

Under the anti-injunction provision of the Code, citizens are denied the opportunity to go into the courts to enjoin the assessment or collection of taxes. The purpose of the law is to allow the government to assess and collect taxes, and then if the taxpayer wants relief he can file a suit for a refund. Some difficult problems have arisen for exempt organizations under this provision. For instance, can an organization contest the revocation of its exempt status by the Internal Revenue Service or must it wait until taxes have been assessed against it? If it waits, what about the fact that in the meantime there will be those who will not make contributions due to the question of deductibiliy? What about where the Internal Revenue Service changes the status of an organization from one category to another so that the organization remains exempt, but contributions to it are no longer deductible?

In *Bob Jones University v. Simon, Secretary of the Treasury*, 416 U.S. 725 (1974), and a companion case, *Alexander v. Americans United*, 416 U.S. 752 (1974), the United States Supreme Court held that Bob Jones University came under the anti-injunction provision of the Internal Revenue Code, and, therefore, prior to the assessment and collection of taxes, could not go to court to enjoin the Internal Revenue Service from revoking its tax-exempt status and withdrawing the advance assurance to donors that contributions to the University constituted a charitable deduction. The Court noted that it was aware that the anti-injunction statute imposed a harsh rule, but said that it was a matter for Congress to weigh the relevant, policy-laden considerations of the present law.

The declaratory judgment procedure provided by H.R. 10612 would mitigate the harsh rule imposed by the anti-injunction statute with regard to tax-exempt status under section 501(c)(3) of the Code. We recommend that a similar procedure be extended to chambers of commerce and trade and professional associations exempt under section 501(c)(6) of the Code.

Tax Exemption for Credit Unions, Mutual Insurance Funds and Certain Financial Institutions

We support retention of existing law with regard to the tax exemption for credit unions, mutual insurance funds and certain financial institutions provided for in section 501(c)(14) of the Code. Section 501(c)(14) organizations are operated without profit, provide essential services to the public, and should be entitled to retain their exempt status.

Deduction of Antitrust Damage Payments

We believe that the Internal Revenue Code should be changed to provide for a full deduction of damage payments made in an antitrust case.

In 1964, the Internal Revenue Service issued a ruling that amounts paid in satisfaction of treble damage claims under section 4 of the Clayton Act were deductible as ordinary and necessary business expenses. The Tax Reform Act of 1969 changed that ruling and said that only one-third of the treble damage should be deductible on the ground that it was the payment of actual damages and that a deduction should be denied as to the other two-thirds as that was a penalty and it would violate public policy to permit a deduction. Since 1969, if a taxpayer in a criminal proceeding is convicted of a violation of the antitrust laws or a plea of guilty or nolo contendere is accepted, then no deduction is to be allowed for two-thirds of any amount paid on a judgment or settlement from a treble damage action brought under section 4 of the Clayton Act.

The tax laws should be used for the purpose of collection of revenues to meet the necessary costs of government. Their purpose should not be extended to inflicting punishment for violations of nontax laws. The changes in the handling of deductions for treble damage payments made by the 1969 Reform Act extended the tax laws to being punitive for violation of the nontax antitrust laws.

Where the purpose behind the statute compelling the wrongdoer to make payments is remedial in nature and is intended to provide a formula for the reparation of a private injury—such payments properly constitute allowable deductions. Where a law is intended to punish a wrongdoer, punishment would be mitigated by the allowance of an income tax deduction. Actions that are brought under section 4 of the Clayton Act are remedial in nature, since the purpose behind the section of the Act is to allow the victim a method of recovering the damages inflicted and not to punish the wrongdoer. To disallow the deduction of the treble damages would amount to ignoring the remedial characteristic of that part of the law and inflict punishment by use of the tax laws.

The antitrust laws are very complex. It is often difficult for those in the agencies of government who enforce the laws to agree on whether a violation has occurred, and the courts have often experienced difficulty in determining whether the law was violated. This difficulty of interpretation means that there will be businesses subjected to treble damages even though they have made every effort to avoid violating antitrust laws. In such cases, treble damages provide remedial relief for the injured party, and the tax laws should not inflict a fine in such cases. Consequently, the National Chamber recommends that the Code be changed to reflect the 1964 position of the Internal Revenue Service that a full deduction be allowable for damage payments made in an antitrust case.

Energy Taxes

H.R. 6860, the Energy Conservation and Conversion Act of 1975, as passed by the House, provides for a tax on the business use of oil and natural gas. When fully effective, the excise tax on the business use of oil and natural gas, as proposed by H.R. 6860, would be $1 per barrel for oil and 18 cents per Mcf for gas. This is a negative approach to the stated purpose of the provision: "Encouraging Business Conversion for Greater Energy Saving." The answer to encouraging greater energy saving is not to put a penalty tax on business but to let the market system produce more efficient energy supplies and new sources of energy.

If the tax is designed to encourage industrial conservation of oil and gas, this has been, and will continue to be, accomplished more efficiently in the marketplace by interaction with higher energy prices. If the tax is designed to encourage industrial conversion to coal, this can also be better accomplished through the marketplace where industry can determine what energy source is most desirable based on cost and availability. Industries which are unable to convert to coal would be unjustly penalized. Those industries which desire to convert to coal should be assisted through a prompt capital cost recovery system, rather than by "prodding" through penalty taxation. Penalty taxes drain needed capital for companies to invest in energy efficiency equipment.

An excise tax on oil and gas will raise revenue, but do nothing to increase production of gas or oil which should be the thrust of national energy policy. Efficient conservation will result from higher energy costs which will also encourage exploration and production of new sources of energy. We urge that tax measures be adopted to encourage energy exploration, energy production, and capital investment in energy-efficient equipment.

Presidential Authority to Change Tax Rates

It has been suggested in the past that the President be given the discretionary authority to raise or lower income tax rates by a limited percentage as a control on the economy. We have opposed since 1962, and continue to oppose, vesting stand-by tax reduction authority in the President.

We favor retention of exclusive authority in the Congress to raise or lower income tax rates. The power to raise or lower income taxes is such a basic legislative power that it should not be shared by two branches of the Federal Government. This is not an area where delegation to the Executive branch is appropriate.

Private Letter Rulings

We support legislation which would preclude publication of private letter rulings previously issued by the Internal Revenue Service. Taxpayers who received private rulings in the past applied for them in reliance that the information submitted to the Internal Revenue Service would be treated as confidential tax information. This confidentiality should not be retroactively abridged.

A private letter ruling is a written statement issued to a taxpayer by the Internal Revenue Service in which interpretations of the tax laws are made and applied to a specific set of facts. The function of the letter ruling is to advise the taxpayer regarding the tax treatment he can expect from the Internal Revenue Service in the circumstances specified in the ruling. In the past, expecting to receive full confidentiality, business taxpayers have not been reluctant to set forth in requests for letter rulings trade secrets, extensive financial data, and other information usually kept guarded from competitors.

H.R. 10612 would require that private letter rulings issued by the Internal Revenue Service after September 25, 1975, be made available to the public, along with the names of the taxpayers receiving the rulings. In addition, technical advice memoranda are to be made public, but without information disclosing the taxpayer's identity. Rulings and technical advice memoranda issued between July 4, 1967, and September 25, 1975, are to be disclosed in the order of issuance but the name of the taxpayer involved is not to be disclosed. Rulings and technical advice memoranda issued prior to July 4, 1967, are not to be made public.

The Internal Revenue Service has been issuing rulings since 1919. The private letter rulings program began in the 1940's, but was not formalized until 1953. Under this program the Internal Revenue Service issues to a taxpayer a letter ruling stating its views on the substantive effect of the tax laws on a specific proposed transaction. If the taxpayer enters into a transaction that has been the subject of a private letter ruling, the Internal Revenue Service generally treats the interpretation it gave in such ruling as binding upon the Service.

The complexity of our tax laws and their importance in the business decision-making process require that taxpayers be afforded the opportunity to clarify tax effects on contemplated transactions prior to their consummation.

After letter rulings are issued to taxpayers, the Internal Revenue Service categorizes them into two classes. The first class of rulings has no significant reference value and such rulings are retained for only four years. The second class is considered to have continuing reference value for the Internal Revenue Service and is retained along with published Revenue Rulings, court decisions and other relevant material helpful in the interpretation of the tax law.

For the Government, the advance private letter rulings program:

1. Promotes voluntary compliance,
2. Reduces litigation,
3. Makes possible a higher degree of uniformity in the application of the tax laws,
4. Simplifies administration, and
5. Serves as a basis for published rulings.

The Internal Revenue Service has recently announced that it will make letter rulings available to the public. In the past, letter rulings have been considered confidential and under the privacy provisions of the Internal Revenue Code. A recent court decision instructed the Internal Revenue Service to make available certain past private letter rulings. This decision may force the Service to open for public inspection all prior letter rulings and not just prospective ones as already announced. Confidential business and personal information could now become matters of public record.

There are a number of business transactions that require prior Internal Revenue Service approval if dire tax results are to be avoided. These include change of accounting method and nonrecognition of gain under certain sections of the Internal Revenue Code. These sections were intended to contribute to a fair and impartial administration of our tax law and to prevent tax avoidance. Requiring prior approval by the Internal Revenue Service for certain transactions was not intended to also require public disclosure of these transactions.

The Internal Revenue Service is one of the most efficient tax collecting organizations in the world. Even so, its personnel are stretched thin in order to perform its duties. The private letter rulings program is an important feature of the Internal Revenue Service's operation. It significantly improves taxpayer compliance and reduces the possibility of expensive litigation. Confidentiality of a taxpayer's contacts with the Internal Revenue Service has been an important factor in the efficiency of the self-assessment tax system. It has been an accepted and vital part of the administration of our tax laws.

The private letter rulings on hand at the Internal Revenue Service contain significant amounts of data that were given to the Service with an understanding of confidentiality. Due to the large amount of material to be considered, it would create an unimaginable administrative burden on Internal Revenue Service personnel to open past private letter rulings if protection of taxpayer privacy is to be maintained.

We oppose secret law. We agree that interpretations of the tax laws by the Internal Revenue Service should be available to all. We do not oppose publication of future private letter rulings provided all identifying and confidential information of taxpayers is kept private where such information is not essential to the substance of the ruling. We do believe that past private letter rulings should not be opened to the public because many, if not most, contain confidential information.

If the Congress decides that the best interests of the Nation are served by retroactively retracting the government's assurance of confidentiality of past private rulings, the disclosure of past private letter rulings could be phased-in beginning with the oldest rulings. A phase-in approach could allow the Internal Revenue Service the time necessary to delete identifying information and confidential data. This is vital for continued protection of taxpayer privacy. Such a phase-in could also provide the opportunity for the Internal Revenue Service to give notice to the past recipients of private letter rulings that disclosure was to be made. It was these taxpayers who entered into the private letter ruling process under a guarantee of confidentiality. It is their confidentiality that would be broken. They should be given the opportunity to review what is to be disclosed and the power to have protection against disclosure of confidential information.

"Deadwood" Provisions

In previous Congresses, legislation designed to remove the "deadwood" from the Code was introduced. This proposed legislation—commonly referred to as the deadwood bill—provides for repeal of approximately 150 obsolete sections and changes in over 850 others. These provisions are included in H.R. 10612. The stated purpose of the deadwood bill is to achieve simplification, but not through making any policy or substantive changes in existing law. We endorse the concept of the deadwood statute. It is one step toward simplification that should be welcomed by all taxpayers. We hope it will be considered in the course of this Committee's deliberations on tax reform, and made a part of the proposed legislation.

Conclusion

We hope that as a result of these hearings Congress will simplify the tax laws, rewrite inequitable provisions in the law and develop a program of tax reduction. As we have pointed out in the past, the complexity of the Internal Revenue Code may be the real "loophole" in our tax system. It should be pointed out that the current legislation under consideration by this Committee—H.R. 10612—is over 650 pages long, contains over 90 sections and is accompanied by 475 pages of explanatory material.

The uncertainty of the tax system adds to its complexity. A new round of tax reform has been a matter of discussion since 1972. Uncertainty as to the future of major tax legislation breeds uncertainty in investment decisions. Taxpayers become reluctant to invest in ventures that could produce jobs and improve economic conditions, because they are uncertain as to the impact of possible new income tax changes on profits. Uncertainty in the tax system discourages economic growth.

Constant changes in the tax system add to the uncertainty and to the complexity for the average individual taxpayer. Constant changes in the tax law require constant changes by the Internal Revenue Service in the individual income tax return forms. Every year the taxpayer must familiarize himself all over again with a new Form 1040. Unable to keep up with these annual changes, the taxpayer often grudgingly pays for assistance in the preparation of his return.

Tax reform rhetoric forecasting major overhauls of the Federal tax system, constant changes in the tax system that cause inconvenience and return compliance problems for the taxpayer, the proposals of changes in the tax laws—so complex that they are often difficult even for most of the members of Congress to fathom—are causing major problems for the average taxpayer and discouraging more job-producing investment.

The burden of taxation should be widely and equitably distributed, in order to reach all segments of the public and all forms of economic activity. The entire Federal tax system should be examined with particular emphasis given to the rate structure, revenue sources, and amendments needed to remove ambiguities and unintended hardships and inequities from the Internal Revenue Code.

On behalf of the National Chamber I wish to thank you, Mr. Chairman, and the members of the Committee for this opportunity to testify on the subject of tax reform. We hope we have been helpful in presenting the views of American business, and we again thank you for the opportunity to appear and be heard.

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 business.

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 below.

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of cost of assets)		
		First taxable year	First 3 taxable years	First 7 taxable years
United Kingdom	1	100.0	100.0	100.0
Canada	[6, 21] 2	[21] 50.0	100.0	100.0
Netherlands	[16, 17, 19] 5	14.0	58.0	108.0
Sweden	[18] 5	60.0	95.7	130.0
Italy [12]	[10] 6	19.6	[11] 67.9	100.0
France	[7, 8] 8	31.3	67.5	[9] 94.9
Do	[21] 8	25.0	57.8	86.7
West Germany	[20] 9	[21] 16.7	49.6	[22] 88.8
Belgium	[3] 10	[3, 4] 20.0	48.8	[5] 89.0
Japan	[13] 11	[15] 34.5	56.9	81.4
Australia	[1] 6	50.0	70.0	110.0
United States:				
1962 law [23]	[2] 13	[26] 21.7	47.9	80.1
1969 law [24]	[2] 13	7.7	33.9	66.1
1971 law [25]	[27] 10½	[28] 23.5	54.7	88.5
1975 law [25]	[27] 10½	[30] 29.5	60.7	94.5

[1] Depreciation in Australia is based on an estimate of its effective life and taxpayers, at their option, may elect to use either the prime cost (straight-line) method or the declining balance method. This computation is for assets acquired after Jan. 1, 1976 and assumes that currently proposed legislation is enacted.

[2] Double declining balance method.

[3] Full year allowance in 1st taxable yr.

[4] Although not considered, installation costs allowed as current deduction which reduces recoverable base cost.

[5] Method changed to straight-line in 5th taxable yr. Straight-line rate applied to original cost for 5th, 6th, and 7th taxable yrs.

[6] Machinery and equipment acquired for manufacturing and processing of goods in Canada can be written off over 2 yrs (50 percent per year).

[7] 250 percent 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 6th taxable yr.

[10] Straight-line method.

[11] Includes additional foreshortened allowances of 15 percent, 15 percent, and 15 percent in 1st, 2d, and 3d taxable yrs respectively.

[12] In terms of a law introduced on Dec. 5, 1975, companies may revalue the carrying value of assets and the related accumulated depreciation and place the resulting credit to a tax-free reserve. The assets which may be revalued include machinery and equipment if acquired before Dec. 31, 1972.

[13] Modified double declining balance method; 18.9 percent 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 hrs of daily average excess usage of an item of machinery and equipment.

[15] Includes special 1st yr allowance of 25 percent; allowance reduces recoverable base cost in 2d and succeeding taxable years.

[16] Reserved.

[17] Depreciation periods are fixed by agreement. With multiple shift operations, a 5 yr life is normal.

[18] Modified declining balance method—30 percent rate plus additional 30 percent allowance in 1st taxable yr (such additional allowance does not reduce recoverable cost); accumulated cost recovery may not be less than 20 percent of cost for each year asset is in service. A special investment allowance of 10 percent will apply to investments made from Oct. 15, 1975, to Dec. 31, 1976, and is deductible from taxable income for State income tax purposes. The allowance is

(Continued)

[Appendix B]

Comparative capital costs of manufacturing machinery and equipment as influenced by income tax policies: Corporation income tax rates, depreciation allowances, and investment allowances and credits; major industrial countries, 1971

Country:	*Comparative cost of capital (United States' 1970=$100)*
United Kingdom	79.1
Japan	81.1
Italy	81.9
West Germany	82.8
Sweden	83.0
Belgium	84.7
France	89.7
The Netherlands	94.1
Canada	97.2
United States (1970)	100.0
United States with ADR	95.6
Plus 5 percent investment credit [1]	88.9
Plus 7 percent investment credit [1]	86.2
Plus 10 percent investment credit [1]	82.1
United States with ADR less modified 1st-yr convention	96.6
Plus 5 percent investment credit	89.8
Plus 7 percent investment credit	87.1
Plus 10 percent investment credit	83.0
United States without ADR:	
But with 5 percent investment credit	93.2
But with 7 percent investment credit	90.5
But with 10 percent investment credit	86.4

[1] Effective credit assumed to be unaffected by income limitation for purposes of international comparisons.

Source: Office of the Secretary of the Treasury; Office of Tax Analysis, (Oct. 6, 1971).

(Continued)

granted for expenditure on machinery and equipment acquired for use in business, agriculture or forestry, provided a purchase agreement has been signed after Oct. 15, 1975, and delivery made before the end of 1976. The allowance is available only if the claim is made in the appropriate tax return. Losses resulting from the allowance may not be carried forward.

As an alternative to the investment allowance, mainly for small businesses or those not making profits, an investment grant will be available under the same conditions. The investment grant is not taxable income and will be 4 percent of the purchase cost of up to S.Kr. 500,000 for each financial year. An investment grant may be claimed in 1 financial yr and an investment allowance in another, but not both in the same year.

[19] Normal life of 8 yrs reduced to 6⅔ yrs to reflect multiple shift operations.

[20] The average cost recovery period for machinery and equipment in West Germany is 8 to 10 yrs to which additional allowances are permitted for multiple shift operations: 25 percent of allowance for 2 shift operations and 50 percent of allowance for 3 shift operations. Allowances may be further increased when plant is located in certain areas such as Berlin and areas bordering on iron curtain countries. 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 percent additional allowance for 2 shift operations is taken into account beginning with the 5th yr when the method is changed to straight-line. The corporate depreciation rate thus computed is slightly over the maximum 20 percent 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. $320 can be expensed.

[21] Full year allowance in 1st taxable yr 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 5th taxable yr. See 20 above.

[23] With investment credit but without ADR.

[24] Without either investment credit or ADR.

[25] With both investment credit and ADR.

[26] Includes 14 percent allowance equivalent to 7 percent investment credit at effective 50 percent income tax rate. Credit does not reduce recoverable base cost.

[27] 13-year recovery period reduced by 20 percent and rounded to nearest one-half year. Double declining balance method.

[28] Machinery and equipment purchased between June 30, 1974, and July 1, 1975, limited to 200 percent declining balance method applicable to an asset with an 3-yr life.

[29] Additional 4 percent investment allowance permitted in 1st and 2d yrs.

[30] Includes 20 percent allowance equivalent to 10 percent investment credit (temporary credit enacted in the Tax Reduction Act of 1975) at effective 50 percent income tax rate. Credit does not reduce recoverable base cost.

[31] The Federal Government has recently enacted an investment tax credit of 5 percent of the cost of new buildings, machinery, and equipment acquired between June 24, 1975, and June 30, 1977, inclusive to be used in manufacturing and processing and other specified activities. Taxpayers will be permitted to apply the credit to the extent of their Federal income taxes up to $15,000 plus one-half of the amount by which their Federal tax otherwise would exceed $15,000. Any unused credit may be carried forward for up to 5 years. For tax depreciation purposes the capital cost of the property acquired will be reduced by any investment tax credit received. The effect of this credit is relatively small in view of the 2-yr write-off allowed in Canada (see footnote 6) and the reduction in basis for depreciation purposes. In the 1st taxable yr the 50 percent aggregate cost recovery would be 52.5 percent with full recovery still allowed in the 2d yr.

Source: The Report of the President's Task Force on Business Taxation, updated by Price Waterhouse and Co.

[Appendix C]

PRODUCTIVITY GROWTH, 1960-1973

[Average Annual Rate]

	Gross domestic product per employed person	Manufacturing output per man-hour
United States	2.1	3.3
Japan	9.2	10.5
West Germany	5.4	5.8
France	5.2	6.0
Canada	2.4	4.3
Italy	5.7	6.4
United Kingdom	2.8	4.0
Eleven OECD nations	[1] 5.2	6.1

[1] Average for 6 OECD countries listed.

Source: Department of the Treasury (May 7, 1975).

The CHAIRMAN. The next witness that we have is the Senator from Massachusetts, who is now with us.

I am pleased to call the distinguished Honorable Senator Kennedy. We are very happy to have you before our committee again.

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

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

I would like the indulgence of the committee, for I have a very extensive statement going into great detail on all the proposals that I would like to highlight today. I would like to ask if it could be made a part of the record, and then I do have a summation and also some charts here.

With the indulgence of the committee, and I know you have a time problem, but if I could go through this, Mr. Chairman, it would take about 20 minutes just to run through, but it would highlight the proposals that I would like to present. I appreciate the indulgence of the committee.

TAX EXPENDITURES

Mr. Chairman, I appreciate this opportunity to present to this distinguished committee my views and proposals concerning the reform of our Federal income tax laws.

Significant income tax reform is one of the most vital issues facing our country. The inequities that permit upper income individuals to pay little or no tax are undermining the foundations on which our tax system rests.

In addition, we now perceive that tax reform also involves spending reform. Decades of past decisions to use the income tax system as the mechanism for vast Federal spending programs are coming home to roost. There are simply not enough Federal dollars in the Federal Treasury to pay for all the direct spending and tax spending and tax relief programs that Congress would like to fund.

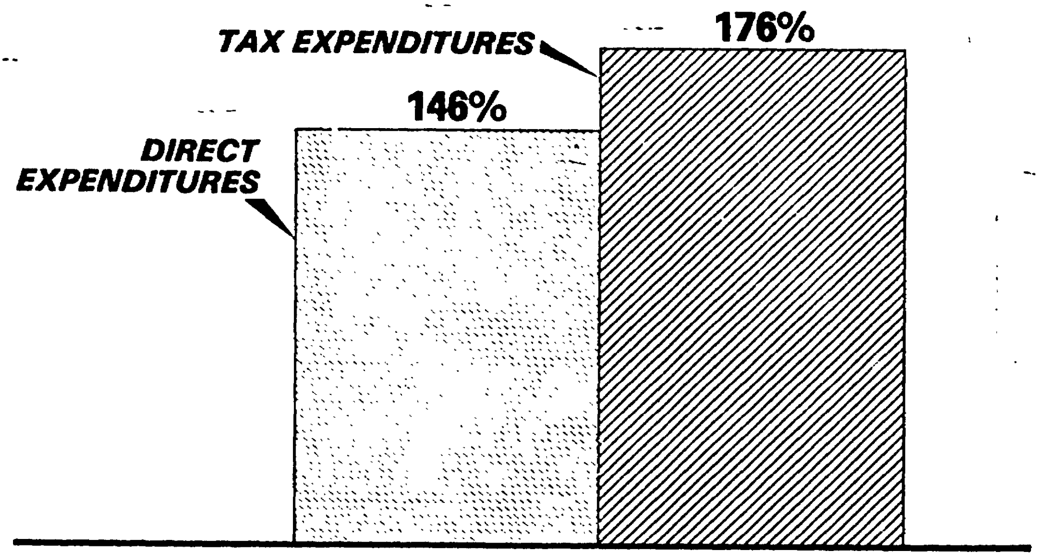
The Budget Reform Act is bringing the same long overdue discipline to tax expenditures as it has already brought to direct expenditures. The Senate looks to this committee and to the Budget Committee for responsible fiscal leadership in controlling tax expenditures, just as it looks to the Appropriations Committee and the Budget Committee for responsible fiscal leadership on direct expenditures.

As part of my testimony, I have prepared three charts to illustrate various aspects of tax expenditures.

The first chart compares the growth of direct expenditures and tax expenditures in recent years. Over the past decade, direct Federal spending has risen by 146 percent, from $158 billion in 1967 to $394 billion proposed by President Ford in 1977. But during the same period, tax expenditures rose by 176 percent, from $36 billion in 1967 to $101 billion in 1977, as estimated by the Congressional Joint Tax Committee. We now have, in round numbers, a Federal budget of half a trillion dollars—$400 billion in direct spending and $100 billion in tax spending, for a total of $500 billion in overall annual Federal spending.

[Chart 1 follows:]

GROWTH OF TAX EXPENDITURES



FY 1967	$158.2 B	$ 36.6 B
FY 1977	$ 394.2 B	$101.1 B

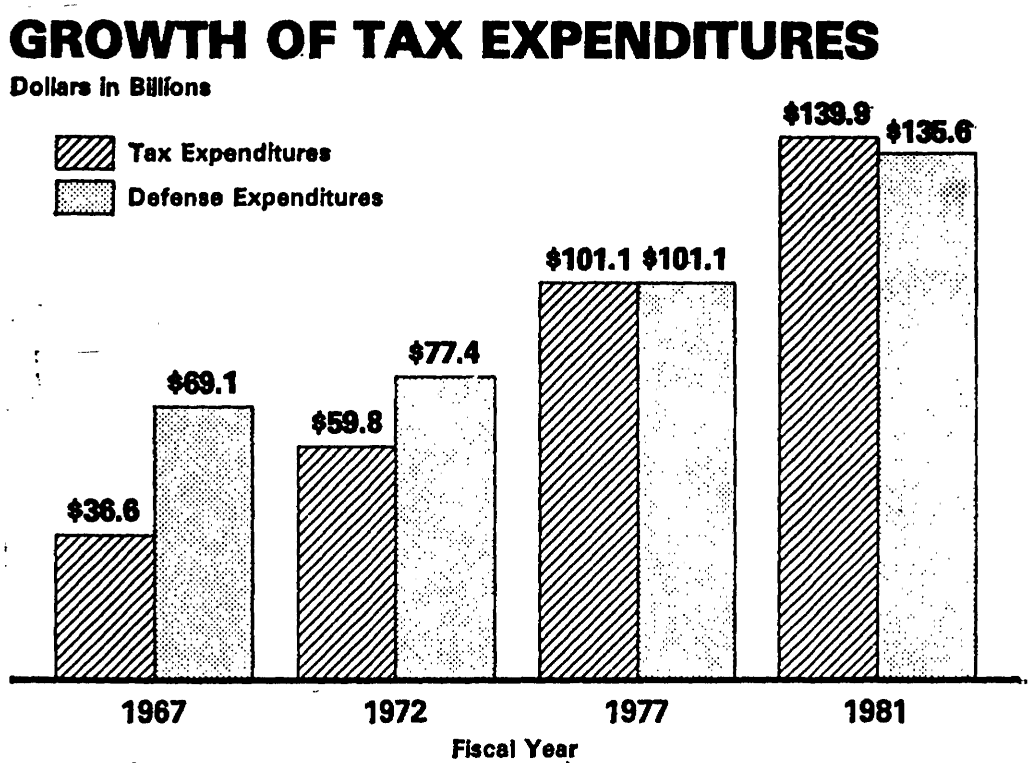
Senator KENNEDY. The second chart shows the relationship between the growth of the tax expenditures and the growth of expenditures for national defense in recent years. In the budget debate this year, as in each debate in past years, one of the leading issues will be the priorities between spending for defense and spending for domestic-social programs like jobs and schools and health.

Congress has devoted major attention and energy and hours to the annual debates over the rising expenditures for defense. But there has been virtually no debate over rising tax expenditures, which have subtly but swiftly mushroomed to levels rivaling the level for defense.

In 1967, the amount of tax spending was only a little more than half the amount of spending for defense. By 1972, the ratio had risen to 80 percent. Now, in fiscal 1977, in a curious coincidence of the budget process, tax expenditures have caught up precisely with defense expenditures, even to the first decimal point—$101.1 billion.

And by 1981, as the Congressional Budget Office projections indicate, tax expenditures will have grown to a level even higher than projected defense expenditures.

[Chart 2 follows:]



Senator KENNEDY. The third chart illustrates still another dimension of the tax expenditure problem—the potential future growth of various tax expenditures. The six examples on the chart indicate the way tax incentives, once ensconced in the Internal Revenue Code, tend to grow like Topsy. According to C.B.O. estimates:

Tax spending for DISC, the export tax subsidy, will rise by 30 percent, to $1.7 billion by 1981.

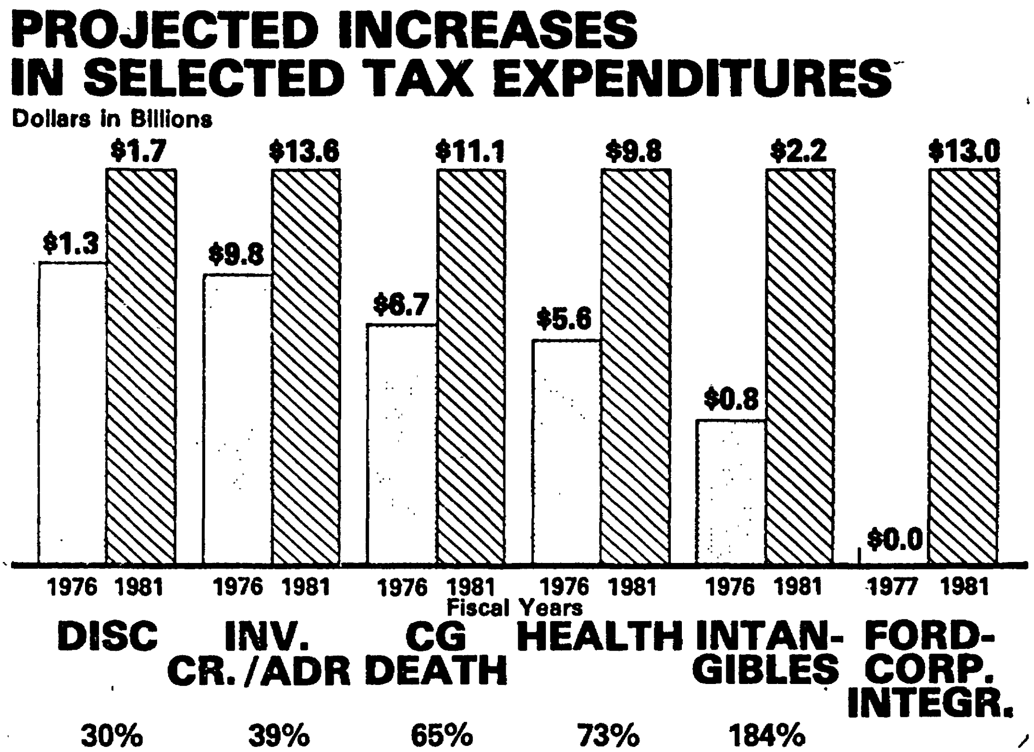
Tax spending for the investment credit and ADR, two of the major subsidies for capital formation in the current law, will rise by 39 percent to $13.6 billion.

Tax spending under the rule exempting capital gains at death will rise by 65 percent, to $11.1 billion.

Tax spending for health—the special deductions and exclusions for medical expenses and for health insurance premiums—will rise by 73 percent to $9.8 billion.

Tax spending for oil, through the deduction for intangible drilling and development costs, will rise by an incredible 184 percent to $2.2 billion.

[Chart 3 follows:]



Senator KENNEDY. Let me digress here to mention what I regard as one of the most cockeyed aspects of the system of tax expenditures. Mr. Chairman, you and Senator Ribicoff and I are all supporters of one or another Federal program for national health insurance.

But we already have a national health insurance program—and I am not referring to Medicare and Medicaid. The Internal Revenue Service is running a multi-billion dollar national health insurance program, and it has been doing so for many years through the Internal Revenue Code and the deduction for health insurance premiums and medical expenses.

Let me describe this program.

The only persons who can take advantage of the program are those who itemize deductions. In general, persons who itemize deductions are usually those with mortgage interest to deduct. So, the tax code has a national health insurance program for homeowners.

The IRS, like many private insurance companies, has a "deductible" in its health insurance program, since health expenses may be deducted only to the extent they exceed 3 percent of income. That eliminates most taxpayers from the program, even if they are homeowners.

Worst of all, the IRS program also has a "coinsurance" feature, like many private policies. Only this coinsurance is upside-down—the richer you are, the more the government pays. For those in the lowest tax brackets, the government pays 14 percent of the health bill, and the taxpayer pays 86 percent. But for the wealthiest taxpayer, the government pays 70 percent of the bill, and the taxpayer pays only 30 percent.

Surely, if we were starting now, none of us would create a national health insurance program with absurdities like that. Yet that is the program the Internal Revenue Service is carrying out today.

I believe that all tax expenditure provisions should be put through a series of tests. I would like to establish some basic tests. You and I have debated this question a number of times on the floor of the Senate. What I would like to ask this committee is, as we review these areas, is to apply some basic and fundamental tests.

The first one is, do we feel in any of these areas that there are sufficient public policy reasons for justifying Federal expenditures, whether direct expenditures or tax expenditures? Are there sufficient justifiable policy reasons?

If there is a need for a Federal expenditure, the second question that we ought to ask is whether, from a public policy position, this is really done most effectively and efficiently through direct expenditures or whether it is done most effectively and efficiently through tax expenditures.

If there is a need for a tax expenditure, the third test is whether the form of tax expenditure achieves the fairest, most equitable, and efficient distribution of Federal funds among taxpayers. When you look at the items that we have raised today, I would hope that you would use those three tests in assessing particular tax expenditures.

I think the questions are, first, are we going to make the decision that we should provide a Federal subsidy at all; second, we make a judgment as to whether the subsidy is through a direct expenditure or through a tax expenditure.

Third, if we make the judgment that it is going to be in the form of a tax expenditure, then we ask whether the particular method is the fairest and most efficient distribution of the tax subsidy.

Those are the tests which I have applied in terms of the proposals that we are discussing here today.

I believe that all tax spending provisions should be reexamined under the criteria we use for evaluating direct spending programs: Need, efficiency and equity. We are applying those tests to direct expenditures, and I think we ought to apply them as well in terms of tax expenditures.

We also must not lose sight of the fact that the tax laws and efforts of this committee must produce equity and fairness for all taxpayers.

In my work in the Subcommittee on Administrative Practice and Procedure, I have come to appreciate the truly remarkable effectiveness with which our self-assessing tax system works. It is no understatement to say that it is the envy of all modern industrialized countries.

But at the same time, the success of the self-assessment system rests on the most fragile of bases—the confidence of each American taxpayer that our tax laws are drafted and administered so that all other taxpayers are contributing their fair share of taxes to meet our common national goals.

There is increasing and disturbing evidence that the confidence of the average taxpayer in our Federal income tax system is being severely eroded. The middle-income individuals who make up the vast majority of taxpayers are losing faith in the integrity of our income tax system.

This loss of faith is directly attributable to the preferential provisions in the Internal Revenue Code that permit individuals with $50,000 and more of income to pay less taxes than workers making $7,500 to $10,000 a year.

Some of these lower income taxpayers understandably wonder why, if the rich can avoid paying taxes by legal means, they should not favor themselves a bit when computing their income tax deductions. Indeed, a distressing number of books and magazine articles have appeared in recent years, purporting to tell average taxpayers how to create their own loopholes on their income tax returns.

Fortunately, most taxpayers file their tax returns fully and honestly. They report their total income and they claim only their legitimate deductions. But the adverse impact of massive—though legal—tax avoidance by upper income individuals on the morale of the ordinary taxpayer cannot be overestimated.

Congress should act this session to reverse this dangerous trend. We must reassure the average taxpayer that his wealthy fellow citizens are paying their fair share of income taxes.

This committee should examine the data on tax avoidance by high income individuals developed by the staff of the Joint Committee on Internal Revenue Taxation. How can we justify facts like these: Two well-known individuals, with incomes in excess of $500,000, paid no Federal income tax. An individual with an income of $2 million paid tax at an effective rate of 2½ percent. An individual with an income of over $900,000 used tax shelter deductions to the extent that he almost entirely escaped paying any income tax. A corporate executive with almost $450,000 of income paid tax at a rate of three-tenths of 1 percent as a result of tax shelter deductions. A corporate executive paid 3.5 percent in tax on $532,000 of income. A lawyer paid no tax on $151,000 of income. A dentist paid no tax on $156,000 of income. A stockbroker with an income of $181,000 paid tax at a rate of five-tenths of 1 percent.

Mr. Chairman, these are actual case histories in which high-income individuals have been allowed to avoid making any significant contribution to their Government. I urge the members of this committee to examine carefully the cases developed by the Joint Committee staff. I believe you will come to share the sense of outrage felt by millions of average wage earners at the glaring injustice of our present system.

H.R. 10612, the tax reform bill now pending before this committee, offers the Senate a real opportunity to remedy some of the worst abuses in the Internal Revenue Code. The House bill contains many important provisions that move us in the direction of genuine tax reform. For their efforts, the Ways and Means Committee and the Joint Tax Committee staff deserve the thanks of all of us interested in tax reform.

But the Senate should view the House bill as a foundation on which to build, not a structure to be demolished. There are some reforms that should be kept. There are others that should be strengthened. There are still other reforms that should be added. And, in some instances, provisions in the bill should be deleted or studied further, lest they become sources of new tax inequity.

I am submitting to the committee as an attachment to this statement my detailed proposals for comprehensive tax reform. In my remarks today, I would like to touch very briefly on the highlights of the proposed reforms and describe how they represent appropriate responses to the inequities in our tax system.

MINIMUM TAX

The House bill substantially strengthens the minimum tax, which is designed to insure that individuals with large economic incomes will make at least some contribution to their Government.

For individuals, the House bill would raise the minimum tax to 14 percent, repeal the deduction for regular taxes, repeal the carryover of unusued regular taxes, and add new items of tax preference. Many of us in the Senate have proposed these changes in the past, and I urge the committee to adopt these actions of the House.

The House failed, however, to adopt these reforms for corporations. This is an unjustified omission in my viewpoint. Corporations use loopholes, too, and they should be subject to the minimum tax on their income from such loopholes.

In addition, the committee should reduce the present $30,000 minimum tax exemption to $5,000. This is the approximate income of a low-income family of four that is now exempt from tax. I do not believe that high income individuals need a larger exemption for tax preference income than we give to families at the poverty level. The $5,000 exemption for individuals should be phased out dollar-for-dollar, so that it disappears at $10,000 of preference income. For corporations, the exemption should be eliminated completely.

MAXIMUM TAX

As another measure to insure that high-income individuals pay their fair share of taxes, I urge the committee to repeal the present 50 percent maximum tax on earned income. This preferential rate produces a $660 million tax benefit for some 1 percent of the taxpayers in the country—virtually all with adjusted gross incomes in excess of $50,000.

One of the principal objectives of the maximum tax was to encourage the highest income earners to "mind their business" instead of concocting tax avoidance schemes. With the adoption of reforms to curb tax shelters directly, and with a stronger minimum tax, this unfortunate tax bow to the wealthy should be eliminated. I would also note that current tax shelter offerings indicate that the maximum tax is actually causing a greater Federal revenue loss from tax shelters than was the case before its enactment. Thus, the provision has apparently failed to achieve the objective originally stated.

CAPITAL GAINS TAX

Another major reason why upper income individuals pay less than their fair share of taxes is the preferential treatment accorded capital gains. This income is taxed at only one-half the normal tax rates, and it is exempt from tax entirely if passed on to heirs at death.

These two rules result in a Federal tax subsidy of over $12 billion in fiscal 1976—$5.5 billion from the preferential rates and $6.7 billion from the failure to tax gains at death. By fiscal year 1981, the Congressional Budget Office estimates that the total subsidy will rise to more than $20 billion.

Who benefits from this Federal generosity? An estimated 42 percent of the benefit from the failure to tax gains at death goes to the top 1.2 percent of income recipients in the country—those with incomes over $50,000 each year. Two-thirds of the lost revenue from preferential rates goes to this same privileged group in our population.

TAX SHELTERS

Let me turn to another area, and that is tax shelters. Tax shelters have become a new American way of life for wealthy individuals in this country in tax brackets of 50 percent or higher. There is hardly an area of economic life that tax shelters have not infected in recent years.

They are used in farming, from cattle to azalea bushes; they are used in drilling for oil and gas; they are used in motion pictures, from family-oriented films to hard-core pornography; they are used in real estate development, from motels and shopping centers to commercial high rises and beach front condominiums; they are used in equipment leasing, from oil tankers that are too big to dock in American ports, to boxcars for the railroads and 747's for the airlines; they are used for professional sports franchises from the machinations that may be keeping baseball out of Washington to the Atlanta Falcons case now in court.

Tax shelters cost the Treasury billions of dollars annually in lost revenues. And all of this tax subsidy goes to investors in the top tax brackets. Indeed, most of the handsome, multicolored brochures advertising tax shelter investments, caution that prospective investors should consider the shelter only if they are in the 50-percent bracket or higher.

Studies of tax shelter transactions show the significant waste of Federal funds involved in these transactions. Much of the Federal tax expenditure is siphoned off—in lawyers' fees, accountants' fees, brokers' fees, computer fees and commissions to those involved.

In some real estate transactions, for example, as much as 40 percent of the Federal tax spending goes not to actual construction costs, but to these parasites in the syndication process by which tax shelters are packaged and sold to wealthy investors.

Congress can and should provide Federal aid to some of the economic activities in which tax shelters now operate—low-income housing, for example. But we owe it to the average taxpayer to spend the funds in a way that achieves the real objective of the Federal aid, and does not create hordes of "tax millionaires" in the process.

The existence of tax shelters also generates significant distortions in the economy. Tax shelters in farming, for example, have artificially driven up the price of land; they have accentuated the boom and bust cycles for legitimate cattle ranchers and citrus growers.

The heart of this aspect of the problem is that many tax shelter deals do not need a real economic profit to make money for the investors—the profit is derived from the tax savings alone. Obviously, legitimate businesses that have to make a real economic profit find it difficult to compete with such tax profit operations.

I urge the committee to adopt strict measures to stop these tax abuses. These various proposals, if enacted, will represent a major step by Congress toward insuring that our progressive tax system is fair to every taxpayer. High-income individuals and corporations must pay their way if the Internal Revenue Code and our self-assessment system are to deserve the confidence of millions of ordinary American taxpayers, who pay too much because others pay too little.

CHILD CARE DEDUCTION

Let me turn now to low- and middle-income individuals.

The House took a significant step toward greater equity by converting the present child care deduction into a tax credit. Under the House bill, the credit would equal 20 percent of child care costs, with a ceiling on the credit of $400 for one child and $800 for two or more children.

The House provision eliminates the "upside-down" effect of the current deduction, which gives much greater benefits to working parents with $35,000 income than to those with $10,000 income. Under the credit mechanism, all working couples with the same amount of child care costs will receive the same benefit, regardless of income.

But the House bill leaves a glaring inequity in the proposed credit. It is not available to those who need it most. The credit goes only to working parents who have a tax liability. All working parents below the poverty level are excluded from the benefit.

To remedy this inequity, the committee should amend the child care credit to make it refundable. Parents with child care costs could obtain a tax refund of $200 to $400, if their income was not sufficient to incur a positive tax liability. This action would parallel the recent committee and Senate action putting the WIN tax credit for child care facilities on a refundable basis, the proposal Senator Mondale worked so well on.

EARNED INCOME CREDIT

The refundable earned income credit is a reflection of the genius of the chairman of this committee. It is an imaginative and useful tax response by Congress which encourages low-income Americans, trying to work their way out of poverty status, by alleviating the burden of social security taxes they have to pay.

The credit is equal to 10 percent of earned income, up to $4,000 of income; it gradually phases out by $8,000 of earned income. In general, the amount of the credit offsets the amount of social security taxes paid by low-income workers.

As presently structured, the credit is typically available only to couples with dependent children. I urge the committee to expand the eligible class to include married couples, even if they have no children. Indeed, if revenue constraints permit, I hope the committee will give serious consideration to extending the earned income credit to single persons working on a substantially full-time basis.

INVESTMENT TAX CREDIT

Finally, I wish to discuss some proposals to provide more rational and equitable rules for capital formation and business operations.

The Budget Reform Act is now requiring Congress to develop more efficient ways to deal with the critical fiscal issues facing the country. As I have mentioned earlier, the terms of the act make clear that Federal spending programs through the tax system must be subjected to the same critical scrutiny and control already being given to direct spending programs authorized by Congress.

This means that these tax-spending programs must be examined in light of the questions we normally ask of other spending.

In the recent past, the investment tax credit has been the primary method by which the Federal Government has encouraged business to invest in capital equipment. The credit has served its purpose reasonably well. It has been an effective tool in stimulating the purchase of machinery and equipment.

But the tool must be sharpened if it is to meet the Nation's modern needs. I, therefore, propose that the investment credit be modified in the following specific respects:

The basic credit—which is presently scheduled to revert to 7 percent in 1977—should be extended at a flat rate of 10 percent.

Beginning in 1977, an additional 5 percent credit should be provided for incremental investment above a 3-year average base period level.

Beginning in 1978, the full 15 percent credit should be made refundable.

The "incremental credit" feature of the proposal recognizes the need to stimulate increased capital investment to create new jobs. The "refundable" feature will provide needed assistance to new businesses, to those undergoing temporary economic losses, and to nonprofit organizations such as hospitals, colleges and universities that are not eligible for the program at this time and which also deserve the benefit of this incentive.

ASSET DEPRECIATION RANGE

To help provide the revenue for this more efficient and more equitable investment credit, Congress should repeal the Asset Depreciation Range [ADR] system, which was unwisely enacted in 1971. There is broad agreement among economic experts that the investment credit—with the changes I have proposed—will be a more efficient and effective stimulus to capital investment than accelerated depreciation gimmicks like ADR.

I also believe that the refundable, incremental investment credit I am proposing will constitute a valuable resource for small businesses, especially those that are in their formative stages of development.

TAX REDUCTIONS FOR SMALL BUSINESS

In addition, I urge the committee to approve the House action in extending for another 2 years the tax reductions for small business. I know that the lower tax rate and higher surtax exemption have been extremely beneficial to many small businesses in my own region of New England and in many other sections of the country. Too often, when tax incentives have been enacted in the past, small business has been left out. The measure in the Tax Reduction Act of 1975 have been of useful value, and they deserve to be extended.

TAXATION OF OIL AND GAS

With the price of oil continuing at astronomic levels, the time has come to end the major Federal tax subsidies for oil and gas. The Congress should take the following specific steps:

Require capitalization of intangible drilling and development costs.

Require "recapture" of the tax benefits in cases where property subject to the intangible deduction is subsequently sold at a gain.

Phase out the 2,000-barrel-per-day exemption from repeal of the percentage depletion allowance.

Reduce the tax credit for foreign oil income to 48 percent.

TAXATION OF MULTINATIONAL CORPORATIONS

In the area of multinational corporations, we must revise the rules that provide "tax favoritism" to American corporations doing business overseas. I believe that America and American business will benefit together if our tax rules are neutral as between enterprises that operate entirely in the United States and those that operate through subsidiaries abroad.

The Senate should once again—as it did in 1975—vote to end the present tax deferral on income earned by foreign subsidiaries of U.S. multinational corporations. We need jobs in the United States. We should not be encouraging American companies to go abroad to hire foreign workers when unemployment is over 7 percent at home.

DISC

The Senate should also repeal the DISC tax benefit. This subsidy is a Treasury-spawned tax loophole enacted in 1971. It has proved to be an almost complete waste of taxpayers' money—now costing the Treasury $1.5 billion a year. The House Budget Committee, after an extensive study, concluded that DISC has created few if any jobs for American workers. The AFL–CIO has reached a similar conclusion. Congress can think of better ways than DISC to spend $1.5 billion to create new jobs.

ESTATE AND GIFT TAX

Finally, comprehensive estate and gift tax reform is long overdue. Not since 1942 has a complete review of the entire system been undertaken by Congress. It is encouraging that the Ways and Means Committee has this week begun hearings on this important subject.

If the committee decides to include estate and gift tax reform in the pending bill, I would appreciate the opportunity to appear at a later date to present detailed views on the steps I believe we should take to insure a fair and effective transfer tax system. I have outlined some of these points in the "detailed" portion of this statement.

I strongly urge the committee, whatever action it takes on broader issues of the estate and gift tax laws, to reject outright the President's proposal to increase the estate tax exemption from $60,000 to $150,000.

This proposal—ostensibly intended to help small farmers—would severely undercut the effectiveness of our estate and gift tax laws.

If the committee does wish to take action at this time to alleviate liquidity problems of farm owners, I would suggest a proposal to achieve this goal without impairing the basic structure of the transfer tax system. Under the proposal, farmers would be entitled to transfer "development" rights to charitable or governmental organizations. In this manner, the land would be valued at its farm value, not its development value for estate tax purposes, and the goal of preserving the Nation's open spaces would be enhanced.

TAX REFORM NEEDED

Let us resolve that "Always a bridesmaid, never a bride" shall not be the epitaph of tax reform in Congress in 1976. The lobbyists and their clients are at the altar now, as always in the past. And for many years, they have taken the bride away in the form of massive subsidies for their interests.

For too long, tax reform has been a failing movement in Congress. Our perennial promises of reform have a hollow ring by now to taxpayers weary of the rhetoric and cynical about their Government. We have the tools and the knowledge to fulfill the promise now. The only doubt is whether we have the will.

Mr. Chairman, I submit these tax reform proposals to the committee in a spirit of constructive cooperation. I stand ready to work with the members of the committee and all other Senators to insure that a major tax reform bill is on the President's desk before election day.

The CHAIRMAN. I appreciate the kind words you said about the low-income tax credit, and I will join with you in seeking to advance that concept to help the poor to improve their condition and move themselves out of poverty into proud reliance upon their own efforts.

CHILD CARE DEDUCTION

I also will enjoy working with you to see that we do better by giving the working people a better tax break when they try to find someone to look after their children while they are working. You perhaps saw a very thoughtful article in the Washington Post about 2 weeks ago, "The IRS Is Unfair to Grandma." It pointed out that you can deduct the cost of leaving your child with a day care center, but if you leave your child with grandma where the child is getting more tender loving care, you cannot deduct it. We in the Senate voted to make it so that grandma would receive the same favorable tax treatment as the day care center and I hope that we can do something about changing the law.

TAX EXPENDITURES

I find myself feeling that a tax expenditure can be just about anything that you want it to be. If you want to, you can start with the assumption that since the top tax rate is 70 percent, everything that fails to take 70 percent away from a person is a tax expenditure.

I used to chide our friend Albert Gore on his view that the Government, in effect, owned 100 percent of the man's income, and anything he was permitted to keep was a tax expenditure, that the Government had a right to take it all if the Government needed it more than he did.

I have found it difficult just to decide where you should draw the line about tax expenditures. It still gets back to the same point, like the difference between an incentive and a loophole. It just depends on one's point of view, which is sort of like looking at a mountain. If you are trying to describe it to someone, he is going to agree with you if he saw it from the same side and the same elevation that you did. But if you saw it from the top and he saw it from the bottom, he is not going to agree with you. The same would be true if you saw it from the east and he saw it from the south.

I believe we can agree that it just gets down to the role of judgment in looking at all those things. Is this amount of tax that we tax this person desirable, or is he getting treatment that is too favorable? A lot of that just gets down to be a matter of subjective judgment.

We tax people on income based on how they made it and what they did with it. We can encourage a great deal of socially desirable conduct and discourage a great deal of undesirable or even marginal conduct through the tax law. That is how the tax laws are structured right now, or how they should be.

Senator KENNEDY. Well, Senator, I would put it in a different way.

We have talked about this at other times and I am sure that we will in the future, but I have given a good deal of thought to your point which is that—what is tax reform for one person is another's tax loophole, or that it is just my set of priorities or yours, and that whoever has the votes wins.

I would hope that we could establish at least some criteria which we could all agree on, or at least which we can submit for 51 members of the Senate to agree on: that is, there are certain objective tests to apply in terms of supporting a particular tax expenditure.

There are many cases where 51 members of the Senate will easily agree that it is valuable and worthwhile to provide a Federal subsidy. If we agree to that, then we can make a decision and determination whether that ought to be in the form of a direct financing, because we feel that is the most effective way, or through a tax expenditure.

If we can again make some agreement on that, by deciding that we want to do it by a tax expenditure, I think we have to ask if the distribution of the subsidy really is the most efficient or effective way of doing it.

If we set reasonable criteria like these, then there is a substantial difference between applying these neutral criteria and simply saying tax reform is whatever 51 Senators say it is.

For example, under the present tax laws, we are providing a tax expenditure for the pornographic movies. Now, does that meet criteria No. 1? Do we feel that there would be any votes over on the floor of the Senate, much less 51, to offer a Federal subsidy in that area? Quite certainly not.

So we see, it does not even meet test No. 1.

To take another issue, should Congress be underwriting real estate?

If you had a direct subsidy program that says we are going to encourage the building of shopping centers and highrise apartments, how many votes over on the floor of the Senate do you think you would get? I do not think that you would meet the test for No. 1.

I think what we ought to do is establish criteria like this for each tax expenditure. We can say, for example, that it meets criteria No. 1. We make a decision that we are going to provide direct expenditure in the area of low-income housing. Now, the question is whether that should be done with tax expenditures or by a direct subsidy. At the present time, our basic housing policy takes advantage of the existing tax expenditure programs, so we must make a judgment on that.

Now, with low-income housing, we should retain the tax expenditures until some better alternative is available.

If you say in the area of tax shelters, say in oil and gas drilling, a subsidy is required to meet our energy needs, then it meets test No. 1. But under test No. 2, should the subsidy be a direct expenditure or should it be a tax expenditure? So you say, well, maybe we agree that we are going to use a tax expenditure. Even if you meet test two and go to test three, the tax shelter fails, where 40 percent of the Federal subsidy is going to benefit a dentist in downtown Boston and is not going to benefit the person who is drilling in the ground out in Texas, Oklahoma, or in other areas.

Could not there be a more effective way of doing that, with a refundable credit? At what rate, I am not prepared to say. It would be above the existing rate of 10 percent. The Finance Committee can make judgments on that. Wouldn't that be a more effective way if you passed the earlier kind of tests on it?

So I think there is a real difference in terms of how to approach that question. We cannot just say that anything we want is tax reform. If we apply this kind of criteria in the analysis of major kinds of tax expenditures, I think we would come up with dramatically different provisions than we now have in the Internal Revenue Code, or what is being proposed now by the administration in terms of a subsidy for shareholders of stock.

The CHAIRMAN. My time has expired.

Senator Talmadge?

Senator TALMADGE. Senator Kennedy, the chairman touched on one aspect of your testimony that I would like to be enlightened on a little more.

Exactly what do you mean by a tax expenditure?

Senator KENNEDY. Any of the expenditures that are being made through the Internal Revenue Code that are not subject to taxation or are taxed at more favorable rates.

Senator TALMADGE. Would unemployment compensation be a tax expenditure?

Senator KENNEDY. It is included in the tax expenditure list.

Senator TALMADGE. Would depreciation on plants that are used to employ people, to pay wages, be a tax expenditure?

Senator KENNEDY. It would be.

Senator TALMADGE. Is it your idea to eliminate all kinds of tax expenditures?

Senator KENNEDY. No. Quite to the contrary, Senator. I think there are many desirable objectives that can and should be reached through tax expenditures. One major advantage is that they eliminate the establishment of a Federal bureaucracy to run other kinds of Federal subsidy programs. All I am asking is that tax expenditures meet the criteria that I have outlined here this morning. If they do meet the criteria, then there is a justification for them. That would be the test that I would use.

Senator TALMADGE. Our capitalistic system is a system of risk and reward.

Senator KENNEDY. Yes.

Senator TALMADGE. Then you think it is necessary that we get people to assume a risk in order to achieve a reward?

Senator KENNEDY. I certainly do.

Senator TALMADGE. Otherwise, we would have no capitalistic system, no employees, no jobs.

Senator KENNEDY. I agree with that.

Senator TALMADGE. Under the system of the so-called tax expenditures, you would agree that it leaves the option to the individual as to what applies to capital, would you not?

Senator KENNEDY. The Senator is correct. But in many instances, the decision is left to a very specialized group of individuals. It does not give the option, for example, for a tax shelter to be used by 80 percent of the American people. They theoretically have the choice, but they do not have the practical choice.

If you want to say there is a freedom of choice in terms of taking advantage of the tax shelter, or taking advantage of the capital gains at death, you can say as a matter of theory that they have the individual choice, but for the practical matter, there is no bluecollar worker who can take advantage of that.

Senator TALMADGE. I know a lot of bluecollar workers that have started businesses and have done extremely well.

Senator KENNEDY. But I am sure that we are not using the exception to prove the rule.

Senator TALMADGE. Well, of course, most of the family fortunes in this country were made that way, including yours, I believe, were they not?

Senator KENNEDY. That is right. Dad was not a bluecollar worker, but sometimes I wish he had been.

Senator TALMADGE. If you eliminate all of your tax expenditures, it would take the option away from the individual and put it in the hands of the Government, would it not?

Senator KENNEDY. I differ with you, Senator. It would simply mean that the tax laws are neutral among various activities. There would be no tax preference for particular activities.

Senator TALMADGE. If you eliminated that depreciation, the Government would have come in and built apartments for the people, would they not?

Senator KENNEDY. Well, not necessarily; not with the proposals that I have offered, with an increase in the investment credit, which I think works a great deal more effectively and efficiently. I think that would be a fair and more equitable way to do it.

Senator TALMADGE. I agree with you that we ought to periodically look at every one of these so-called exemptions.

Senator KENNEDY. Can I ask you a question?

Senator TALMADGE. Sure.

Senator KENNEDY. If you are interested in construction of high-rise apartments, what is the advantage of giving the tax benefit to wealthy investors, rather than to the people who are going to construct them, or the workers on the job? Why give the subsidy to a dentist in Boston, who may get 40 percent of the tax expenditure for the project?

Senator TALMADGE. I think the main thing that you have got to do is attract capital to a cause that is socially worthy. I do agree with you that we must periodically review every one of these deductions, exemptions.

Senator KENNEDY. Don't you think the burden ought to be on the committee to justify the tax subsidy, before we extend these loopholes ad infinitum?

Senator TALMADGE. I do not say we ought to extend the matter ad infinitum. They ought to be reviewed, and it is a matter of judgment as to how best to try to capitalize on the capitalistic system for a worthy purpose. It is likely that under your proposal that capital is going to have to come from the Government itself.

If you do that, you will change our capitalistic system to one which is not capitalistic. I do not think you or I want to do that.

Senator KENNEDY. That is true. Take capital gains at death. This committee ought to be very sure that the continuation of the capital gains at death expenditure is going to mean more capital in terms of the free enterprise system, rather than less capital, which I believe is the result of the present system.

Senator TALMADGE. I share that view, but I can't in the name of tax reform go so far as to destroy the goose that laid the golden egg with the capital system.

Senator KENNEDY. No; but I would dare say, under that general kind of admonition, we have written into the tax code many, many golden eggs for many, many people to take advantage of. It raises the fundamental question about the integrity of the tax laws.

Senator TALMADGE. I think every one of them ought to be examined periodically to determine whether they serve a worthy cause.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Senator Kennedy, to save time, would you mind putting a few things in the record?

Senator KENNEDY. I put in a lot already.

Senator CURTIS. I mean, in response to some of my questions.

Senator KENNEDY. Sure.

Senator CURTIS. Would you give us a breakdown of how you arrived at the $100 billion of tax expenditures, showing what they are and how much each one accounts for?

Senator KENNEDY. I would be glad to. The figures are provided by the Joint Committee on Taxation and published by the Congressional Budget Office, but I would be glad to supply it for you.

Senator CURTIS. But I would like to have you set forth each item.

Senator KENNEDY. I will be glad to submit the table. The table sets forth the amount for each tax expenditure item. If differs in few items from the Joint Tax Committee table, because CBO assumes for purposes of the table that the investment credit, the corporate surtax exemption, the earned income credit, and the increased standard deduction will all be continued through 1981. The Joint Tax Committee table assumes that only the standard deduction is continued.

[The table referred to follows:]

Source: "Budget options for fiscal year 1977: a report to the Senate and House Committees on the Budget," Congressional Budget Office, March 15, 1976; pp. 384–387

TAX EXPENDITURE ESTIMATES, BY FUNCTION [a]

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
National defense (050):										
Exclusion of benefits and allowances to armed forces personnel						650	650	650	650	650
Exclusion of military disability pensions						90	100	110	120	130
International affairs (150):										
Exclusion of income earned abroad by U.S. citizens						160	175	195	205	220
Exclusion of gross-up on dividends of LDC corporations	55	55	55	55	55					
Deferral of income of domestic international sales corporations (DISC)	1,420	1,460	1,495	1,580	1,735					
Deferral of income of controlled foreign corporations	365	365	365	365	365					
Special rate for Western Hemisphere trade corporations	50	50	50	50	50					
Natural resources, environment and energy (300):										
Exclusion of interest on state and local government pollution control bonds	170	220	265	300	330	75	100	125	145	160
Expensing of exploration and development costs	840	1,045	1,285	1,540	1,850	195	245	305	365	435
Excess of percentage over cost depletion	1,020	1,015	1,110	1,215	1,325	575	625	640	670	695
Pollution control: 5-year amortization	15	5								
Capital gains treatment of royalties on coal and iron ore	20	20	25	25	30	50	60	65	75	85
Capital gains treatment of certain timber income	165	175	190	200	215	65	70	75	80	85
Agriculture (350):										
Expensing of certain capital outlays	115	120	130	135	150	360	370	380	390	400
Capital gains treatment of certain income	40	40	45	50	50	565	655	705	760	820
Cooperatives: deductibility of noncash patronage dividends and certain other items	455	485	520	555	595					
Commerce and transportation (400):										
Exemption of credit unions	135	145	155	165	175					
Corporate surtax exemption	6,185	6,745	7,300	7,865	8,455					
Deferral of tax on shipping companies	130	155	180	205	230					
Railroad rolling stock: 5-year amortization	10	5								
Financial institutions: excess bad debt reserves	570	635	730	900	1,060					
Deductibility of nonbusiness state gasoline taxes						600	665	735	815	910
Depreciation on rental housing in excess of straight line	125	135	145	155	170	455	480	510	545	580
Depreciation on buildings (other than rental housing) in excess of straight line	280	300	325	350	375	215	235	250	275	300

See footnotes at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION—Continued

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
Expensing of research and development expenditures	695	725	755	785	815					
Capital gains: Corporate (other than farming and timber)	900	1,015	1,090	1,170	1,260					
Investment credit	7,585	8,045	8,480	8,890	9,310	1,530	1,635	1,750	1,870	1,995
Asset depreciation range	1,630	1,825	2,000	2,095	2,135	175	195	220	230	235
Dividend exclusion						350	370	385	405	425
Capital gains: Individual (other than farming or timber)						6,225	7,360	7,905	8,490	9,145
Capital gains at death						7,280	8,120	9,015	10,005	11,105
Deferral of capital gains on home sales						890	935	980	1,030	1,080
Deductibility of mortgage interest on owner-occupied homes						4,710	5,225	5,800	6,440	7,150
Deductibility of property tax on owner-occupied homes						3,825	4,245	4,710	5,230	5,805
Deductibility of interest on consumer credit						1,075	1,195	1,325	1,475	1,635
Exclusion of interest on state and local industrial development bonds	195	235	270	315	355	90	110	130	150	170
Excess 1st year depreciation	165	180	200	220	240	85	95	105	115	130
Expensing of construction period interest and taxes	1,065	1,110	1,150	1,190	1,230	570	595	620	645	670
Credit for purchase of new home						100				
Community and regional development (450):										
Housing rehabilitation: 5-year amortization	25	20	15	10	10	40	25	15	15	15
Education, training, employment, and social services (500):										
Exclusion of scholarships and fellowships						220	235	245	255	270
Parental personal exemption for student age 19 and over						715	735	760	780	805
Deductibility of charitable contributions (education)	280	325	355	390	430	500	555	610	670	735
Deductibility of child and dependent care expenses						420	460	510	560	615
Child care facilities: 5-year amortization	5	5								
Credit for employing AFDC recipients and public assistance recipients under work incentive program	10	10	10	10	10					
Deductibility of charitable contributions (social services)	352	402	446	489	536	3,124	3,468	3,847	4,274	4,740
Health (550):										
Exclusion of employer contributions to medical insurance premiums and medical care						4,225	4,730	5,300	5,935	6,650
Deductibility of medical expenses						2,095	2,325	2,580	2,865	3,175
Deductibility of charitable contributions (health)	173	198	219	241	264	831	922	1,023	1,136	1,260

See footnotes at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION[1]—Continued

[Fiscal years, in millions of dollars]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
Income security (600):										
Exclusion of social security benefits:										
Disability insurance benefits						370	415	470	525	595
OASI benefits for aged						3,525	3,965	4,460	5,020	5,645
Benefits for dependents and survivors						565	635	715	805	905
Exclusion of railroad retirement system benefits						200	215	230	245	260
Exclusion of unemployment insurance benefits						2,855	2,655	2,470	2,295	2,135
Exclusion of workmen's compensation benefits						640	705	775	855	940
Exclusion of public assistance benefits						130	145	165	185	210
Exclusion of special benefits for disabled coal miners						50	50	50	50	50
Exclusion of sick pay						350	370	385	405	425
Net exclusion of pension contributions and earnings:										
Employer plans						6,475	7,120	7,835	8,620	9,480
Plans for self-employed and others						965	1,065	1,180	1,300	1,440
Exclusion of other employee benefits:										
Premiums on group term life insurance						895	965	1,050	1,135	1,230
Premiums on accident and accidental death insurance						60	65	70	80	85
Income of trusts to finance supplementary unemployment benefits						5	5	5	5	5
Meals and lodging						305	320	335	350	365
Exclusion of capital gains on home sales if over 65						50	55	60	65	70
Excess of percentage standard deduction over minimum standard deduction						1,560	1,635	1,720	1,805	1,895
Additional exemption for the blind						25	25	25	25	25
Additional exemption for over 65						1,220	1,280	1,340	1,410	1,480
Retirement income credit						110	100	90	80	70
Earned income credit: nonrefundable portion						280	270	255	245	235
Earned income credit: refundable portion						1,110	1,065	1,025	985	945
Exclusion of interest on life insurance savings						1,855	2,025	2,210	2,410	2,625
Deductibility of casualty losses						330	355	380	405	430
Maximum tax on earned income						505	580	670	770	885
Veterans' benefits and services (700):										
Exclusion of veterans' disability compensation						595	595	595	595	595
Exclusion of veterans' pensions						30	30	30	30	30
Exclusion of GI bill benefits						280	265	255	240	230

See footnotes at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION[a]—Continued

(Millions of dollars, fiscal years)

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
General government (800):										
Credits and deductions for political contributions						65	40	50	50	85
Revenue sharing and general purpose fiscal assistance (850):										
Exclusion of interest on general purpose state and local debt	3,150	3,375	3,630	3,925	4,300	1,390	1,490	1,605	1,735	1,880
Exclusion of income earned in U.S. possessions	285	305	325	350	375					
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes and gasoline)						6,680	7,415	8,230	9,140	10,140
Interest (900):										
Deferral of interest on savings bonds						685	765	845	925	1,005

Source: Staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation.

[a] Sum of the Tax Expenditure Items by Type of Taxpayer and Fiscal Year[1]

(Millions of dollars)

Fiscal year	Corporations and individuals	Corporations	Individuals
1977	106,970	29,680	77,290
1978	115,600	30,950	84,650
1979	125,475	33,315	92,160
1980	136,250	35,790	100,460
1981	148,160	38,485	109,675

[1] These totals represent the mathematical sum of the estimated fiscal year effect of each of the 82 tax expenditure items included in this table.

Senator CURTIS. Is the nontaxable status of the Social Security payments a tax expenditure?

Senator KENNEDY. Yes; it is.

Senator CURTIS. And is it true that the earned income credit——

Senator KENNEDY Pardon?

Senator CURTIS. The earned income credit?

Senator KENNEDY. There are some 82 tax expenditures in the table.

Senator CURTIS. I would like to ask about some specifically.

Would you regard the earned income credit as an expenditure?

Senator KENNEDY. It is so listed.

Senator CURTIS. And also the investment credit?

Senator KENNEDY. Yes, sir.

Senator CURTIS. Is the deduction for interest paid a tax expenditure?

Senator KENNEDY. The Senator is correct.

Senator CURTIS. Would you make any change in it?

Senator KENNEDY. I am not suggesting any change; no.

Senator CURTIS. Is the personal exemption, whether it be $1,000 or $750 or $850, a tax expenditure?

Senator KENNEDY. A personal exemption?

Senator CURTIS. Whether it be $750, $1,000; is that a tax expenditure?

Senator KENNEDY. No, sir, it is not.

Senator CURTIS Well, is it, according to your definition, a tax expenditure?

Senator KENNEDY. No; I would say no.

Senator CURTIS. Are charitable deductions a tax expenditure?

Senator KENNEDY. Yes, sir.

CAPITAL GAINS TAX

Senator CURTIS. You are recommending the inclusion of the capital gains tax at death, whether it is sold or not; is that correct?

Senator KENNEDY. Yes; that is correct.

Senator CURTIS. So, if someone is living in a home that cost $10.000 many years ago and at the time of the person's death is worth $50,000, even though they do not sell it and their widow or their family continues to live in there, you would collect from them a capital gains tax on the $40,000?

Senator KENNEDY. No; the Senator is not correct. The tax would not reach back to past gains. And it would not apply to transfers to a spouse at death.

Senator CURTIS. Would you explain that?

Senator KENNEDY. Yes. All gains up to December 1975, would be exempt from the tax. That is on page 8. It would be phased in gradually.

Senator CURTIS. But it would apply in the future?

Senator KENNEDY. Yes. But you would have the basic $60,000 exemption available. All transfers between spouses would be exempt; all transfers to charities would be exempt. And special rules would apply to small farms and businesses with liquidity problems. I outlined that previously.

Senator CURTIS. It will be phased in in the future, though?
Senator KENNEDY. The Senator is correct.

ESTATE TAX

Senator CURTIS. And are you opposed to raising the estate tax exemption from 60 to 150?
Senator KENNEDY. Yes, Senator, for this reason: Only 7 percent of estates pay an estate tax now, 93 percent of the estates are already exempt, because they are not large enough to owe any estate tax. The principal concern which has been expressed has been over farm and agricultural lands. I have outlined a way that I hope the committee would consider, so that the land would be evaluated for farming purposes, not development purposes.
The developmental rights could be contributed to a charitable organization or a State organization. The land would be maintained as open space, and the farmer would not be taxed on the development value of the land.

TAX EXEMPT BONDS

Senator CURTIS. Do you feel that the tax-exempt bonds are tax expenditures?
Senator KENNEDY. Yes; I do.
Senator CURTIS. Would you make them taxable?
Senator KENNEDY. No.
Senator CURTIS. Is that a tax expenditure that benefits the rank and file people of the low-income bracket?
Senator KENNEDY. I think it passes one of the tests which I have outlined here. There is a major need for Federal aid to States and cities. But I do think it fails the other tests. The tax expenditure is a very inefficient Federal subsidy, and much of it is siphoned off by wealthy individuals.
A much better approach would be to offer a Federal interest subsidy for bonds that a State or city agrees shall be taxable instead of tax exempt.
Senator CURTIS. You cited several cases where people with substantial incomes paid no tax. Would you take three or four of those and, for the record, state what the source of the income was and what sections of the Internal Revenue Code were used by them, and to how much it would reduce their tax liability to zero?
Senator KENNEDY. I would, certainly. I would be glad to. The cases I referred to are from a 1974 study by the Joint Tax Committee, which analyzed the returns of some unidentified wealthy individuals and celebrities. I don't believe that any more information on the study has been published. But I would be glad to submit for the record a pamphlet published by the Joint Tax Committee, which provides similar information on tax shelters.
[The pamphlet entitled "Tax Shelter Investments: Analysis of 37 Individual Income Tax Returns, 24 Partnerships and 3 Small Business Corporation Returns", prepared for the use of the House Committee on Ways and Means, by the staff of the Joint Committee on

Internal Revenue Taxation, submitted by Senator Kennedy in response to Senator Curtis, was made a part of the official files of the committee.]

The CHAIRMAN. I was looking over this list of top expenditures that you made reference to and that includes things like this under tax expenditures for general government—deductions for political contributions. I thought that this was something we worked to put into law ourselves. The list also has things like this: Exclusion from taxes of social security benefits, disability insurance benefits, benefits for the aged, benefits for survivors, benefits under the railroad retirement system, employment insurance benefits, and exclusion of workmen's compensation benefits.

Senator KENNEDY. I support many tax expenditures. I only want to change the wasteful ones. One of the most dramatic facts is the extraordinary increase in tax spending in the past few years. We have to bring this runaway tax spending under control.

EARNED INCOME CREDIT

The CHAIRMAN. Let us just look at a few other items on this tax expenditure list: Earned income credit. If I had my way, we would expand the earned income credit to take care of a lot of additional poor people, and so would you.

Senator KENNEDY. The Senator is right. I have indicated here in terms of the child care credit where I would expand it, by making it refundable, like the earned income credit. There is an alternative to the tax expenditure for intangible drilling costs. I would support an increased investment credit for that area and work out what the rate ought to be. The tax subsidy should be going to the person who is out on the rig and trying to get the oil, rather than somebody in Boston taking advantage of a tax shelter. So we do not have any disagreement.

The CHAIRMAN. I do not want people to get the wrong impression from your testimony. I suspect 80 percent of the tax expenditures in the red column of your chart you would advocate yourself.

When you are talking about increasing tax revenues by eliminating so-called tax expenditures, you are talking about a relatively small part of that red column that you put on that chart.

Senator KENNEDY. I would not go along with the Ford administration program, which is basically tax relief for shareholders. The average tax bracket for shareholders is 42 percent. If they have $13 billion to give away, they should be giving it away to those who are working people.

The CHAIRMAN. That is not on the tax expenditure list you made reference to.

INVESTMENT TAX CREDIT

Senator KENNEDY. It is on my complete statement.

The CHAIRMAN. Let me ask you this: Would you put the investment tax credit on there or leave it off?

Senator KENNEDY. I would put it on.

The CHAIRMAN. I think it belongs on there.

Senator KENNEDY. That is right.

The CHAIRMAN. When we passed the so-called Tax Reform Act in 1969, that was the biggest item of revenue gain. I asked President Nixon to recommend that it be repealed and so did Wilbur Mills. We voted to repeal it. We thought we were going to pick up about $2.9 billion. By the time we got through, I am confident that the Treasury lost money, because so many people canceled out their orders that we lost revenue by the ripple effect, the secondary and tertiary effect. All that repeal did was to roll back employment to put people out of jobs, I have no doubt that when we reenacted it in August 1971, it probably did more the second time to start moving us out of the recession.

Now, it was your brother who first recommended this credit, and I was persuaded against my will to go along with it. It looked to me like a gift out of the Treasury for an expense that does not exist. But I would be the first to confess today that it has probably been more beneficial in encouraging people to make capital investments, which lead to jobs more than any single thing we have tried as long as I have been on this committee.

It has been very effective in increasing employment. Now, you are not advocating repealing that?

Senator KENNEDY. Senator, you are quite correct, because it meets the criteria.

The CHAIRMAN. As a tax expense?

TAX REFORM

Senator KENNEDY. Yes; I want to make it very clear that I advocated in some of these areas that tax expenditures should be increased, because they do meet basic and fundamental public policy needs, and they meet them in the fairest, most equitable way.

I have also indicated other areas, such as DISC and ADR, capital gains at death, and tax shelters, where there is no justification for the tax expenditures.

The CHAIRMAN. It seems to me that it serves very little purpose for us to discuss these things in terms of tax expenditure or in terms of reform. A tax expenditure, as you have explained here, might be a very good thing for the country and might not be a very good thing for the country, depending upon your point of view.

Reform means that you are making a change for the better; at least we would like to think so. I do not know of any bill that anybody introduced that he regarded as anything other than a change for the better, I think the average Senator or Congressman thinks that if we passed all the bills that he suggested, all the world's problems would disappear.

There are a lot of other Senators and Congressmen that do not agree with that. They have their own bills and they think that their package is what would solve all of the world's problems. The only way you can see we are going to solve these things is to take them individually.

I do not like calling a bill a reform bill. I helped to pass that Pension Reform Act. After we did that, we found that practically no new pension systems had been established and thousands of those that were established had been dissolved.

That is why I offered an amendment to change the name of the Trade Reform Act to the Trade Act, and let time tell whether it is a reform or not. I must say that after some of these reforms I voted for down through the years, I must ask the people to accept my contrite apology, because they did not work out the way we anticipated.

Would you agree with me that some of these do more good than harm?

Senator KENNEDY. I feel that in the principal areas that we have talked about here this morning, the abuses are flagrant and inexcusable. I would hope that we could make a hard and critical judgment on each of these various matters, which I know you and the committee are doing. If you feel that we need Federal aid, as a public policy matter, whether it is in housing or energy or other areas, we have to ask ourselves: Is a tax expenditure the most effective way and fairest way to provide that aid?

I believe it can be done, for example, in the case of the expanded investment credit. We can do it fairly and efficiently. I would much rather see tax expenditures and refundable credits for child care and for investment and for earned income, rather than the kind of tax expenditures in areas like tax shelters and capital gains at death.

The CHAIRMAN. Senator Byrd?

Senator HARRY F. BYRD, JR. Thank you, Mr. Chairman.

I shall yield my time back to you in a moment. I just want to say that I have not been able to be here, Senator, for your entire presentation. The Senate has been voting on a very important bill.

Senator KENNEDY. I hope it did not lose by one vote.

Senator HARRY F. BYRD, JR. No; that particular amendment that the Senate just voted on, I went to the desk to look at how the vote stood. It was only one vote against the amendment. The amendment added two independent members to the Commission. So the independents were doing pretty good at that point.

I could not be here for your entire testimony this morning because of a very fine group of Virginians representing the Boilermakers Union in my office about some matters.

This appears to be a very comprehensive statement, Senator Kennedy, of 71 pages. I want to study it carefully and yield my time to Chairman Long.

The CHAIRMAN. Thank you very much, Senator.

Senator KENNEDY. Thank you very much, Senator.

The CHAIRMAN. You made a very useful presentation here.

Senator KENNEDY. I appreciate the chance to appear. You have always been very attentive and, at least, receptive to the points which I have raised. I want to express my personal appreciation to you and the members of this committee.

The CHAIRMAN. We will certainly study what you have suggested here and we will agree with you where we can, and what we cannot agree upon, we will just discuss it on the floor again.

Senator KENNEDY. Thank you again.

[Senator Kennedy's prepared statement follows. Oral testimony continues on page 236.]

TESTIMONY OF SENATOR EDWARD M. KENNEDY

Mr. Chairman, I appreciate this opportunity to present to this distinguished Committee my views and proposals concerning the reform of our federal income tax laws.

Significant income tax reform is one of the most vital issues facing our country. The inequities that permit upper income individuals to pay little or no tax are undermining the foundation on which our tax system rests.

In addition, we now perceive that "tax" reform also involves "spending" reform. Decades of past decisions to use the income tax system as the mechanism for vast federal spending programs are coming home to roost. There are simply not enough Federal dollars in the Federal Treasury to pay for all the direct spending and tax spending and tax relief programs that Congress would like to fund.

The Budget Reform Act is bringing the same long overdue discipline to tax expenditures as it has already brought to direct expenditures. The Senate looks to this Committee and to the Budget Committee for responsible fiscal leadership in controlling tax expenditures, just as it looks to the Appropriations Committee and the Budget Committee for responsible fiscal leadership on direct expenditures.

As part of my testimony, I have prepared three charts to illustrate various aspects of tax expenditures.

The first chart compares the growth of direct expenditures and tax expenditures in recent years. Over the past decade, direct federal spending has risen by 146%, from $158 billion in 1967 to $394 billion proposed by President Ford in 1977. But during the same period, tax expenditures rose by 176%, from $36 billion in 1967 to $101 billion in 1977, as estimated by the Congressional Joint Tax Committee. We now have, in round numbers, a federal budget of half a trillion dollars—$400 billion in direct spending and $100 billion in tax spending, for a total of $500 billion in overall annual Federal spending.

The second chart shows the relationship between the growth of tax expenditures and the growth of expenditures for national defense in recent years. In the budget debate this year, as in each debate in past years, one of the leading issues will be the priorities between spending for defense and spending for domestic social programs like jobs and schools and health.

Congress has devoted major attention and energy and hours to the annual debates over the rising expenditures for defense. But there has been virtually no debate over rising tax expenditures, which have subtly but swiftly mushroomed to levels rivaling the level for defense.

In 1967, the amount of tax spending was only a little more than half the amount of spending for defense. By 1972, the ratio had risen to 80%. Now, in fiscal 1977, in a curious coincidence of the budget process, tax expenditures have caught up precisely with defense expenditures, even to the first decimal point—$101.1 billion.

And by 1981, as the Congresional Budget Office projections indicate, tax expenditures will have grown to a level even higher than projected defense expenditures.

The third chart illustrates still another dimension of the tax expenditure problem—the potential future growth of various tax expenditures. The six examples on the chart indicate the way tax incentives, once ensconsed in the Internal Revenue Code, tend to grow like Topsy. According to C.B.O. estimates:

Tax spending for DISC, the export tax subsidy, will rise by 30%, to $1.7 billion by 1981.

Tax spending for the investment credit and ADR, two of the major subsidies for capital formation in the current law, will rise by 39% to $13.6 billion.

Tax spending under the rule exempting capital gains at death will rise by 65%, to $11.1 billion.

Tax spending for health (the special deductions and exclusions for medical expenses and for health insurance premiums) will rise by 73% to $9.8 billion.

Tax spending for oil, through the deduction for intangible drilling and development costs, will rise by an incredible 184% to $2.2 billion.

Let me digress here to mention what I regard as one of the most cockeyed aspects of the system of tax expenditures. Mr. Chairman, you and Senator Ribicoff and I are all supporters of one or another Federal program for national health insurance.

But we already have a national health insurance program—and I am not referring to Medicare and Medicaid. The Internal Revenue Service is running a multi-billion dollar national health insurance program, and it has been doing so for many years through the Internal Revenue Code and the deduction for health insurance premiums and medical expenses.

Let me describe this program.

The only persons who can take advantage of the program are those who itemize deductions. In general, persons who itemize deductions are usually those with mortgage interest to deduct. So, the tax code has a national health insurance program for homeowners.

The IRS, like many private insurance companies, has a "deductible" in its health insurance program, since health expenses may be deducted only to the extent they exceed 3% of income. That eliminates most taxpayers from the program, even if they are homeowners.

Worst of all, the IRS program also has a "coinsurance" feature, like many private policies. Only this coinsurance is upside-down—the richer you are, the more the government pays. For those in the lowest tax brackets, the government pays 14% of the health bill, and the taxpayer pays 86%. But for the wealthiest taxpayer, the government pays 70% of the bill, and the taxpayer pays only 30%.

Surely, if we were starting now, none of us would create a national health insurance program with absurdities like that. Yet that is the program the Internal Revenue Service is carrying out today.

I believe that all tax spending provisions should be re-examined under the criteria we use for evaluating direct spending programs—need, efficiency and equity. As a result of such studies, it is increasingly clear that many of the present tax expenditures should either be eliminated or substantially modified to make them more efficient and equitable.

We also must not lose sight of the fact that the tax laws and efforts of this committee must produce equity and fairness for all taxpayers.

In my work in the Subcommittee on Administrative Practice and Procedure, I have come to appreciate the truly remarkable effectiveness with which our self-assessing system works. It is understatement to say that it is the envy of all modern industrialized countries.

But at the same time, the success of the self-assessment system rests on the most fragile of bases—the confidence of each American taxpayer that our tax laws are drafted and administered so that all other taxpayers are contributing their fair share of taxes to meet our common national goals.

There is increasing and disturbing evidence that the confidence of the average taxpayer in our federal income tax system is being severely eroded. The middle income individuals who make up the vast majority of taxpayers are losing faith in the integrity of our income tax system.

This loss of faith is directly attributable to the preferential provisions in the Internal Revenue Code that permit individuals with $50,000 and more of income to pay less taxes than workers making $7,500 to $10,000 a year.

Some of these lower income taxpayers understandably wonder why, if the rich can avoid paying taxes by legal means, they should not "favor" themselves a bit when computing their income tax deductions. Indeed, a distressing number of books and magazine articles have appeared in recent years, purporting to tell average taxpayers how to "create" their own loopholes on their income tax returns.

Fortunately, most taxpayers file their tax returns fully and honestly. They report their total income and they claim only their legitimate deductions. But the adverse impact of massive—though legal—tax avoidance by upper income individuals on the morale of the ordinary taxpayer cannot be overestimated.

Congress should act this session to reverse this dangerous trend. We must reassure the average taxpayer that his wealthy fellow citizens are paying their fair share of income taxes.

This Committee should examine the data on tax avoidance by high income individuals developed by the Staff of the Joint Committee on Internal Revenue Taxation. How can we justify facts like these:

Two well known individuals, with incomes in excess of $500,000, paid no federal income tax.

An individual with income of $2 million paid tax at an effective rate of 2½%.

An individual with income over $900,000 used tax shelter deductions to the extent that he almost entirely escaped paying any income tax.

A corporate executive with almost $450,000 of income paid tax at a rate of three-tenths of 1%, as a result of tax shelter deductions.

A corporate executive paid 3.5% in tax on $532,000 of income.

A lawyer paid no tax on $151,000 of income.

A dentist paid no tax on $156,000 of income.

A stockbroker with income of $181,000 paid tax at a rate of five-tenths of 1%.

Mr. Chairman, these are actual case histories in which high income individuals have been allowed to avoid making any significant contribution to their government. I urge the members of this Committee to examine carefully the cases developed by the Joint Committee Staff. I believe you will come to share the sense of outrage felt by millions of average wage earners at the glaring injustice of our present system.

H.R. 10612, the Tax Reform Bill now pending before this Committee, offers the Senate a real opportunity to remedy some of the worst abuses in the Internal Revenue Code. The House bill contains many important provisions that move us in the direction of genuine tax reform. For their efforts, the Ways and Means Committee and the Joint Tax Committee Staff deserve the thanks of all of us interested in tax reform.

But the Senate should view the House bill as a foundation on which to build, not a structure to be demolished. There are some reforms that should be kept. There are others that should be strengthened. There are still other reforms that should be added. And, in some instances, provisions in the bill should be deleted or studied further, lest they become sources of new tax inequity.

I am submitting to the Committee as an attachment to this statement my detailed proposals for comprehensive tax reform. In my remarks today, I would like to touch briefly on the highlights of the proposed reforms and describe how they represent appropriate responses to the inequities in our tax system.

OBJECTIVES OF TAX REFORM PROPOSALS

In broad terms, my proposals for income tax reform have these objectives:

First, to insure that upper income individuals pay their fair share of income taxes.

Second, to provide greater equity in certain tax rules for low and middle income taxpayers.

Third, to provide more rational and equitable rules for capital formation and business operations.

Let me outline the steps that need to be taken to achieve these objectives.

REFORMS TO INSURE THAT UPPER INCOME INDIVIDUALS PAY THEIR FAIR SHARE OF INCOME TAXES

The Minimum Tax

The House bill substantially strengthens the minimum tax, which is designed to insure that individuals with large economic incomes will make at least some contribution to their government.

For individuals, the House bill would raise the minimum tax to 14%, repeal the deduction for regular taxes, repeal the carryover of unused regular taxes, and add new items of tax preference. Many of us in the Senate have proposed these changes in the past, and I urge the Committee to adopt these actions of the House.

The House failed, however, to adopt these reforms for corporations. This is an unjustified omission. Corporations use loopholes, too, and they should be subject to the minimum tax on their income from such loopholes.

In addition, the Committee should reduce the present $30,000 minimum tax exemption to $5,000. This is the approximate income of a low income family of four that is now exempt from tax. I do not believe that high income individuals need a larger exemption for tax preference income than we give to families at the poverty level. The $5,000 exemption for individuals should be phased out dollar-for-dollar, so that it disappears at $10,000 of preference income. For corporations, the exemption should be eliminated completely.

Repeal of Maximum Tax

As another measure to insure that high income individuals pay their fair share of taxes, I urge the Committee to repeal the present 50% maximum tax on earned income. This preferential rate produces a $660 million tax benefit for some 1% of the taxpayers in the country—virtually all with adjusted gross incomes in excess of $50,000. One of the principal objectives of the maximum tax was to encourage the highest income earners to "mind their business" instead of concocting tax avoidance schemes. With the adoption of reforms to curb tax shelters directly, and with a stronger minimum tax, this unfortunate tax bow to the wealthy should be eliminated. I would also not that current tax shelter offerings indicate that the maximum tax is actually causing a greater federal revenue loss from tax shelters than was the case before its enactment. Thus, the provision has apparenlty failed to achieve the objective originally stated.

Capital Gains at Death

Another major reason why upper income individuals pay less than their fair share of taxes is the preferential treatment accorded capital gains. This income is taxed at only one-half the normal tax rates, and it is exempt from tax entirely if passed on to heirs at death.

These two rules result in a federal tax subsidy of over $12 billion in fiscal 1976—$5.5 billion from the preferential rates and $6.7 billion from the failure to tax gains at death. By fiscal 1981, the Congressional Budget Office estimates that the total subsidy will rise to more than $20 billion.

Who benefits from this federal generosity? An estimated 42% of the benefit from the failure to tax gains at death goes to the top 1.2% of income recipients in the country—those with incomes over $50,000 each year. Fully two-thirds of the lost revenue from preferential rates goes to this same privileged group in our population.

In light of these figures, it is imperative that Congress move now to end the tax exemption accorded to gains on property transferred at death. Last September, I introduced legislation to achieve this result. I believe the bill—S. 2345—represents a sound proposal from which this Committee can develop fair and effective rules to terminate this gaping tax loophole. The proposal would impose the income tax on all gains in property transferred at death or by gift after March 31, 1976.

The proposal represents a balanced and gradual approach to the capital gains at death problem:

All gains up to December 31, 1975 will be exempt from the tax; then the new system will be phased in gradually. Thus, the reform will not reach back to gains occurring in the past or unsettle estate plans already in effect. But it will close this flagrant loophole for the future.

A basic $60,000 exemption will be available, so that decedents with relatively small amounts of gains will not be subject to the tax.

All transfers between spouses will be exempt.

All transfers to charity will be exempt.

Special rules will apply to owners of farms and small businesses with liquidity problems, to insure that the tax does not force an unwanted sale of property in the estate.

The capital gains tax will be a deduction for estate tax purposes.

Accrued losses at death will be allowed as income tax deductions.

Tax Shelters

"Tax shelters" have become a new American way of life for wealthy individuals in this country in tax brackets of 50% or higher. There is hardly an area of economic life that tax shelters have not infected in recent years.

They are used in farming, from cattle to azalea bushes.

They are used in drilling for oil and gas.

They are used in motion pictures, from family-oriented films to hard-core pornography.

They are used in real estate development, from motels and shopping centers to commercial high rises and beach-front condominiums.

They are used in equipment leasing, from oil tankers that are too big to dock in American ports, to boxcars for the railroads and 747's for the airlines.

They are used for professional sports franchises from the machinations that may be keeping baseball out of Washington to the Atlanta Falcons case now in Court.

Tax shelters cost the Treasury billions of dollars annually in lost revenues. And all of this tax subsidy goes to investors in the top tax brackets. Indeed, most of the handsome multi-colored brochures advertising tax shelter investments caution that prospective investors should consider the shelter only if they are in the 50% bracket or higher.

Studies of tax shelter transactions show the significant waste of federal funds instead in these transactions. Much of the federal tax expenditure is siphoned off—in lawyers' fees, accountants' fees, brokers' fees, computer fees and "commissions" to those involved.

In some real estate transactions for example, as much as 40% of the federal tax spending goes not to actual construction costs, but to these parasites in the syndication process by which tax shelters are packaged and sold to wealthy investors.

Congress can and should provide Federal aid to some of the economic activities in which tax shelters now operate—low income housing, for example. But we owe it to the average taxpayer to spend the funds in a way that achieves the real objective of the federal aid, and does not create hordes of "tax millionaires" in the process.

The existence of tax shelters also generates significant distortions in the economy. Tax shelters in farming, for example, have artificially driven up the price of land; they have accentuated the boom and bust cycles for legitimate cattle ranchers and citrus growers.

The heart of this aspect of the problem is that many tax shelter deals do not need a real economic profit to make money for the invstors—the profit is derived from the tax savings alone. Obviously, legitimate businesses that have to make a real economic profit find it difficult to compete with such "tax profit" operations.

I urge the Committee to adopt strict measures to stop these tax abuses.

Specifically, I propose that in the case of limited partnerships—the primary legal form used to market most syndicated tax shelter deals—the investor's tax deductions should be limited to his actual financial risk. If an investor puts $10,000 of his own funds into a tax shelter limited partnership, he should not be able to take more than $10,000 in tax deductions from the shelter. Present rules, however, permit the limited partner to deduct amounts attributable to non-recourse financing, where the investor has no liability for the borrowed funds. By limiting the deductions for limited partners to their investment at risk, we can end the leveraging by which tiny investments are passed through the Internal Revenue Code and transformed into huge tax savings.

In addition, the House bill includes a measure—the limitation on artificial losses (LAL)—that will supplement my proposal. LAL is intended to prevent the use of artificial deductions generated by tax shelters; under present law, these deductions can be used to offset or eliminate tax liability on income from other actiivties—doctors' and dentists' fees, executive compensation and other high salary and high income individuals.

The "at risk" limitation I have proposed is directed at the leverage abuse in tax shelters. LAL is directed at the deferral abuse that occurs when artificially large deductions from one activity are used against income from totally different sources.

The LAL provision in the House bill represents an appropriate response to the tax shelter problem. I am, however, proposing several modifications to insure that it constitutes an effective limitation on these operations. Of course, LAL is complex. But tax shelter transactions themselves are among the most complex business transactions in the country. The Committee should not be deferred by objections based on LAL's complexity. The objective is clear. I am satisfied, after consulting with many experts knowledgeable in the field, that LAL represents a proper, timely, and effective response to the abuses created by tax shelters.

Other Proposals Affecting Upper Income Taxpayers

I also urge the Committee to adopt reforms in the following areas:

We should curb "expense account living" by denying a deduction for first class air travel and for attending certain conventions outside the United States.

We should provide proper tax treatment for beneficiaries of accumulation trusts, by requiring that they employ a correct method of computing tax liability. We should also impose an interest charge on tax liability deferred through the use of such trusts.

These various proposals, if enacted, will represent a major step by Congress toward insuring that our progressive tax system is fair to every taxpayer. High income individuals and corporations must pay their way if the Internal Revenue Code and our self-assessment system are to deserve the confidence of millions of ordinary American taxpayers, who pay too much because others pay too little.

PROPOSALS TO PROVIDE GREATER EQUITY FOR LOW AND MIDDLE INCOME INDIVIDUALS

Refundable Child Care Credit

The House took a significant step toward greater equity by converting the present child care deduction into a tax credit. Under the House bill, the credit would equal 20% of child care costs, with a ceiling on the credit of $400 for one child and $800 for two or more children.

The House provision eliminates the "upside-down" effect of the current deduction, which gives much greater benefits to working parents with $35,000 income than to those with $10,000 income. Under the credit mechanism, all working couples with the same amount of child care costs will receive the same benefit, regardless of income.

But the House bill leaves a glaring inequity in the proposed credit. It is not available to those who need it most. The credit goes only to working parents who have a tax liability. All working parents below the poverty level are excluded from the benefit.

To remedy this inequity, the Commitee should amend the child care credit to make it refundable. Parents with child care costs could obtain a tax refund of $200 or $400, if their income was not sufficient to incur a positive tax liability. This action would parallel the recent Committee and Senate action putting the WIN tax credit for child care facilities on a refundable basis.

Earned Income Credit

The refundable earned income credit is a reflection of the genius of the Chairman of this Committee. It is an imaginative and useful tax response by Congress which encourages low income Americans, trying to work their way out of poverty status, by alleviating the burden of Social Security taxes they have to pay.

The credit is equal to 10% of earned income, up to $4,000 of income; it gradually phases out by $8,000 of earned income. In general, the amount of the credit offsets the amount of Social Security taxes paid by low income workers.

As presently structured, the credit is typically available only to couples with dependent children. I urge the Committee to expand the eligible class to include married couples, even if they have no children. Indeed, if revenue constraints permit, I hope the Committee will give serious consideration to extending the earned income credit to single persons working on a substantially full time basis.

PROPOSALS TO PROVIDE MORE RATIONAL AND EQUITABLE RULES FOR CAPITAL FORMATION AND BUSINESS OPERATIONS

The Budget Reform Act is now requiring Congress to develop more efficient ways to deal with the critical fiscal issues facing the country. As I have mentioned earlier, the terms of the Act make clear that federal spending programs through the tax system must be subjected to the same critical scrutiny and control already being given to direct spending programs authorized by Congress.

This means that these tax spending programs must be examined in light of the questions we normally ask of other spending:

Is there a need for any federal subsidy at all? Are free market mechanisms truly inadequate to meet the problem?

If so, what is the most efficient way to meet the need? Direct grants? Low interest loans? Loan guarantees? Or, tax subsidies?

If the tax spending or other routes are selected, are the benefits of the program equitably distributed?

I have applied these criteria to the tax expenditure programs, discussed above, that primarily affect individuals. The proposals I have offered are intended to assure more efficient and more equitable operation of those programs.

It is equally necessary that the Senate examine in the same way the tax expenditures used to stimulate capital formation and to aid certain business operations. My own analysis leads me to recommend a number of changes that will make our present tax spending programs for business more rational, more equitable, and more beneficial to the economy as a whole.

Capital Formation

In the recent past, the investment tax credit has been the primary method by which the federal government has encouraged business to invest in capital equipment. The credit has served its purpose reasonably well. It has been an effective tool in stimulating the purchase of machinery and equipment.

But the tool must be sharpened if it is to meet the nation's modern needs. I therefore propose that the investment credit be modified in the following specific respects:

The basic credit (which is presently scheduled to revert to 7% in 1977) should be extended at a flat rate of 10%.

Beginning in 1977, an additional 5% credit should be provided for incremental investment above a three-year average base period level.

Beginning in 1978, the full 15% credit should be made refundable.

The "incremental credit" feature of the proposal recognizes the need to stimulate increased capital investment to create new jobs. The "refundable" feature will provide needed assistance to new businesses, to those undergoing temporary economic losses, and to non-profit organizations such as hospitals, colleges and universities, which also deserve the benefit of this incentive.

To help provide the revenue for this more efficient and more equitable investment credit, Congress should repeal the Asset Depreciation Range (ADR) system, which was unwisely enacted in 1971. There is broad agreement among economic experts that the investment credit—with the changes I have proposed—will be a more efficient and effective stimulus to capital investment than accelerated depreciation gimmicks like ADR.

I also believe that the refundable, incremental investment credit I am proposing will constitute a valuable resource for small businesses, especially those that are in their formative stages of development.

In addition, I urge the Committee to approve the House action in extending for another two years the tax reductions for small business. I know that the lower tax rate and higher surtax exemption have been extremely beneficial to many small businesses in my own region of New England and in many other sections of the country. Too often, when tax incentives have been enacted in the past, small business has been left out. The measures in the Tax Reduction Act of 1975 have been of useful value, and they deserve to be extended.

With the price of oil continuing at astronomic levels, the time has come to end the major federal tax subsidies for oil and gas. The Congress should take the following specific steps:

Require capitalization of intangible drilling and development costs.

Require "recapture" of the tax benefits in cases where property subject to the intangible deduction is subsequently sold at a gain.

Phase out the 2000 barrel per day exemption from repeal of the percentage depletion allowance.

Reduce the tax credit for foreign oil income to 48%.

Multinational Corporations

We must also revise the rules that provide "tax favoritism" to American corporations doing business overseas. I believe that America and American business will benefit together if our tax rules are neutral as between enterprises that operate entirely in the United States and those that operate through subsidiaries abroad.

The Senate should once again—as it did in 1975—vote to end the present tax deferral on income earned by foreign subsidiaries of U.S. multinational corporations. We need jobs in the United States. We should not be encouraging American companies to go abroad to hire foreign workers, when unemployment is over 7% at home.

The Senate should also repeal the DISC tax benefit. This subsidy is a Treasury-spawned tax loophole enacted in 1971. It has proved to be an almost complete waste of taxpayers' money—now costing the Treasury $1.5 billion a year. The House Budget Committee, after an extensive study, concluded that DISC has created few if any jobs for American workers. The AFL-CIO has reached a similar conclusion. Congress can think of better ways than DISC to spend $1.5 billion to create new jobs.

Estate and Gift Tax Reform

Finally, comprehensive estate and gift tax reform is long overdue. Not since 1942 has a complete review of the entire system been undertaken by Congress. It is encouraging that the Ways and Means Committee has this week begun hearings on this important subject.

If the Committee decides to include estate and gift tax reform in the pending bill, I would appreciate the opportunity to appear at a later date to present detailed views on the steps I believe we should take to insure a fair and effective transfer tax system. I have outlined some of these points in the "detailed" portion of this statement.

69-460 O—76——15

I strongly urge the Committee, whatever action it takes on broader issues of the estate and gift tax laws, to reject outright the President's proposal to increase the estate tax exemption from $60,000 to $150,000. This proposal—ostensibly intended to help small farmers—would severely undercut the effectiveness of our estate and gift tax laws.

If the Committee does wish to take action at this time to alleviate liquidity problems of farm owners, I would suggest a proposal to achieve this goal, without impairing the basic structure of the transfer tax system. Under the proposal, farmers would be entitled to transfer "development" rights to charitable or governmental organizations. In this manner, the land would be valued at its farm value, not its development value for estate tax purposes, and the goal of preserving the nation's open spaces would be enhanced.

CONCLUSION

Let us resolve that "Always a bridesmaid, never a bride" shall not be the epitaph of tax reform in Congress in 1976. The lobbyists and their clients are at the altar now, as always in the past. And for many years, they have taken the bride away in the form of massive subsidies for their interests.

For too long, tax reform has been a failing movement in Congress. Our perennial promises of reform have a hollow ring by now to taxpayers weary of the rhetoric and cynical about their government. We have the tools and the knowledge to fulfill the promise now. The only doubt is whether we have the will.

Mr. Chairman, I submit these tax reform proposals to the Committee in a spirit of constructive cooperation. I stand ready to work with the members of the Committee and all other Senators to insure that a major tax reform bill is on the President's desk before election day.

KENNEDY TAX REFORM PROPOSALS—ESTIMATED FISCAL YEAR REVENUE EFFECTS OF PRINCIPAL RECOMMENDATIONS

[In billions]

Item	1977	1981
Minimum tax reform:		
Individuals	$2.587	$3.772
Corporations	.527	.691
Repeal of maximum tax	.665	1.205
Capital gains at death	.010	.350
Limitations on tax shelters	1.810	1.958
Restrictions on expense account living	.100	.637
Refundable child care credit	(−).365	(−).470
Earned income credit		(−).815
Investment credit reform/ADR repeal		(−)4.500
Oil and gas operations	.280	2.720
Multinational corporations	1.564	2.065
Estate tax revision for farm operations	(−).050	(−).190

I. PROPOSALS TO INSURE THAT UPPER INCOME INDIVIDUALS PAY THEIR FAIR SHARE OF INCOME TAXES

A. The Minimum Tax

Background.—The minimum tax was enacted in 1969 as a measure to insure that high income individuals in the United States paid a fairer share of the tax burden. While sound in purpose, the performance of the minimum tax in accomplishing this goal has been disappointing. Its relative ineffectiveness has been occasioned by several structural defects:

1. The rate of the minimum tax is too low.
2. The exemption from minimum tax is too high.
3. A deduction against minimum tax liability is allowed for regular taxes paid.
4. A carryover of unused regular income taxes is permitted.
5. The minimum tax base does not include a number of items of tax preference.

The House bill made a number of desirable changes in the minimum tax as it applies to individuals. The minimum tax rate would be increased from 10% to

14%; the exemption would be reduced from $30,000 to $20,000 (the exemption phasing out on a dollar-for-dollar basis as tax preferences exceed $20,000, so that the exemption would vanish entirely at $40,000 of tax preferences); the deduction for regular taxes paid and the carryover of unused regular taxes would be eliminated; and new tax preference items would be added to the minimum tax base, notably (1) the excess of deductible intangible drilling and development costs for nonexploratory oil and gas wells over the amount that could have been deducted had such costs been capitalized, and (2) itemized personal deductions in excess of 70% of adjusted gross income.

Proposals For Reform.—Provisions contained in the House bill are fundamentally sound, but need to be strengthened in order that the minimum tax can realize its full potential.

1. The 14% minimum tax rate, the repeal of the deduction for regular taxes paid, and the repeal of the carryover of regular taxes must apply to corporations. There is no reason why the loopholes involved in the deduction for regular taxes paid and the carryover for regular taxes paid should continue for corporations while being eliminated for individuals. The House bill raised the minimum tax rate to 14% for individuals since that is the starting tax rate under the regular individual tax structure. Logically this should mean that the minimum tax rate for corporations should be raised to 20%, the starting rate of tax for corporate taxpayers. At the least, the minimum tax rate for corporations should also be increased to 14%, thus maintaining the parity between the two types of taxpayers.

2. For individuals, the exemption from minimum tax should be reduced to $5,000, with the $5,000 exemption being phased out dollar-for-dollar as tax preferences rise above $5,000 (so that the exemption would disappear entirely at $10,000 of tax preference income). Although the House action in reducing the $30,000 exemption to $20,000 (with a phase-out) is a step in the right direction, it does not go far enough. In view of the fact that the minimum tax applies only to individuals with large amounts of economic income, one can question whether any exemption should be provided at all. However, a maximum $5,000 exemption should apply to individuals. This is approximately the amount of exemption that is provided for a family of four with poverty level income. It does not seem necessary to provide a larger exemption for tax preference income of wealthy individuals than is provided for the earned income of poverty level workers.

3. There should be no exemption from the minimum tax for corporations. Whatever reasons of alleged administrative convenience justify an exemption for minimum tax purposes for individuals, none of these are applicable to corporations. There is no personal exemption for corporations and these business entities are fully capable of having their accountants compute minimum tax liability from the first dollar of tax preference income, just as they compute regular tax liability from the first dollar of taxable income.

4. The minimum tax base both for individuals and corporations should include the excess of the intangible drilling and development expenditure deduction over the amount that would have been allowed had the expenditure been capitalized and recovered through cost depletion. All intangible deductions should be subject to the minimum tax, both with respect to exploratory as well as development wells.

The amendments to the minimum tax should apply to tax preferences for taxable years beginning after December 31, 1975. Carryover of unused regular income taxes from prior years should not be allowed to offset tax preferences for years after December 31, 1975. It is estimated that the proposed changes in the minimum tax will increase revenues by $2.587 billion for fiscal 1977, and $3.772 billion for fiscal year 1981.

B. Repeal of 50% Maximum Tax on Earned Income

Background.—As part of the Tax Reform Act of 1969, Congress provided a new "maximum tax on earned income." Under Section 1348 of the Code the maximum marginal tax rate applicable to an individual's earned income cannot exceed 50%. The curious justification offered for this preferential rate was to "reduce the pressure for the use of tax loopholes," notably tax shelter activities, by reducing "the incentive to engage in otherwise unprofitable operations and reduce the time and effort devoted to 'tax planning' at the expense of pursuing normal business operations." It is true that the higher an individual investor's marginal tax bracket is, the greater are the financial rewards of engaging in tax shelter operations. But the proper remedy is to deal with the abuses created by tax shelters, not to enact preferential reductions in rates for certain kinds of income. With the adoption of effective measures to curtail the use of tax shelters, the alleged justification for the maximum tax on earned income disappears.

In fact, it appears that the maximum tax has had the effect of increasing the wastage of federal revenues involved in tax shelter operations. Tax shelter investments are now structured to provide a rate of return from their tax benefits sufficient to induce investment by a doctor or dentist whose income is taxed at the special 50% rate. But this means that an additional tax windfall is now produced for the 70% bracket investor because the rate of return provided by the tax shelter is greater than is required to make the investment attractive to him. Thus, the 50% marginal tax rate has only resulted in a restructuring of tax shelter investment packages that has increased their tax escape effects; it has not eliminated them. This restructuring has thus actually increased the revenue loss to the Federal Government from tax shelters rather than decreasing it.

The benefits of the maximum tax are available only to the highest income individuals in the United States. In 1972 the preferential 50% maximum tax was utilized only by 88,000 taxpayers with adjusted gross incomes in excess of $50,000. Thus, this $270 million government subsidy to encourage people not to engage in tax shelter transactions went to only about 1% of the taxpayers in the country. The detailed data show how seriously wrong is this maximum rate. Over 90% of the benefits go to those with earnings over $100,000—42,000 individuals. The inequitable distribution of this federal tax expenditure is illustrated in the following table:

DISTRIBUTION OF BENEFITS OF MAXIMUM TAX—1972

Adjusted gross income	Total number of returns in AGI class	Number of returns claiming maxtax	Total tax savings due to maxtax for AGI class (millions)	Average individual tax savings from maxtax
Under $50,000	76,533,982	0	0	0
$50,000 to $100,000	483,677	46,000	$23.2	$510.00
$100,000 to $200,000	91,707	35,000	103.7	2,925.00
$200,000 to $500,000	19,233	6,000	87.9	14,068.00
$500,000 or more	3,696	1,000	55.8	78,468.00

Source: Internal Revenue Service, Statistics of Income—Individual Income Tax Returns 1972, at 145.

The above table presents a graphic picture of the inequity of the maximum tax. It provides no benefit at all to some 99.9% of American taxpayers. But to those favored few on whom the federal subsidy is bestowed, the benefit is substantial indeed. For the 46,000 individuals with adjusted gross incomes between $50,000 and $100,000, the average benefit from the maximum tax was $510. This figure may be compared to the maximum $400 benefit that is provided to the poorest wage earners in the country through the earned income credit.

But the benefits rapidly rise for those taxpayers who have demonstrated that they are so wealthy that they do not need any federal subsidy. Thus, individuals with adjusted gross income in excess of $500,000 who claimed the maximum tax were provided an average subsidy of $78,468 in 1972. Surely a more effective way of preventing these wealthy individuals from engaging in tax shelters can be found than by giving them a government grant of $78,500 per year.

The inequity created by the maximum tax represents a growing problem. The staff of the Congressional Joint Committee on Internal Revenue Taxation estimates that the revenue loss from this provision will total $665 million for fiscal year 1977 and $1.205 billion by 1981. Assuming the same distribution of benefits as in 1972, this would represent a $130 million tax subsidy in 1977 to those handful of wealthy individuals with incomes in excess of $500,000.

Proposals for Reform.—The maximum 50% tax on earned income should be repealed for all taxable years after December 31, 1975.

Repeal of the provision will increase revenues in fiscal 1977 by an estimated $665 million, and $1.205 billion in fiscal 1981.

C. Capital Gains

Under present law, income which qualifies for treatment as "capital gain" income receives preferential treatment over other income in three ways: (1) tax on the income is deferred until the gain is "realized" (in effect, the taxpayer is given the benefit of an interest-free loan from the Government in the amount of the tax that otherwise would be imposed on the increase in value of the asset each year); (2) when gain is "realized," it is subject to tax at only one-half the normal rates; (3) the gain is permanently exempted from tax if the taxpayer holds the property until death and transfers it to his heirs or beneficiaries.

The preferential rate for capital gain income and the exclusion from the tax base of gain on property transferred at death (or by gift) result in an escape from tax that produces an enormous revenue loss to the Federal Government. The Congressional Budget Office has estimated that, in fiscal 1977, the Federal Government will forego over $13.5 billion in revenue as a result of these two tax preferences for individuals: $6.2 billion as the result of the preferential rate for capital gains and $7.3 billion as the result of the failure to tax accrued gains on property transferred at death.

And who benefits from these tax preferences? As to the benefits from the failure to tax accrued gains at death, almost 42% of the federal revenues involved in this tax preference—over $3 billion— will go to the 1.2% of individuals with adjusted gross incomes in excess of $50,000. Over 78% of the benefits go to the top 25% of income recipients in the country. If the benefits of the preferential rates for capital gains are added in, the total federal subsidy to the wealthiest individuals in the United States—those with over $50,000 of income—for fiscal year 1977 will be over $7 billion.

In light of these data, it seems incredible that there are those who want to see this federal subsidy to the highest income individuals in the United States increased still further by adding new preferences for capital gain income. These proposals move in entirely the wrong direction. Congress must begin to remove the preferences for capital gain income so that this income will be taxed on a parity with other types of income.

The essential first step is to institute a system of taxation of accrued gains on property transferred at death. Necessarily, the accrued gains on property transferred by gift must also be taxed.

1. Taxation of Accrued Gains on Property Transferred at Death or by Gift

Background.—The failure to tax gains on property transferred at death (or by gift) has been labeled by many tax experts as the single greatest loophole in our federal income tax system. The figures above dramatically demonstrate the benefits that failure to tax accrued gains at death confers on the highest income individuals in the country. This failure creates serious and unacceptable inequities in our income tax system. Wealthy individuals are able to pass on appreciated property to their heirs completely free of federal income tax. By contrast, wage earners, whose accumulated wealth is mostly in the form of savings accounts and retirement benefits, must provide for their heirs out of accumulated income which has already been subject to federal income tax. This is not fair. In addition, the present failure to tax capital gains at death—a zero rate of tax—creates highly undesirable economic effects. Economists have noted the "lock in" result of the present rules. Taxpayers are unwilling to sell appreciated assets, even though a sale might be desirable for non-tax reasons, for example, by switching from low yield to higher income producing assets. The present tax rules interfere with the free mobility of capital and thus prevent the economy from realizing the full benefits of an efficient free market system.

Proposals for Reform.—The income tax should be imposed on accrued gains on property transferred at death or by gift.

The tax should be applied only to transfers after March 31, 1976 on gain or appreciation in value that has accrued after December 31, 1975. Under this proposal, property transferred between spouses should not be subject to tax, whether that property is transferred during life by gift or at death. Likewise, property tarnsferred to charity would be exempt from the tax. A special averaging provision would be available to prevent an excessive tax burden from being imposed in the final tax return of the decedent. In addition, as in the case of any other income tax, the capital gains tax itself would be a deduction from the gross estate for estate tax purposes. A special rule should be applied in the case of farms and small businesses, assets which create special liquidity problems. In the case of farms, the farm property should be valued only at its use for farm purposes, under the proposal described more fully in the proposals for estate tax reform set forth below. In the case of small businesses, liberalized rules for the payment of the tax over a period of time should be provided; and the special redemption rules in section 303 of the Internal Revenue Code should be further liberalized so that corporate funds can be made available for payment of federal taxes attributable to ownership at death of stock in closely held businesses.

Under the effective dates proposed above for the taxation of accrued gains on property transferred at death or by gift, the revenues for fiscal 1977 will be increased by an estimated $10 million, a figure which will increase to $350 million by fiscal 1981. The short-term revenue effects of this tax reform proposal are relatively modest because of the transition rule that exempts all pre-1976 appreciation in value from the tax.[1] However, the long-term revenue effects are significant. For example, the Congressional Budget Office has estimated that if present law is continued, the Federal Government will lose over $11 billion in revenue in fiscal 1981 from the failure to tax capital gains at death. It is thus imperative that Congress take action now to end this unjustified tax preference for the wealthy.

2. Deduction of Capital Losses Against Ordinary Income

Under present law, 50% of net long-term capital losses in excess of net short-term capital gains may be deducted against ordinary income, with a maximum allowable deduction of $1,000. Thus, $2,000 of net long-term capital losses will produce a $1,000 deduction against ordinary income (only one-half of the capital losses are allowed to be deducted against ordinary income since only one-half of capital gains are subject to tax). The capital gain preferences described above are so substantial that it is entirely inappropriate to grant further tax relief to holders of capital assets until the rules governing the treatment of capital gains have been brought into line with the treatment of ordinary income. When that occurs, it might then be appropriate to consider increased use of capital losses against ordinary income.

Section 1401 of the House bill should be deleted; there should be no increase in the amount of capital losses that may be deducted against ordinary income.

The House provision would produce a revenue loss of $140 million for calendar year 1976, rising to $352 million by 1981, of which about 75% (or $264 million) would go to those with adjusted gross incomes in excess of $20,000. This additional revenue loss to benefit the highest income individuals in the country is simply not justified at this time.

D. Tax Shelters

Two practicing tax attorneys have described tax shelters as "the Achilles heel of the federal income tax" if their use is not brought to an end. It is therefore heartening that the House bill proposed to take action to limit the abuses created by tax shelters. The Senate Finance Committee should adopt the basic approach of the House bill, but it does need to add some further provisions to insure that the House-passed measure in fact will constitute an effective deterrent to the use of tax shelters. Although there are many kinds of tax shelters, certain essential ingredients are present:

(1) The deferral of federal income taxes that results from special provisions (or improper methods of accounting) that accelerate deductions into the early years of an investment in amounts in excess of the income from the investment.

(2) The shelter resulting from the ability to deduct the artificial tax "losses" thus created against income other than that derived from the investment, for example, doctors' or lawyers' fees, executive compensation, and the like.

(3) The enhancement of the deferral and shelter benefits by the use of leverage, that is, using borrowed funds on which the investor may have no personal liability at all.

(4) And, in some types of tax shelters, the realization of capital gains upon the ultimate sale of the property.

---

[1] Alternative transition methods may be considered by the Committee. For example, the new tax could be phased in over a 10-year period. Thus, 10% of the total accrued gain in the property could be taxed for those transferring property at death or by gift in 1977, 20% for transfers in 1978, and so on.

The effect of each of these elements of the tax shelter can be readily seen from the following simplified example. Suppose that an individual on December 1, 1976 invests $200,000 in an oil drilling venture. If those funds are expended on intangible drilling and development expenses by December 31, 1976, the investor will be entitled to deduct the full $200,000 in 1976. Under the rule applicable to ordinary businesses, this $200,000 expenditure would have to be capitalized and recovered ratably over the life of the property. Typically, in the case of oil wells, this would be a period of about ten years. Thus, the artificial deduction for intangible drilling and development expenses permits the investor to deduct $200,000 in 1976, rather than only $20,000 as would be permitted under proper capitalization rules. Since the oil well does not produce any income in the year of investment, the second aspect of the tax shelter—the ability to use the artificial tax "losses" against non-oil income—is necessary for the investor to enjoy the full benefit of the tax shelter. Thus, present rules permit the investor to deduct the $200,000 against other income. If the investor is in a 70% tax bracket, this means that in 1976 he will pay $140,000 less in taxes than otherwise would have been the case (70% × $200,000).

But the transaction can be made still more attractive to the investor by adding the third element of the tax shelter—leverage. Suppose that instead of being required to invest the full $200,000 from his own funds, the investor can obtain a non-recourse loan of $100,000 so that he is only required to utilize $100,000 of his own funds. Under present rules, the tax benefits remain the same. That is, the investor gets to deduct the full $200,000, even though he has no personal liability whatsoever to repay the $100,000 non-recourse loan. Note what has happened now: By virtue of the tax benefits alone, the investor has not only recovered the full $100,000 of his own money that he actually invested, but $40,000 in addition. Finally, if the oil well is ultimately sold at a gain, the investor, although he has deducted the intangible drilling costs entirely against ordinary income, will only be required to include one-half of the gain in his income tax base.

These startling tax benefits are available only to the high income individual. Indeed, brochures advertising tax shelters clearly state that they are tailored only for the individual who is in a 50% income tax bracket or higher.

Although the particular rules and the tax benefits very somewhat from tax shelter to tax shelter, the foregoing describes the basic operation of all tax shelters whether they be in oil and gas, equipment leasing, real estate, vineyards, vegetables, azalea bushes, motion picture films, or sports franchises.

Of course, it is not usually possible for a single person in one of the tax shelter operations to use all of the tax "losses" that are artificially generated by present special tax rules. Thus, we have seen the "syndication" of tax shelters, primarily through the sale of interests in tax shelter limited partnerships. Through this syndication device, the special tax benefits applicable to the particular shelter can be divided up and sold to individual investors. The volume of offerings registered with the Securities and Exchange Commission supplies dramatic evidence of the burgeoning growth of the tax shelter industry. And, of course, these public offerings are only the tip of the iceberg since the vast majority of tax shelter deals are structured in such a form as not to require registration with the Securities and Exchange Commission.

It is essential that the Senate adopt provisions that effectively curtail the different elements that are utilized to create an effective tax shelter.

1. Restrictions on Limited Partnerships Used as Tax Shelter Investment Vehicles

Background.—The principal method of marketing interests in tax shelters is the limited partnership. The primary reason for the use of the limited partnership arises from the fact that a limited partnership can pass through the benefits of "leverage"—and the tax losses attributed to it—to the individual partners. Technically, this result is achieved by permitting limited partners to include in the basis of their partnership interests their ratable share of non-recourse borrowing obtained by the partnership itself. Since an investor-limited partner's basis in his partnership interest determines the amount of the deductions from the partnership operations that he can take against his other income, the rule is crucial to a successful tax shelter limited partnership.

For example, suppose each of ten investors puts $10,000 into a real estate tax shelter limited partnership, for a total capital investment of $100,000. The limited partnership then borrows $900,000, on a non-recourse basis, to construct a building. Under the present Treasury regulations, each partner is entitled to include his allocable share of the non-recourse financing in his partnership basis ($90,000), so that his partnership basis is $100,000. This regulation insures that the investor-limited partner will be able, on an investment of $10,000 of his own funds, to deduct from his other income a total of $100,000 of partnership tax "losses" that are generated by special tax preferences, notably construction period interest and taxes and accelerated depreciation.

Although the rule that an [illegible]ual may include non-recourse financing in his tax basis perhaps may [illegible] for individual operators, it is not the correct rule for investors who [illegible]ited partners. Congress has recognized this fact in a similar situation [illegible] it has provided that investors in subchapter S corporations are entitled to include in their tax basis only the amount of their actual investment in their stock in the corporation. They may not include in their stock basis non-recourse borrowing engaged in by the corporation and, as a result, they are not entitled to take deductions against other income that are attributable to that non-recourse financing.

Proposals for Reform.—Two basic reforms are required to limit the use of limited partnerships as vehicles for syndicating tax shelter investments.

a. *Limitation on the tax deductions of a limited partner to the actual investment at risk.*—The same rule that Congress has applied to subchapter S corporations should be applied to limited partnerships. This step is appropriate because limited partners occupy very much the same relationship to their investment as do stockholders in a subchapter S corporation. That is to say, limited partners do not have any liability resulting from partnership operations such as tort liability, wage claims, and the like. Since the liability of a limited partner is restricted very much in the same manner as is that of a stockholder, it is appropriate to apply the rules developed for investors in a subchapter S corporation to investors in limited partnerships.

Therefore, the Treasury Regulation permitting limited partners to include non-recourse financing of the partnership in their partnership basis (thus permitting the limited partners to obtain deductions attributable to the non-recourse financing) should be repealed. Limited partners should be able to obtain tax deductions only to the extent that their own funds are actually invested in the partnership operations (or to the extent they have full personal liability for partnership borrowing). This will put investors in limited partnerships on a tax parity with investors in subchapter S corporations.

b. *Accrual method of accounting for publicly held limited partnerships.*—As a second measure to bring limited partnerships into tax parity with other business operations; the Senate should require all limited partnerships in which interests are offered for public sale to use the accrual method of accounting. In some kinds of tax shelter operations—notably in agriculture and motion pictures—the cash method of accounting is permitted under present rules, even though proper accounting rules applicable to other kinds of business operations would require the use of the accrual method of accounting. The use of the cash method of accounting in these tax shelter operations results in an acceleration of deductions as compared to business operations that must match expenses with the income actually generated from the business operations.

The cash method of accounting may be justified in relatively simple business operations such as small farms where use of the more complex accrual method of accounting might be burdensome. However, this justification has no relevance whatsoever to limited partnerships engaging in syndicated public sales of interests in the partnerships. These limited partnerships employ the most knowledgeable attorneys, accountants, computer experts, and underwriters to market the interests in their tax shelters.

It is ludicrous to assert that such syndicated limited partnerships need a "simple" method of accounting when the basic business operation in which they are engaged is one of the most complex in the entire business spectrum.

A "publicly owned limited partnership" includes (1) any limited partnership in which an interest in the partnership has been offered for sale in an offering required to be registered with a Federal or State agency having authority to regulate the offering of securities for sale; (2) any limited partnership in which more than 50% of the losses during any period are allocable to limited partners; and (3) any other enterprise if at any time an interest in the enterprise has been offered for sale in a registered offering or if the allocation of losses in the enterprise is similar to an allocation of more than 50% of the losses to limited partners. (This definition of a "publicly owned limited partnership" is derived from the definition of a "farming syndicate" contained in § 101 of the House bill.)

c. *Effective dates.*—The changes proposed with respect to the tax treatment of limited partnerships should be applicable to all limited partnerships formed after April 1, 1976. However, in the case of limited partnerships engaged in the construction or rehabilitation of low-income rental housing, the changes should not be effective for limited partnerships formed prior to January 1, 1981. The effective date should be deferred for limited partnerships engaged in low-income rental housing projects because virtually all low-income housing being constructed or rehabilitated in the United States today is being carried on through tax shelter limited partnership vehicles. While there is substantial evidence that this method of financing the construction of low income housing by the Federal Government is an inefficient and inequitable mechanism and a clear tax abuse, nonetheless, because of the inertia of the reliance on this tax abuse, there is no other method presently available in our housing programs to insure that adequate low income housing will be built. It is imperative to develop means of providing federal assistance for the construction of low income housing that do not rely on this tax shelter abuse.

Accordingly, Congress should require the Congressional Budget Office, in cooperation with the Joint Committee on Internal Revenue Taxation, the Senate and House Committees on Banking and Housing and the Department of Housing and Urban Development, to submit to the Congress by not later than June 30, 1977, methods for providing Federal assistance to low income housing construction that do not involve tax abuse. If Congress has not enacted an effective and fair alternative method by December 31, 1981, present tax rules for low-income housing must be continued. Unfortunate though the situation may be, Congress cannot remove present tax benefits for low-income housing until such time as it has enacted an effective method that insures an adequate supply of housing for low-income persons in this country without creating tax preferences.

If LAL is adopted, the revenue effect from the proposals to limit the use of limited partnerships as tax shelter vehicles will not have an appreciable effect on revenues. If these proposals are adopted in lieu of LAL, the revenue gain from LAL attributable to its application to limited partners would be realized by these proposals.

2. *Limitation on Artificial Losses (LAL)*

Background.—Section 101 of the House bill contains a provision to impose a "limitation on artificial losses" (LAL). This provision is intended to deal with the second element of the tax shelters outlined above, i.e., the ability to deduct artificial "losses" generated by a tax shelter investment against other incomes such as doctors' and lawyers' fees, executive compensation, investment income and the like. In general, LAL provides that special accelerated deductions that result either from preferential deductions or the improper use of the cash method of accounting can only be used to offset income generated by the tax shelter investment itself. Thus, if a tax shelter investor's "artificial deductions" in the first year of his investment exceed the "net related income" generated by the investment, he will not be permitted to deduct the artificial deduction against other income. Instead, the deductions must be placed in a deferred deductions account. These deferred deductions can be deducted in subsequent years when the investment actually produces income. LAL is thus designed to prevent special deductions granted for a particular type of investment from being used to reduce income taxes on totally unrelated income. The LAL approach is an effective means of reaching tax shelters generally and should be adopted by the Senate. However, important improvements need to be made in the House version of LAL in order that it will be fully effective as an anti-tax shelter mechanism.

a. *Application of LAL to corporations.*—In the House bill, the limitation on artificial losses provision is applicable only to individuals. It is true that the use of tax shelters produces the greatest distortion in the individual income tax system. However, it is essential to apply LAL to corporations in order to prevent the shift of tax shelter operations from individuals to corporations.

Past experience demonstrates that unless LAL is applied to corporations, tax shelter operations will simply be conducted in corporate form as opposed to limited partnership form as at the present time. For example, in the Revenue Act of 1971, Congress provided that the investment credit could not be claimed by individual lessors of machinery and equipment. This action was taken because of the use of the investment credit in equipment leasing tax shelter operations, primarily conducted in limited partnership form. However, corporate lessors were permitted to continue to obtain the benefit of the investment credit.

As a result, virtually all of the tax shelter operations involving the investment credit—primarily equipment leasing—were shifted from limited partnerships to corporations, mostly banks. Data filed with the Securities and Exchange Commission reveal that the use of equipment leasing tax shelters by banks completely undercut the tax reforms enacted in 1969 which were intended to bring the effective rate of taxation for commercial banks up to that of other businesses. If LAL is not made applicable to corporations, the same results can be expected to follow in other tax shelter operations. Banks and other corporations will move into such tax shelter operations in housing, and Congress will merely have shifted the inequities of tax shelters from the individual income tax system to the corporate tax system.

The limitation on artificial losses (LAL) provision should be applied to corporations with the same effective dates as are specified in the House bill. The effect of applying LAL to corporations will result in a revenue increase in excess of the House provision of $380 million in fiscal 1977, rising to $500 million by fiscal year 1981.

b. *Denial of double benefit for long-term capital gains.*—Under Section 101 of the House passed bill, accelerated deductions can be deducted aganist "net related income" from the tax shelter investment. The House bill includes in "net related income" the full amount of long-term capital gains. Thus, accelerated deductions can be taken to the full extent of such gains. However, the House bill provides that such long-term capital gains can then qualify for the alternative tax or the 50% deduction in sections 1201 and 1202 of the Code. This is not the proper result. Under the House bill, an individual investor could realize $100,000 in long-term capital gains from qualifying LAL property. He would be entitled to offset this $100,000 of gain with $100,000 of accelerated deductions. However, the investor also would then be permitted, in computing his actual taxable income, to obtain the 50% deduction against capital gains allowed under section 1202 of the Code. Thus, the $100,000 in long-term capital gain would generate a total of $150,000 in deductions—$100,000 in accelerated deductions permitted under LAL and the additional 50% deduction allowed for long-term capital gains under section 1202 of the Code.

The proper result is to provide that if long-term capital gains are included in "net related income," the alternative tax and the 50% deduction for long-term capital gains cannot be employed by the taxpayer with respect to that same gain. This is the result reached by the House bill in the limitation imposed on the deduction for non-business interest in § 206 of the bill.

The effective dates for this revision in the "net related income" definition should be the same as those specified in the House-passed bill. The effect of the change will be to increase the revenues from LAL by less than $5 million in fiscal years 1977 and 1981.

c. *Definition of "LAL real estate property."*—In the case of most of the tax shelter operations covered by LAL, the provision is to be applied on a property-by-property basis. That is to say, accelerated deductions can only be utilized to offset income generated by the particular investment itself. Thus this "property-by-property" rule was aplied to tax shelter investments in farming, oil and gas, equipment leasing, motion pictures and professional sports franchises. In each case, artificial deductions from one investment property cannot be used to offset income genrated by a different investment property. However, this basic rule was not followed in the case of real estate.

Under the House passed bill, an investor in real estate operations is permitted to aggregate all of his real estate investments to determine "net related income." Thus, deductions resulting from building an office building or shopping center can be utilized to offset the income generated by an apartment house in which the taxpayer has also invested. This special treatment of real estate is inappropriate. It favors the largest operators and will encourage certain real estate packaging arrangements designed to take advantage of this loophole.

The LAL rules should be applied to real estate on a property-by-property basis, just as in the case of all other tax shelter operations to which LAL applies. An amendment to achieve this result was offered by Congressman Mikva on the House floor, and was narrowly defeated. The Senate should adopt the proper rule.

Adoption of the property-by-property rule for LAL real property would not have an adverse effect on residential housing. As the distinguished Chairman of the Ways and Means Committee, Congressman Ullman pointed out: "[I]t does not in any way affect the construction of residential real estate during 1976 nor during 1977 if there is a commitment to build the housing in 1976. In addition, it does not affect subsidized low-income housing until 1981 if there is a commitment with HUD by 1979."

As pointed out above, it is critical that there be no changes in the tax rules concerning low-income housing until after Congress has enacted a viable financing method for such housing. However, it is important that correct LAL rules apply to non-residential real estate from the outset and that correct rules governing residential real estate be adopted now, to go into effect for low-income housing tax shelters after Congress has enacted a viable method of financing the construction of low-income housing.

The effective dates for the proposed revision in the rules governing the application of LAL to real estate should follow those specified in the House bill. The effect of the proposed change in the definition of "LAL real property" will be to increase revenues in fiscal year 1977 by an estimated $296 million, and in 1981 by $731 million.

d. *LAL oil and gas rules.*—Although the LAL provisions in the House-passed bill cover accelerated deductions from oil and gas investments, notably the deduction for intangible drilling and development expenses, the provision does not apply to "exploratory" wells. This exception from the LAL oil and gas rules virtually emasculates the provision. According to the most recent data available from the Securities and Exchange Commission, some 2/3 of the offerings in tax shelter drilling funds filed with the SEC ar for exploratory wells. Thus, the House passed version covers only a small portion of the tax shelter oil and gas drilling funds.

It is essential that the Senate amend the House bill. LAL should apply to intangible drilling and development expenses attributable to exploratory wells (and to wells drilled to inject water or other substances to stimulate or increase the production of oil and gas from other wells).

The effective date for this revision should be the same as specified in the House bill for application of LAL to oil and gas wells. The effect of the provision will be to increase revenues by an estimated $1.085 billion in fiscal 1977, and by $344 million in fiscal year 1981.

e. *Treasury authority to develop regulations to apply LAL to other tax shelters.*—The LAL provision passed by the House covers six specified types of tax shelter transactions—real estate, farm operations, oil and gas, motion picture and television films, equipment leasing, and sports franchises. Certainly, these are the major areas in which tax shelter operations are currently being conducted. However, Congress can be virtually assured of the fact that, when LAL is passed, tax shelter experts and their computers will begin devising tax shelters in areas other than the six specified in the bill. It is undesirable for Congress to have to enact a new LAL provision every time a new tax shelter operation is developed by the tax shelter industry.

Accordingly, the Congress should authorize the Treasury to issue regulations applying appropriate LAL rules as and when the Treasury discovers tax shelter operations not specifically covered under the six enumerated in the bill. This authority in the Treasury would be very similar to that contained in section 305 (c) of the Code. Congress there gave to the Treasury the authority to issue regulations covering new financing devices that may be developed to avoid the taxable stock dividend rules adopted by Congress in section 305 (b); those rules covered the transactions known to Congress in 1969.

3. Recapture of Depreciation on Real Estate

Background.—The House bill strengthened the present rules concerning the recapture of depreciation where real estate is sold at a gain. Under present rules, various recapture rules are applicable to different types of real estate:

(1) In the case of commercial real estate, the excess of accelerated over straight-line depreciation is recaptured in full regardless of the length of time the property has been held;

(2) In the case of residential real estate (other than low-income housing), the excess of accelerated depreciation over straight-line depreciation is recaptured in full only if the property has been held for less than 100 months, the depreciation recapture being reduced by one-percent per month thereafter so that there is no recapture of any depreciation if the property is held for more than 16 years, 8 months; and

(3) In the case of low income housing, there is no depreciation recapture if the property is held for ten years or more.

The House bill revised these rules by providing that, in the case of residential real estate other than subsidized low-income rental housing, the excess of the accelerated over straight-line depreciation will be recaptured in full regardless of the length of time that the property was held. Thus, the same recapture rules would apply to residential real estate as currently apply to commercial non-residential real estate.

Proposal for reform.—The House bill represents a step in the right direction. However, it is defective in failing to maintain a differential between commercial real estate and residential real estate. Accordingly, the House bill should be amended to provide full recapture of all depreciation (not just the excess of accelerated over straight-line depreciation) in the case of the sale of commercial (non-residential) real estate. For this class of real estate, the depreciation recapture rules would be the same as those applicable to machinery and equipment under section 1245 of the Code.

With respect to residential real estate (other than low-income housing), the House rules should be adopted.

In the case of subsidized low-income rental housing, present recapture rules should be retained.

The provisions relating to the complete recapture of all depreciation from commercial real estate should apply to depreciation attributable to taxable years beginning after December 31, 1976. The provisions relating to the recapture of accelerated depreciation in the case of residential real estate (other than low-income housing) should apply to accelerated depreciation attributable to taxable years beginning after December 31, 1975 (as in the House bill).

It is estimated that these changes would result in an increase in tax revenues of $11 million in 1977 and $355 million in 1981.

4. Accrual Accounting for Corporations Engaged in Farming

Background.—The Treasury initially granted farmers the right to use the cash method of accounting to simplify bookkeeping for small farm operators. However, the cash method of acounting does not clearly reflect income in situations where inventories are involved, such as crops and animals, and can result in the creation of artificial tax "losses" as a result of the mismatching of income and expenses.

In recent years, corporations have come increasingly to dominate the farm sector of the economy. These corporations are often sophisticated business operations employing the most highly skilled legal and accounting advisors. In many instances, farm corporations have been utilized in tax shelter transactions.

As the House bill properly recognized, it is inappropriate to permit these sophisticated farm operations, conducted in corporate form, to enjoy the benefits of the cash method of accounting intended for small farm operations. Large farm operations conducted in corporate form should be required to use the accrual method of accounting, just as do corporations in other business activities.

However, the House bill does not achieve its obejctive because it excepted subchapter S corporations and "family owned" corporations from the accrual accounting requirement for farm corporations. While an exception to the accrual accounting requirement may be justified for *small* farm operations conducted in corporate form, the exception for subchapter S corporations and "family owned" corporations is not sufficiently refined to achieve this objective. Family owned corporations and subchapter S corporations can be quite large operations. The criteria selected by the House, thus, are not adequate to distinguish those small farming operations, for which the cash method of accounting arguably should be continued, from large farming operations, for which it is plainly inappropriate.

Proposal for Reform.—Accordingly, the Senate should amend the House bill to require all farm operations conducted in corporate form to utilize the accrual method of accounting if the gross sales from farm activities exceed $100,000 per year. According to the Department of Agriculture, this sales level will apply the accrual method to only 115,000 farms, or 3.8% of the total. It requires on the average 2,261 acres to generate $100,000 of gross sales from farm operations. Thus, this proposed rule will permit truly small farm operations to continue to use the simple cash method of accounting. But it will require large corporations, regardless of the form of corporation employed and regardless of the nature of its ownership, to use the correct accrual method of accounting. In addition, this proposed change avoids the necessity for developing the elaborate and complex attribution rules that are necessary under the House bill in order to define what constitutes a "family owned" farm corporation.

The provision should apply to taxable years beginning after December 31, 1975. It is estimated that the reform will result in an increase in corporate tax liability of $28 million in fiscal 1977, and $28 million in 1981.

5. House Provisions That Should Be Adopted by the Senate

The House bill contains a number of other provisions designed to impose limits on the special rules by which tax shelters are created. These provisions are sound and should be adopted by the Senate as passed by the House:

The limitation on the deduction for prepaid interest, under which prepaid interest must be capitalized and deducted in the taxable years to which it is related.

The limitation on the deduction of non-business interest, under which non-business interest in excess of $12,000 per year plus net investment income and long-term capital gains must be capitalized and deducted in later years when investment income is realized. The House rule protects the deductibility of interest on general home mortgages and consumer loans, while insuring that excessive non-business interest is deductible only from investment income.

The limitation of losses with respect to motion picture films, livestock, certain crops, and intangible drilling costs to the amount for which the taxpayer is at risk, whereby tax "losses" will be permitted to be deducted by investors only to the extent that the taxpayer is at risk with respect to his investment. The purpose of this rule is similar to that proposed above whereby investors in limited partnerships would be allowed to deduct partnership "losses" only to the extent of their actual "at risk" investment.

The rules governing the allocation of the consideration paid for the purchase of a professional sports franchise between depreciable player contracts and the non-depreciable franchise, which prevent manipulation by purchasers of sports franchises to obtain greater depreciation deductions than are properly allowable.

The limitation on partnership additional first-year depreciation under section 179 to prevent partnerships from unjustifiably multiplying this special deduction originally intended for small businesses.

The provision clarifying partnership rules as to the proper tax treatment of syndication and organization fees, retroactive allocations of partnership income or loss, and special allocations.

E. Tax Treatment of Accumulation Trusts

Background.—In 1969, Congress enacted badly needed reforms to correct abuses that had developed with respect to the utilization of accumulation trusts by wealthy taxpayers in order to reduce overall family income tax liability. At the extreme, some grantors had created multiple trusts for the same beneficiary or beneficiaries, each trust to accumulate income and then terminate at specified intervals. The trust beneficiaries were thereby assured of periodic distributions of accumulated income and principal of the trust. The tax advantage resulted from the fact that income accumulated by the trust was taxed at rates applicable to the trust, which were frequently much lower than those that would have been paid by the beneficiary had the income in fact been distributed. Thus, the overall tax saving was the difference in taxes that would have been paid by the beneficiary had the trust income been distributed and the income taxes in fact paid by the trust.

To correct this problem, the Tax Reform Act of 1969 strengthened the so-called "throwback" rules applicable to the accumulation trusts. Under the new rules, distributions of accumulated income from a trust to the beneficiary are taxed in the same manner as if the income had been currently distributed to the beneficiary by the trust. In effect, the beneficiary recomputes his income tax liability for the years in which the trust accumulated the income, takes a credit for the taxes paid by the trust, and pays the difference, if any. If the trust paid tax at a higher rate than applicable to the beneficiary in the accumulation years, then the beneficiary generally gets the refund. Similar rules are applied to "throwback" accumulated capital gains for those trusts which are also accumulating ordinary income.

Three problem areas remained after the 1969 legislation:

1. In addition to recomputation of the tax on the beneficiary of an accumulation trust under the "exact method" (described above), the 1969 Act also provided a "short cut" method for computing the benficiary's tax. Unfortunately, the Act imposed on trustees the obligation to compute the throwback tax under the method which resulted in the least tax. This produced an unnecessary complication for and burden on trustees.

2. The 1969 Act failed to impose an interest charge on the deferral of the taxes that is still enjoyed by beneficiaries of accumulation trusts. Thus, even

though the beneficiary of an accumulation trust may owe an additional tax in the year that the accumulated income is distributed, he has nonetheless been able to defer payment of that tax from the year in which the trust income was accumulated until the year it was distributed. No interest is charged on this deferred income tax obligation. The Senate Finance Committee in the 1969 Act did impose an interest rate of 3 percent (nondeductible), but this provision was dropped by the Conference Committee.

3. The capital gains throwback rules apply only to trusts which accumulate ordinary income.

The present House bill did deal with the subject of accumulation trusts, but unfortunately its proposed changes move in the wrong direction from proper tax reform. The House bill would repeal the "exact method" of computing the beneficiary's tax liability on accumulation distributions and retain only a modified form of the "short cut" method. The "exact method" is the only method that produces proper tax liability for the trust beneficiary. Therefore, in order to relieve the bookkeeping problem that has been imposed on trustees as the result of having to make computations under both methods, the Senate should repeal the "short cut method" and retain the "exact method" of computing the beneficiary's tax liability. In addition, the House bill repealed the capital gains throwback rule for accumulation trusts rather than extending it to all trusts. Finally, the House bill did nothing with respect to the tax deferral privilege that is accorded to beneficiaries of accumulation trusts, nor did it take any steps to strengthen the rules dealing with multiple trusts for the same beneficiaries.

Proposals for Reform.—The Senate should amend the House bill in several respects:

1. It should reverse the House action concerning methods of computing the throwback tax. The "short cut method" should be abolished and the "exact method" required in all cases. This will produce the proper income tax liability for beneficiaries of accumulation trusts and will eliminate the need for trustees to compute the tax under both methods as is true under present law. Further, in those cases where the accumulations were made by the trust during years in which its income tax bracket was higher than that of the beneficiary, the beneficiary should be entitled to a refund. Under the House bill the use of the "short cut method" precludes this result. The House bill results both in unjustified tax benefits for some beneficiaries and unjustified tax penalties for others.

2. The Senate should impose an interest charge on beneficiaries of accumulation trusts whose taxes have been deferred as the result of accumulation of the income in their trust. The interest rate should be set at the rate established by the Treasury for all other tax deficiencies. The House bill provides a similar interest charge in the case of foreign trusts—where the problems are much the same.

3. The capital gains throwback rules should be extended to all trusts so that trust benficiaries receiving distributions of accumulated capital gains will be taxed as if those gains had been distributed currently. In some instances this will produce a tax refund for beneficiaries and in other instances it will produce additional tax liability. But in either case, the correct tax will be produced.

The interest charge on deferred taxes should be imposed for all distributions of trust income accumulated after December 31, 1976. The short cut method of computing throwback tax liability should be repealed for all accumulation distributions made after December 31, 1976. The revised capital gains throwback rules should apply to all capital gains accumulations after December 31, 1976.

It is estimated that these proposals will not have a significant effect on federal revenues.

F. Restrictions on "Expense Account" Living

1. Denial of Deduction for Portion of Air Travel Costs Attributable to First Class Fare

Background.—Under present rules, the full cost of first class air fare for business trips is allowed as a deduction. While travel expenses for business purposes certainly constitute a legitimate deduction, the excess of the cost of first class air fare over coach fare is not. It is obviously a legitimate business decision to travel by air as opposed to train or car or bus or ship. But once the decision is made to travel by commercial airline, the business objective of the expenditure is achieved by travelling in coach class. The business executive will travel on the same flight, arrive at the same time, and land at the same destination regardless of whether he travels in the coach or first class section. Thus, only the cost of coach fare is a proper business deduction. The balance of the fare attributable to the decision to fly first class is simply a cost incurred for personal consumption of the business executive. It is a luxury item and should not be allowed as a business deduction.

Proposal for Reform.—The difference between first class and coach fare for air travel should be disallowed as a business deduction. Where an employer pays the travel cost of an employee on a business trip, the reimbursement constitutes taxable income to the employee. Typically, the employee would be entitled to a corresponding business deduction and the transaction thus is a wash for tax purposes. However, under the proposed revision, no business deduction would be allowed to the employee for the difference between the first class fare and coach fare, thus requiring him to include the difference in taxable income with no corresponding deduction. Employers would be required to report the excess of reimbursed first class fare over coach fare as additional compensation income to the employee.

The proposal would be effective for air fares paid or incurred after December 31, 1976. Revenues would be increased by an estimated $60 million in fiscal 1977, and $330 million in fiscal 1981.

2. Limitation on Deductions for Costs of Attending Conventions Outside North America

Background.—One of the more serious administrative problems that has confronted the Internal Revenue Service in recent years is policing the rapid expansion of deductions claimed for attending meetings or conventions outside the United States. While there may be some business carried on in connection with such conventions, the advertising literature put out by the sponsoring organizations tends to emphasize much more heavily the vacation aspects. The proliferation of seminars in exotic vacation spots, and even aboard cruise ships, should not be financed by the United States Treasury. In effect, these foreign conventions become in too many instances tax deductible vacations. For most working people, vacations have to be paid for out of after-tax dollars.

What is needed are clear guidelines that will identify those expenditures for conventions that are primarily business in nature—and hence properly deductible—and those that are primarily personal—and hence nondeductible.

The House bill does contain a provision that attempts to deal with the "tax deductible vacation" problem. The House proposal, however, is not a satisfactory resolution of the problem. Under the House bill, no deduction would be allowed for expenses incurred by an individual in attending more than two foreign conventions in any year. As to the two permissible conventions, the deductible amount is limited to expenses for transportation and subsistence.

The difficulty with the House resolution of the problem is that it is not based on sound tax principles. As to the two conventions for which deductions are permitted, the business connection required is still insufficient. Permitting the deduction for the costs of these conventions held outside the United States in effect continues all the abuses of the present law. On the other hand, the House bill would deny deductions for attending conventions abroad which are legitimately held outside the United States. This is true, for example, in the case of international organizations whose membership is drawn from many countries.

Thus, the basic problem which the Senate should address in dealing with the foreign convention issue is whether there is a legitimate reason for holding a convention outside the United States. If there is no legitimate reason, then none of the expenses of attending the convention should be deductible. On the other hand, if there is a legitimate reason for holding the convention outside the United States, the expenses should be deductible (assuming that the convention is related to the taxpayer's trade or business), and it is not proper to impose a limit on the number of such conventions that can be attended for business purposes each year.

Proposal for Reform.—The deductions for costs of attending conventions, educational seminars and similar meetings outside the United States would be denied. The only exception to this rule would be for costs for attending conventions, educational seminars, or meetings conducted by an organization which has foreign members of a sufficient number and with a sufficient geographical dispersion that it is reasonable for the organization to meet outside the United States. In no event should deductions be allowed for cruises.

The foregoing proposal is based on a tentative decision reached by the House Ways and Means Committee in 1974. This decision represents a sounder approach to the foreign convention problem than the provision contained in the present House bill. The proposed reform should apply to expenses paid or incurred for conventions held after December 31, 1975. It is estimated that this provision will result in increased revenues of less than $5 million annually.

3. Limitations on Deductions for Office in Home and Vacation Home

The House-passed bill contained worthwhile provisions to limit the deductions now being claimed by taxpayers for "offices" in homes and for vacation homes. These provisions correct problems in the present system in an appropriate fashion and should be adopted by the Senate.

G. Broadening of Foundation Management

Background.—In 1969, Congress enacted extensive provisions to insure that private foundations in fact operated for the benefit of charity. Obviously, if the federal government grants income, estate and gift tax deductions for charitable contributions, it is necessary to insure that the federal purpose in granting the deductions is achieved—that is, by prompt and regular disbursement to charity of earnings on foundation endowments.

Thus, the new rules require a minimum payout of foundation income and diversification of foundation investment portfolios. These provisions constituted appropriate actions to insure that the federal objectives in granting tax benefits for charitable contributions were being met. In addition, the 1969 changes corrected certain abuses that had occurred in the management of some private foundations where self-dealing between the foundation and its principal donor or donors was occurring.

The 1969 changes have, by and large, proved effective to assure that, in the rare cases of abuse, private foundations would be required to operate exclusively for public charitable purposes. There is, however, one additional area in which Congress should take action so that the general taxpaying public can be assured that their federal dollars—represented by the federal deduction for charitable contributions—will be spent consistently with broad public objectives.

Proposal for Reform.—The creator of a foundation, and members of the creator's family, would after the first 25 years of existence of the foundation be limited to 25% of the membership of the managing board of the foundation. The creator of the foundation would be defined as any person who has made a substantial contribution to the foundation, controls a corporation which has made a substantial contribution to the foundation, or is the beneficiary of a trust which has made a substantial contribution to the foundation. Members of the family covered by the limitation would include the creator's spouse, brothers, sisters, parents, ancestors, lineal descendants and spouses of such relatives.

Foundations presently in existence would be required to broaden their management in compliance with this provision within the 25-year period or fifteen years from the effective date of this provision, whichever is longer. Foundations organized on or after the effective date would be required to comply within the 25-year period.

This proposal to broaden foundation management will insure that objective evaluation of the foundation's charitable activities will be made by persons other than the creator of the foundation and the creator's family. On the other hand, the 25-year period within which the creator and his family can control the operation of the foundation will provide an adequate time within which to infuse the foundation with the direction and goals to be achieved by it. However, broad public participation in the foundation after the 25-year period will insure that the foundation in fact is addressing itself to current charitable concerns. Since the charitable contribution deduction in effect gives the members of the governing board of the private foundation control over federal funds—as the result of the federal deductions for charitable contributions—it is entirely appropriate that the general public be represented on the board which makes the decisions for spending these funds.

Although the recent Filer Commission study did not make any specific recommendations to restrict donor control of private foundations, the above proposal is consistent with its statement that Congress examine the issue. The Commission did espouse "the general view that openness and accessibility are as important for donor-controlled foundations as for other philanthropic, non-profit organizations. If, in any particular organization, relinquishing a degree of donor control serves to further the cause of greater accessibility, then this course should, we feel, be positively pursued."

The above proposal to broaden foundation management is consistent with the spirit of the Filer Commission Report.

The proposed change should be effective January 1, 1977. Under the transition rule, foundations organized before that date would have 25 years from the date of the creation of the foundation, or 15 years from January 1, 1977, to satisfy the new requirement, whichever is earlier. Foundations created after January 1, 1977 would have 25 years within which to meet the requirements. It is estimated that the proposed change would have no effect on federal revenues.

II. PROPOSALS TO PROVIDE GREATER EQUITY FOR LOW AND MIDDLE INCOME INDIVIDUALS

A. Refundable Tax Credit for Child Care Costs

Background.—The House bill contains a provision to replace the present itemized personal deduction for child care costs with a tax credit equal to 20% of the costs incurred for the care of a child under age 15 or for an incapacitated dependent or spouse, to enable the taxpayer to work. The credit would apply to a maximum of $2,000 in costs for one dependent and $4,000 for two or more dependents, whether the expenditures were for services inside or outside the home. Thus the maximum credit would be $400 for one dependent and $800 for two or more dependents.

The decision by the House to provide federal financial assistance for parents, who must incur child care expenses in order to work, in the form of a tax credit is sound. It moves in the direction of greater equity by providing the same dollar amount of assistance for lower income as for higher income individuals, thus removing the upside-down effect of the present itemized personal deduction. This and other changes in the tax credit adopted by the House should be approved by the Senate.

However, in one respect the House Bill is seriously deficient in its treatment of the credit for child care costs. The credit is not refundable. Therefore the one group that is excluded from any assistance for necessary child care costs is the group that is most in need of federal financial aid—those parents who are presently below poverty level income figures and are trying to work to get out of poverty. It is completely unacceptable to adopt a system providing financial assistance for child care costs that excludes the one group in the United States that is most in need of help. Accordingly, in order to make the credit equitable, the Senate should provide that it be refundable.

Proposal for Reform.—The House provision converting the present itemized personal deduction for child care costs to a 20% tax credit (for expenses up to specified limits) should be adopted by the Senate. However, the Senate should make the child care credit refundable, so that poverty level families who incur child care expenses to work would be eligible for the credit. If necessary to reduce the cost of the refundable credit, the Senate should limit the maximum credit to those with $18,000 of adjusted gross income or less, and phase out the credit by $27,000 of adjusted gross income. In establishing priorities for federal financial assistance, the Senate clearly should decide that those parents whose earned income is still below the poverty level should have priority for federal financial assistance ahead of the top 15% of income earners in the United States, those whose adjusted gross incomes exceed $25,000 per year.

The revised child care credit should be effective for taxable years beginning after December 31, 1975. It is estimated that the provision will result in a decrease in tax liability of $425 million for fiscal 1977, and $540 million for fiscal 1981 (assuming that the maximum credit is limited to $18,000 of adjusted gross income, as proposed).

B. Earned Income Credit

Background.—One of the very worthwhile reforms enacted as a part of the Tax Reduction Act of 1975 was the introduction of a refundable earned income credit. Under this provision, for qualifying taxpayers, a refundable credit equal to a maximum of 10 percent of $4,000 of earned income is provided, with the benefits of the credit gradually phasing out as earned income increases. The credit is due to expire June 30, 1976.

The earned income credit is available only to joint return filers with dependents, or a person filing a head of household return.

Proposals for Reform.—The earned income credit should be made permanent. In addition, the group of those eligible for the credit should be expanded to permit all joint return filers, whether or not they have dependent children, to qualify for credit. Those working at poverty level incomes and trying to get out of poverty status should qualify for the credit, even though they may not have dependent children.

Further, the Committee, if revenue constraints permit, should give serious consideration to extension of the earned income credit to all single persons who are working in substantially full time jobs.

The earned income credit should be extended from July 1, 1976 on a permanent basis. Joint return filers without dependent children should qualify for the credit for taxable years beginning after December 31, 1976.

The proposed reform to increase eligibility will have a minimal effect on revenues for fiscal 1977 and will decrease revenues by $855 million in fiscal 1981 (above the amount of revenue lost from the present earned income credit).

III. PROPOSALS TO PROVIDE MORE RATIONAL AND EQUITABLE TAX RULES FOR CAPITAL FORMATION AND BUSINESS OPERATIONS

A. Treatment of Capital Investment

Background.—The Tax Reduction Act of 1975 provided a 10% investment tax credit for all taxpayers (including public utilities) for property acquired and placed in service after January 1, 1975, and before January 1, 1970. For taxable years beginning after January 1, 1977, the investment credit is to return to 7% (4% for public utility property).

The investment tax credit has been a part of United States tax policy for encouraging investment in machinery and equipment, off and on, since 1962. However, there is increasing evidence that the investment tax credit needs revision to make it a more effective and more equitable tax expenditure program.

For example, there appears to be a consensus among economic experts that a higher investment credit, if based on incremental investment above a base period (for example the average investment for the three preceding years), would be a more effective and efficient stimulus to capital investment. Such a credit will provide assistance to new and expanding businesses.

Further, the investment credit presently is available only to businesses that show a positive tax liability. Corporations experiencing a temporary economic loss do not get any current benefit from the tax credit. It is true that carryovers of unused credits are provided, but this does not provide any immediate stimulus or assistance to newly formed businesses or to those businesses that need a boost to turn a temporarily unprofitable operation into a profitable one.

The fact that the financial assistance offered through the credit is conditional on the existence of tax liability means that organizations such as hospitals and institutions of higher education, which often have large capital needs, cannot obtain the benefit of the credit.

Finally, the investment credit has become quite complex because of the limits and the carryover rules that are a part of the Code. Simplification of the credit is a desirable objective.

Proposals for Reform.—The present 10% investment tax credit should be retained and an additional 5% investment tax credit should be available for incremental investment above the average investment of the business for the prior three-year base period.

The entire investment credit should be made refundable. The refundable feature will enable (1) new businesses and other companies experiencing temporary economic losses, and (2) organizations described in § 501(c)(3) (other than state or local governments or instrumentalities thereof), to be eligible for the investment credit. Present limitations on the amount of the investment credit that can be obtained and the provision for carryovers of unused credits can be eliminated.

The proposed changes in the investment tax credit will have the following beneficial results:

1. The revised credit will provide a powerful stimulus to increased capital investment by business;
2. Businesses with temporary, current losses, especially those just commencing new business enterprises, will be able to obtain an immediate tax benefit from their capital investment, without having to await the generation of a positive tax liability in future years to take advantage of investment credit carryovers;
3. Tax-exempt organizations can be made eligible for the credit, thus providing valuable stimulus and badly needed assistance for the non-profit sector of our economy;
4. The use of the investment tax credit in tax shelter operations, notably equipment leasing, would be substantially reduced. Loss corporations who presently have to "sell" their investment credit in exchange for lower rental rates in leasing transactions will be able to obtain the benefit of the credit whether they lease or purchase equipment. Thus, business decisions can be made on a more neutral basis, with a corporation obtaining the benefit of the tax credit, whether it decides to lease or purchase;
5. Considerable simplification can be achieved by eliminating the limitations and the carryover provisions of present law.

With the proposed changes in the investment tax credit, the "asset depreciation range system" (ADR) should be repealed. That is, the present rules that permit a 20% deviation from guideline lives for assets should be repealed. The use of guideline useful lives would be continued as prior to 1969, with authority in the Treasury to insure that guideline lives correspond to actual business experience. Economists generally appear to agree that accelerated depreciation is a markedly inferior vehicle for stimulating capital investment when compared to a properly structured investment credit. The revenue made available from the repeal of ADR can be used to help fund the proposed 15%, partially incremental, and refundable investment tax credit.

The new tax credit should be phased in over a two-year period. The additional 5% incremental credit should be applicable to all qualifying assets placed in service after December 31, 1976. The refundable credit should be available for all assets placed in service after December 31, 1977. Carryovers of pre-1978 investment tax credits may be used in 1978 and thereafter to reduce tax liability, but such carryovers cannot be utilized to create a refund. The changes in the asset depreciation range system should apply to depreciation on all assets placed in service after December 31, 1976.

As a further modification of the investment credit, the Senate should repeal the present rule that motion picture and television films may qualify for the investment tax credit. The investment tax credit is intended to stimulate investment in capital machinery and equipment. It is not intended to provide financial benefit for the results of personal services. Since virtually all the costs of motion picture and television films result from personal efforts of actors, directors and producers, it is inequitable to allow the investment credit for this particular result of personal effort when it is not available for the result of personal efforts generally, for example, books or works of art. Repeal of the investment tax credit for motion pictures should be effective for motion pictures produced after December 31, 1976.

The increase in revenues from repeal of the asset depreciation range system is estimated to provide increased revenues for fiscal 1977 sufficient to offset continuation of the investment credit at 10% base plus the 5% incremental credit. By fiscal 1981, the net revenue decrease from the two changes would be approximately $2.4 billion. For fiscal 1978, introduction of the refundable feature will result in an additional revenue decrease of $1.8 billion, and for fiscal 1981 of $2.1 billion.

B. Tax Treatment of Oil and Gas Operations

1. Capitalization of Intangible Drilling and Development Costs

Background.—Section 263 (c) of the Internal Revenue Code permits intangible drilling and development costs to be deducted currently. Such costs primarily involve wages and other expenses for non-tangible items in drilling a well. As in the case of other industries, these costs should be capitalized and recovered through cost depletion. For example, wages of workers constitute a significant portion of the cost of constructing a building. But these wages are not immediately deductible; they must be capitalized and recovered through depreciation.

Proposal for Reform.—In the case of oil and gas wells, intangible drilling and development costs should be capitalized and recovered through cost depletion. (Dry hole costs would, of course, continue to be fully deductible on a current basis.) Adoption of this rule would place the oil and gas industry on a parity with other businesses.

Adoption of the proposal to require capitalization of intangible drilling and development expenses would make it unnecessary to apply LAL or the minimum tax to oil and gas operations.

The requirement that intangible and drilling costs be capitalized should be effective with respect to all such expenditures incurred after December 31, 1976. The effect of the proposal would be to increase revenues by an estimated $160 million in fiscal 1977, rising to $2.3 billion by fiscal 1981.

2. Recapture of Deduction for Intangible Drilling and Development Costs

Background.—The House bill provides that, in the event of a sale of an interest in an oil and gas well, the taxpayer would be required to "recapture" as ordinary income a portion of the amount previously taken as a deduction against ordinary income under the special intangible drilling and development expense rule. In other words, if an investor or driller in an oil and gas well has claimed the special deduction for intangible drilling and development expenses and subsequently sells his interest, he must report as ordinary income the gain on the sale to the extent of the excess of the accelerated deductions claimed over the amount that would have been allowable as a deduction had the drilling and development expenditures been capitalized and recovered through cost depletion. The purpose of the rule is to curtail the ability of taxpayers involved in oil and gas operations to deduct intangible drilling and development expenses against ordinary income and then have the gain on the sale of the interest, which gain is a reflection of that deduction, taxable at preferential capital gain rates. A similar rule presently is applied in the case of accelerated depreciation taken with respect to machinery and equipment and to real estate. (IRC §§ 1245 and 1250).

The House bill moves in the right direction in requiring a recapture of a portion of the intangible drilling and development expenses deduction.

Proposal for Reform.—The House provision should be amended to require the full recapture of all intangible drilling and development deductions in the event of a sale of an oil and gas interest at a gain. Thus, recapture as ordinary income should apply not just to the excess of the special deduction over the amounts that would have been deductible had the expenditure been capitalized, but to the full amount of the intangibles deduction previously taken. This latter approach is the rule that applies under section 1245 of the Code in the case of machinery and equipment and that rule should be applied to the intangible drilling and development expenses deduction.

The full recapture rule should apply to dispositions of oil and gas properties in taxable years ending after December 31, 1975, with respect to intangible and development costs paid or incurred after that date (the same as in the House bill). The proposed changes would have a negligible effect on revenues in fiscal 1977, but would increase revenues by an estimated $.3 billion in fiscal 1981.

3. Repeal of 2,000 Barrel Per Day Allowance for Percentage Depletion

Background.—In the Tax Reduction Act of 1975, Congress took a major step by repealing percentage depletion for major oil companies. Unfortunately, however, Congress continued percentage depletion applicable to income derived from the first 2,000 barrels of daily production, a figure which is gradually reduced to 1,000 barrels of daily production by 1980. Although the 2,000 barrel per day exception was justified on the basis that "small business" needed to be able to continue to benefit from percentage depletion, this obviously was a red herring. During 1975, the average price of oil was $8.80 per barrel for independent producers. Thus, at this level gross receipts qualifying for the 22% depletion rate could total $6,424,000 annually. Only two-tenths of one percent of all U.S. businesses have gross receipts of $5,000,000 or more per year. It thus seems obvious that the businesses that are going to continue to benefit from percentage depletion are hardly "small" as the ordinary individual understands that term. Accordingly, Congress should complete the job on percentage depletion.

Proposal for Reform.—Congress should repeal the 2,000 barrel per day allowance for percentage depletion. The 2,000 barrel per day allowance will be gradually reduced to 1,000 barrels by 1980 and then it should be ratably reduced to be eliminated entirely for taxable years beginning after January 1, 1985. The provision would result in no increased revenues for fiscal 1977 over present law, but would produce a long-term revenue gain of $2.0 billion annually.

4. Excess Foreign Tax Credits for Oil

Background.—The Tax Reduction Act of 1975 imposed a limit on the amount of foreign tax credit that can be claimed with respect to income derived from foreign oil extraction. In 1976, the foreign tax credit for oil is limited to 50.4% of foreign oil and gas extraction income, and 50% in subsequent years. Foreign "taxes" in excess of the limit are not allowed as tax credits to reduce U.S. taxes.

The purpose of the 1975 changes was to correct the inequity that had resulted from the ability of oil companies to claim as a credit for foreign "taxes" amounts paid to foreign governments that in fact constituted royalties. Royalty payments, of course, do not and should not qualify for the credit. However, the 50% limit still exceeds the 48% U.S. tax rate.

Proposal for Reform.—The foreign tax credit attributable to foreign oil and gas extraction income should be limited to 48% of such income. Amounts paid to foreign governments in excess of this amount will not qualify for the credit.

The proposed change will be effective for all taxable years beginning after January 1, 1976. The change will increase revenues by an estimated $120 million for fiscal 1977, and thereafter.

C. Tax Treatment of Multinational Corporations

1. Repeal of Deferral of Taxation of Earnings and Profits of Controlled Foreign Corporations and Their Shareholders

Background.—Under present rules, the foreign source income of a foreign corporation is subject to United States income tax only when it is actually remitted to U.S. corporate or individual shareholders as a dividend. Because no U.S. tax is imposed until—and unless—income is distributed to the U.S. shareholders, who are generally corporations, a tax deferral results. An exception to the deferral rule applies to income from so-called "tax haven" activities conducted by foreign corporations controlled by U.S. shareholders. With respect to these tax haven activities, income is deemed distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend.

The benefit of tax deferral is primarily utilized by multinational corporations. By indefinitely retaining earnings in their foreign subsidiaries, the multinationals can avoid or postpone paying income tax for long periods of time or forever. As a result, there is a powerful incentive for U.S. corporations to invest abroad, leading to a loss of capital for domestic enterprise and, judging from the available data, a loss of jobs for United States workers.

The Senate in the Tax Reduction Act of 1975 voted to repeal the deferral privilege and thus tax the income earned by foreign subsidiaries in the same manner as income earned by domestic subsidiaries. The Conference Committee, while tightening the rules somewhat to limit the benefits of deferral, did not adopt the Senate provision.

Proposal for Reform.—United States persons holding a 1 percent or greater interest in a foreign corporation should be taxed currently on their proportionate share of the income from the foreign corporation in cases where more than 50 percent of the stock of the foreign corporation is controlled by United States persons. Appropriate adjustments in the foreign tax credit should be made so that investments abroad and domestically are treated on a neutral basis.

2. Repeal of Domestic International Sales Corporation (DISC) Provision

Background.—In 1971, at the urging of the Treasury Department, Congress unwisely enacted a system of tax deferral for "domestic international sales corporations" (DISCs) and their shareholders. The profits of a DISC—which can be only a paper operation—are not taxed currently to the DISC when earned, but instead are taxed to the shareholders when distributed. However, each year a DISC is deemed to have distributed income equal to 50 percent of its profits, thus producing in effect a tax deferral for 50 percent of the export income of a DISC.

The primary justification offered by the Treasury for enactment of DISC was that it was necessary to provide tax deferral to some extent for domestic subsidiaries engaged in export activity in order to counter the 100 percent deferral afforded to controlled foreign subsidiaries. In short, in the Treasury's view, the way to combat one tax loophole was to create another one. The provision has been far more costly than was ever predicted. Congressional Budget Office estimates now project a $1.7 billion revenue loss from the provision for fiscal 1981. And the objective studies of the DISC provision that have been made indicate that very little, if any, increased export activity has resulted from the provision. United States exports have increased substantially since 1971, but this increase can be attributed to the decision to move to a floating currency, the devaluation of the dollar and general increases in international trade volume.

The House bill does restrict the DISC provision somewhat. However, it appears that the House failed to repeal DISC in its entirety largely because of a barrage of business lobbying that repeal of DISC would destroy jobs for U.S. workers. The AFL–CIO, which supports repeal of DISC, disagrees and has called the lobbying blitz in the House a screen to hide the multi-billion dollar windfall under DISC. Moreover, preliminary economic analyses now indicate that DISC actually causes a net loss of U.S. jobs. That is to say, continuation of DISC may destroy more United States jobs than it creates.

The reason for this is relatively simple. If DISC does cause any expansion in exports, the dollar will appreciate on foreign exchange markets. As a result, foreign firms will expand their exports to the United States. When these imports are expanded, United States workers will be displaced by the import competition.

Proposal for Reform.—The preferential tax treatment for DISCs should be repealed effective for taxable years beginning after June 30, 1976. (If evidence presented to the Committee should indicate that it is appropriate, the Committee may wish to consider an extension of DISC for small export businesses until 1981. thus allowing time to develop a more effective method of encouraging small business to increase export activities.) The proposed change would produce an estimated increase in revenue in fiscal 1977 of $1.4 billion, and $1.7 billion in fiscal 1981.

3. Other House Provisions Dealing With Foreign Income

The House bill included several other provisions designed to provide more equitable rules for the United States tax treatment of foreign income:

Retention of the 30 percent withholding tax imposed by the United States on interest, dividends and other similar types of income of a nonresident alien or a foreign corporation (if such income or gain is not effectively connected with the conduct of a trade or business within the United States).

Repeal of the preferential tax rates for Western Hemisphere Trade Corporations and China Trade Act Corporations.

Strengthening of rules for taxation of income of foreign trusts and transfers to foreign trusts and other entities.

The Senate should retain these House actions.

Section 1051 of the House bill effect a change in the tax treatment of United States corporations operating in Puerto Rico and possessions of the United States, other than the Virgin Islands. The present treatment is very beneficial to certain companies and significantly reduces their overall tax liability. This proposed change can operate to provide even more significant financial benefits to these companies. The House Committee Report instructed the Treasury Department to review the operations of the basic treatment of U.S. corporations operating in Puerto Rico in order to appraise Congress of the effects of that treatment. However, the first report is not due until 18 months after the close of calendar year 1976, or July 1978. But, the proposed House increase in the present benefits itself goes into effect in 1976. The Senate should reverse the order of these two events. That is, Congress should require submission of a report by the Treasury on the effect of the present tax treatment of corporations operating in Puerto Rico and other possessions, and any proposed changes, before any revision is made. Therefore, the Senate should amend the House bill by requiring the Treasury to submit a report to Congress not later than July 1, 1977 on the effect of the present treatment and on the estimated effect on the House-proposed change or other changes (thus analyzing the effect of such changes on 1975 transactions as if they had been in effect in that year). Action on the House change should await a determination of the merits of the proposal.

IV. PROPOSALS FOR ESTATE AND GIFT TAX REFORM

Background.—Comprehensive revision of federal estate and gift tax laws is long overdue. The House Ways and Means Committee has begun hearings on this vital subject. Congress should give high priority to enactment of comprehensive estate and gift tax legislation.

The major structural problems in the present estate and gift tax laws are created by:

The dual transfer tax system that creates inequities between transfers of property by gift and those at death;

The marital deduction;

The existence of generation-skipping transfers to avoid estate taxes;

Improper treatment of transfers of certain types of property.

Briefly the changes that are necessary to insure that our estate and gift tax system is both fair and effective in achieving its objectives include:

1. Unification of present estate and gift taxes into a single transfer tax system.

2. Revision of the rate structure to distribute the tax burden in a more equitable manner.

3. Providing an unlimited marital deduction so that transfers between spouses would not be subject to the tax.

4. Provide rules to insure that transfers of wealth are taxed at least once each generation, thus eliminating the generation-skipping transfers that allow wealthy families to avoid estate taxes for as much as 100 years.

5. Repeal or modify provisions that grant preferential tax treatment to certain kinds of transfers.

In addition, considerable concern has been expressed in recent months about the impact of federal estate taxes on family farm operations. Some publicity has asserted that families are being forced to sell all or part of family farm operations in order to meet their federal estate tax liability. It is important to our nation that an adequate amount of our open spaces be retained for farm purposes. From a land use perspective, it is also desirable to maintain the open spaces that farm land represents.

Undoubtedly, the administrative problem of valuing farm land for estate tax purposes, especially that which is also usable for commercial or residential development, has proved to be a difficult one. And owners of farms who have not been willing or able to undertake estate planning to insure that liquid funds will be available to their estates undoubtedly do encounter difficulty in meeting federal estate tax obligations.

However, the liquidity problem caused for family farms by the federal estate tax needs to be placed in perspective. According to the most recent data, only about 7 percent of the decedents who die each year are subject to the federal estate tax at all. The $60,000 exemption accorded for federal state tax purposes exempts 93 percent of all decedents from federal estate tax each year. Thus, the fact that an estate owning a farm has a federal estate tax liability to be concerned about, alone demonstrates that the decedent was in the top percentile of wealth holders in the United States. Thus, in formulating a response to the alleged liquidity problem for owners of farms, it is important that any provision enacted by Congress be carefully tailored to insure that its benefits in fact are directed only to those farm owners who are really in need of federal assistance.

In this connection, the Congress and the Senate Finance Committee should reject out of hand proposals such as that advanced by President Ford to increase the present $60,000 estate tax exemption to a level of $150,000, or even $200,000 as suggested by others. Such proposals would virtually eliminate the federal estate tax as an effective federal revenue measure and as a means of insuring that undue concentrations of wealth are not perpetuated in the United States. Increasing the federal estate tax exemption level to $200,000, for example, would remove almost one-half of the revenues presently obtained from the federal estate tax. It would mean that less than 1% of decedents would be subject to the tax.

The ultimate thrust of tax reform should be to broaden the scope of the estate tax, not restrict it. To employ an increase in the estate tax exemption to solve liquidity problems of deceased farmers is to let the farm tail wag the estate tax dog. The benefits of increasing the exemption to $150,000 or $200,000 would extend far beyond those owning farms, and would provide estate tax reductions in situations in which they are neither needed nor desirable. The estate tax must not be gutted under the guise of providing assistance to owners of family farms. Estates with liquid assets must not hide behind the farm house.

Proposals for Reform.—The House Ways and Means Committee is currently conducting hearings on the general subject of estate and gift tax reform. Orderly procedure would indicate that the Senate take no action with respect to estate tax problems of owners of family farms separate and apart from the comprehensive estate tax reform bill that should result from the Ways and Means consideration. It is more likely that an effective and fair provision to deal with the liquidity problems of farm operators can be developed in the context of comprehensive estate and gift tax reform than by an ad hoc decision in the Senate as an amendment to a bill designed to deal with income tax inequities.

However, if the Committee feels that action on this matter is appropriate in the pending bill, the following proposal represents an appropriate solution to the liquidity problems of owners of family farms:

A "family farm" (the term "family farm" should be defined in the same manner as in section 204(a) of the House bill) will be valued for federal estate tax purposes at its value for farm use if the following conditions are met:

a. The decedent in his or her will, or the decedent's estate within the period of time for filing a federal estate tax return, transfers the development rights with respect to the property to a state or local government (or to an instrumentality thereof), or to an organization described in section 501(c)(3) of the Code, the exempt function of which is to preserve land and open spaces. The decedent, of course, may have taken this action prior to death, and thus guaranteed valuation at the value for farm purposes.

b. Alternatively, the decedent or the decedent's estate can transfer such development rights to the Secretary of Agriculture.

Either of these transfers will constitute satisfaction of the federal estate tax liability for the tax that otherwise would be attributable to the difference in the value of the land at its highest and best use and its value as farm property. (Of course, no charitable contribution deductions will be allowed for the transfer of the development rights.)

"Development rights" are actually negative easements. They do not give the holder of the rights the power to take any action with respect to the land covered by the development rights except the right to prevent commercial or residential development on the land. Thus, the use of the farm property as farm property by the heirs and beneficiaries of the decedent will not in any way be impaired by possession of the development rights by an estate or local government, for example.

This proposal will insure that federal estate taxes will be forgiven only in those situations in which there is assurance that the farm property will in fact continue to be used as farm property. If at some later date, the owners of the farm desire to develop it, or to sell it to a purchaser who wants to develop the land, they can do so and they (or the purchaser) can acquire the development rights from the state or local government, charitable organization, or the Secretary of Agriculture, as the case may be, by paying to the holder of the rights the estate taxes foregone by the federal government, plus interest.

This proposal offers several advantages over other proposals that have been advanced to solve the liquidity problem for owners of farm operations:

1. It confines the federal estate tax relief to farm operations and to those farm families who are serious in their desire to continue operating as a family farm.

2. It does not involve any interference in the family farm operation by federal, state or local government.

3. If it subsequently becomes desirable to utilize the farm land in commercial or residential development, it will be possible to do so, but at no financial loss to the federal government, in the case of development rights held by the Secretary of Agriculture. In the case of rights held by state or local governments, the proposal can be seen as a form of revenue sharing.

4. The proposal takes advantage of the most innovative of the techniques presently being utilized for conservation of open spaces and thus encourages use of these progressive land use techniques.

The proposal should be effective for the estates of all decedents dying after December 31, 1976. It will result in an estimated revenue loss in fiscal 1977 of $50 million, and of $190 million in fiscal 1981.

V. PROPOSALS FOR NEW TAX EXPENDITURES THAT SHOULD BE REJECTED

In order to insure that the present tax reform bill actually constitutes "tax reform" the Senate should firmly reject those proposals to create new tax expenditures or other tax escapes that will further undermine the equity of the federal income tax system. Some of these proposals have been advanced by the President and the Treasury, others are contained in the House bill itself, and still others were passed by the House in the "Energy Conservation and Conversion Act of 1975," now pending before the Senate Finance Committee.

Among the proposals advanced by the Administration that should be rejected are:

1. The reduction of the corporate tax rate to 46 percent. This proposal would cost an estimated $1.7 billion. Economists are generally agreed that corporate rate reductions do nothing to stimulate capital investment and may even be counter-productive under certain conditions. The only candidates for corporate tax-reduction are small businesses, as has been proposed above. The proposed revisions in the investment credit will provide the most effective means of stimulating capital investment in the corporate sector.

2. The proposed deduction for stock purchases. This will cost an estimated $700 million. Like all special and preferential deductions, it will have an upside-down effect, providing no benefits to nontaxpayers and a benefit rise as income increases. Introduction of a federal bias toward purchases of stock by individuals not only creates tax inequities, but is inconsistent with a free market economy. Individual investors in a market economy will purchase corporate stocks (as opposed to bonds, for example) when those investments are attractive as the result of the increased yield and dividend potential of the company itself. Introduction of the special deduction distorts the decision-making process by investors in a free economy and results in less than optimal efficiency in the use of capital. The Government can safely rely on the good judgment of individual investors to evaluate and determine the best investment for their own particular needs.

3. The proposed special mortgage tax credit for financial institutions, which would cost an estimated $900 million per year when fully effective. A Task Force of the House Budget Committee has held hearings on this proposal and testimony before it indicated that the proposed credit would be undesirable from the standpoint of both tax and housing policy.

4. The proposed tax relief for electric utilities, including a provision to permit shareholders to defer the tax on dividends paid by those utilities where they elect to have the dividends reinvested in additional common stock. The combined changes proposed by the Administration would reduce tax liabilities of electric utilities and their shareholders by $800 million per year in the long run. Electric utility companies would seem to be among the least likely candidates for further tax relief. According to data filed with the Securities and Exchange Commission for 1974, many utilities paid no taxes at all, either to the United States Government or any other government, and others paid at very low effective rates. Commonwealth Edison paid an effective rate of 15.2 percent, Pacific Gas and Electric 10.6 percent. Consolidated Edison paid no tax at all. It is not electric utilities who need financial relief; it is their customers. And there is nothing in the Administration proposals that will insure that any of the proposed tax benefits will in fact be passed on to the consumers in the form of lower utility rates.

5. The proposed corporate dividend tax relief. Whatever may be the merits of full integration of corporate and personal income taxes—and economists and tax experts are divided on the subject—the Administration proposals do not acomplish full integration and really produce only tax reductions for upper income shareholders in corporations. In fact, the proposals cost far more than full integration. It is the virtually unanimous view of economists who have studied the matter that corporate dividend tax relief will not result in the formation of aditional capital; it will simply reallocate available capital from those companies that desire to retain earnings for future growth to those companies that pay out earnings in current dividends. The economic case for this type of reallocation of capital resources is unclear at best.

6. Insulation, solar energy, and garden tool tax credits. The proposals for tax credits contained in the House-passed version of the Energy and Conservation Act of 1975—notably for costs of residential insulation and residential solar energy equipment—should likewise be rejected by the Senate. These new tax credits are inequitable and represent an unproven method of encouraging energy conservation practices. The credits are not refundable and therefore provide no assistance to those who do not otherwise incur tax liability. In addition, the effectiveness and efficiency of the credits have not been analyzed by Congress and these new tax preferences should not be enacted until Con-

gress can be assured that the benefits outweigh the costs and that the tax credit is the best means of providing financial assistance. The appropriate action at this time for the Senate Finance Committee is to require the Congressional Budget Office to review and evaluate the proposals and to submit a report to the Congress within a reasonable period of time. Then the Congress can act in an informed manner with respect to these tax credit proposals.

Similarly, the provision in the pending House-passed Tax Reform Bill creating a new $7 tax credit for the purchase of home garden tools should be deleted from the bill. The justification given for this provision was that it would relieve the pressure of rising food prices. However, the need for the measure is questionable in view of the fact that food prices have been moderating in recent months. Furthermore, since the credit is not refundable, it provides no financial assistance or encouragement to those families that are hardest hit by food prices, i.e., those with below poverty level incomes. Finally, the tax credit appears almost impossible to administer and likely would be the subject of widespread abuse.

VI. PROVISIONS AFFECTING THE ADMINISTRATION OF THE TAX LAWS

The House-passed bill contains a number of provisions designed to improve the administration of the federal tax laws. Generally these provisions represent desirable changes which should improve both the efficiency and equity of Internal Revenue Service administrative practices and procedures. The inclusion of the so-called "Deadwood Bill" in the tax reform bill is most desirable since it will remove unnecessary Code provisions, simplify the tax laws, and streamline the voluminous Internal Revenue Code.

The provisions regulating income tax return preparers, providing declaratory judgment procedures for organizations seeking to qualify for tax exempt status, improving jeopardy and termination assessment procedures, clarifying rules with respect to summons issued by the Internal Revenue Service to obtain taxpayer's books and records, and establishing procedures for disclosure of Internal Revenue Service determination letters all represent steps in the right direction in terms of equity and efficiency in the administration of our tax laws. The Senate should adopt these provisions of the House bill, making such improvements as testimony before the Finance Committee indicates may be required. As in the case of estate and gift taxation, I intend to submit specific proposals for reform and improvement to this Committee as consideration of these areas continues.

The CHAIRMAN. Our next witness is Robert M. Brandon, director, Tax Reform Research Group.

Mr. Brandon.

STATEMENT OF ROBERT M. BRANDON, DIRECTOR, TAX REFORM RESEARCH GROUP

Mr. BRANDON. My name is Robert Brandon. I am the director of Public Citizen's Tax Reform Research Group—part of Ralph Nader's organization. With me is William Pietz, a staff attorney with our organization. I have quite an extensive statement, which I will not read, but I would ask that it be inserted in the record.

I would like to focus specifically this morning on the House-passed Tax Reform bill.

In my travels around the country, I have found many members of the public concerned about the glaring inequities they see in the tax system. It is really not their concern over excesive tax burdens; it is really a concern that they see other individuals paying much less than they should.

TAX SHELTERS

Let me start out by focusing in on the tax shelter aspects of the House bill. This is probably the most important area of reform that is contained in the House bill. The tax shelters themselves are unfair. They are wasteful; and they are very distorting to the economy.

For that reason, the Nixon administration back in 1973 first opposed tax shelters and recommended they be totally eliminated, and the House bill goes along in doing that. Tax shelters are unfair because they provide an enormous amount of tax avoidance to very high-income individuals. The Joint Committee has prepared a booklet containing 37 tax returns of these high-income individuals with typical tax shelter partnershp operations.

For instance, we have in our statement a couple of examples; an executive who bought into a limited partnership in a real estate deal was making a $428,000 salary and paid only three-tenths of 1 percent in taxes. Another individual who had a small business, a cattle shelter operation, and who had an income of $396,000, paid a little less than 12 percent.

More importantly, beyond the equity question is the fact that tax shelters rob vitally needed capital from important areas of the economy; they are very wasteful because of the tax gimmicks involved. They say to the potential investor to invest in this property, not because it s productive or because it is economical or because there is a demand for it, but rather because the tax laws will make the investment attractive.

The problem with these wasteful investments is that when they do produce losses, it is the Treasury that winds up underwriting the lack of productivity involved.

Tax shelters, finally, are very distorting to the economy. They promote overbuilding in areas where there is no demand for housing. They promote overbuilding of commercial office space. If you go into downtown Manhattan you will find an enormous amount of empty office space, yet buildings continue to go up because tax-sheltered deals are packaged to create an enormous amount of benefits taxwise to potential investors.

Tax shelters are also distorting to the economy because they produce wild gyrations in prices creating instability for legitimate entrepreneurs, farmers, et cetera. There is testimony in the Ways and Means Committee by the egg producers, which we have quoted in our statement, that the legitimate egg producer cannot plan investment with any kind of realistic expectations of price because of outside money coming in. And these tax shelter deals drive down the price far below what their expectation was.

When syndicators do not have that much money to play with, investors come out of the market and the prices go way back up again.

LAL AND TAX SHELTERS

LAL simply says, all tax preferences for real estate, for oil, for farming, et cetera will continue. In fact, these investments will remain very attractive because they will produce a good rate of return and a relatively tax-free situation. By investing in real estate today, I am going to pay very little tax on my real estate income. That remains untouched by the LAL approach.

What the LAL goes after is what is used beyond the investment involved to shelter other income and to provide almost a negative tax rate for the individuals involved. The shelter makes it economical for those individuals to invest in areas that are not truly productive areas of investment. Real estate, for instance, will still remain an excellent investment.

I would suggest one change, though, in the House-passed bill, and that is that the real estate LAL proposal should be applied on a property-by-property or venture-by-venture basis. Otherwise, we would still be providing for significant distortions through tax-shelter investments, leaving the opportunity for wealthy individuals to buy into several real estate ventures, and use the write-offs from one venture to shelter the income from another venture.

That means, all over again, that the second venture that is being used to shelter the income from the first venture is spinning off additional tax benefits beyond the benefit from the actual investments and it will create additional pressure to invest in the second venture even if it is a marginal or uneconomical investment.

Finally, if we are going to end tax shelters and the distortion of tax shelters and the abuse of tax shelters, we have to end them all, not just simply most of them. Leaving any exceptions open will provide a shelter for the high-income investors in those areas left open.

Tax shelters are very wasteful to a large extent because of enormous frontend costs raked off the top by promoters and syndicators. In addition, unscrupulous promoters prey off investors seeking shelter. I have some examples here. If we leave, for instance, exploratory drilling open for a tax shelter investment, there is going to be an explosion of syndicated drilling funds on Wall Street. We are going to continue to read in the papers headlines like, "Thirteen Indicted in Swindle of Celebrities," and "The Sawdust Trail," and "Small-Scale Drillers Lure Investor Money," and so on.

Enormous amounts of wasteful investments are being created by the existence of these tax shelters. The oil industry alone has enormous incentives for drilling and exploring right now. They do not need this kind of outside capital. Publicly syndicated oil shelters amounted to $700 million last year, and only about half of that was actually purchased.

That compares quite unfavorably to the $10 billion increase in oil drilling revenues as a result of recent price increases. Recent price increases should be ample investment incentive for the people to get involved in oil drilling.

In the livestock feed lot area alone, there were $2 to $3 billion in lost capital investments last year. Yet feed lot tax shelters benefit the unscrupulous managers who brought unsuspecting customers into that investment.

MINIMUM INCOME TAX

Let me turn to the minimum tax. The present tax is inadequate as a tax on preference income to assure that everybody pays some tax on those tax preferences that we grant them. It only hits the wealthiest 30,000 taxpayers in the entire country, and at about a 4.4 percent effective rate. The changes that were made in the House bill are very important and go a long way to strengthen the minimum tax to where it should be.

We would suggest, however, that the 14-percent rate could be progressive along the lines of what the Ways and Means Committee did adopt in 1974—a sliding scale of 14 to 20%. An important feature of the minimum tax is that it——

The CHAIRMAN. I will have to ask you to conclude your statement.

Mr. BRANDON. I will wrap it up quickly.

The alternative minimum tax, we feel, is conceptually sound as an option for the minimum tax, but it is dangerously unsound as an alternative to the LAL because it will continue to allow tax shelters to flourish and will still allow some indivduals to shelter up to 50 percent of their income, through the use of tax shelters.

We would suggest that if the alternative tax is adopted, it should be adopted in conjunction with LAL, as the Treasury has suggested.

DISC

Finally, we would suggest that the DISC preference be eliminated. It is, and has proven to be, an inefficient stimulus for exports. Because it increases imports at the same time, it has lost more jobs than it actually has created.

TAXATION OF FOREIGN INCOME

Finally, in the foreign taxation area. The present law has caused an enormous capital drain in this country, due in a large part to the favorable treatment that multinational corporations get on their foreign earnings. Two recent studies have shown that up to 20 percent of the annual capital formation is going overseas.

We would suggest that the tax credit, which does achieve basic tax neutrality, remains. However, the specific abuses in the tax credit area where excess credits are used to shelter other income should be eliminated. The important thing is that once you have tax neutrality with the foreign tax credit, deferral of the tax on overseas earnings tips the balance back in favor of overseas investments. Deferral must be eliminated in order to keep the concept of tax neutrality intact.

I would like to expand on some of these points, and any questions you might have.

The CHAIRMAN. Senator Byrd?

Senator HARRY F. BYRD, Jr. No questions.

LAL

The CHAIRMAN. I am going to suggest that we perfect alternatives to the LAL proposal that would drastically shorten the tax law, and would achieve what you are talking about, about treating all of the so-called tax shelters alike. We would simply try to tax a person more in line with what his banker felt he actually made, assuming he did all sorts of desirable things, gave to charities, gave to education, invested money in ways we would like to see him do it, to improve and help our economy.

He would still pay taxes. I do not think anybody is going to be for or against this until he sees how it works out specifically as it applies to him and to the situation in which he is interested.

Mr. BRANDON. Senator, if I may—the proposal itself, as long as it remains an alternative to the minimum tax, would allow certain individuals to get involved in tax shelter operations. And its effect is very random. If you have an executive who makes $100,000 and has $75,000 in tax preferences, and another person has just simply $75,000 worth of tax preferences, that first person is going to pay no minimum tax and the second person is going to pay a minimum tax. The difference is that they are both investing in tax shelter operations, one having a greater incentive.

Now, since there is no additional tax due to the first investor he will continue to be involved in wasteful tax shelters. The advantage of LAL is that it has one bottom-line effect. The final result is that it will end the wasteful use of tax shelters in this country which diverts needed capital into marginal or unproductive investments.

I think adopting LAL and adopting the minimum tax should go together.

The CHAIRMAN. Well, you have your opinion, of course, and maybe you made up your mind before you have seen alternative proposals, and everyone has a right to do that.

When I am in my hometown, I drive past a complex of office buildings, hotels, department stores, and it is a very fine investment, a tremendous asset to the community. The people who went into that thought they were going to make a lot of money. They thought they were going to be able to keep most of it after taxes.

By the time they get through, anybody who escapes bankruptcy will be lucky, even the banks that loaned the money will take a million-dollar loss out of all that. But they went into it and put a lot of people to work and benefited the community in the hope of making a profit. You take away the hope of making a profit, and you would not see a beautiful investment, which has given a lot of people employment and is a tremendous asset to the community.

Mr. BRANDON. Senator, that is not what the LAL does. All it does is take away the additional artificial losses. It does not eliminate actual economic losses and, second, it promises the investor and real estate investors that they will make money. Real estate does have a good rate of return, almost tax free, because of the existing tax preferences. We are not suggesting, under LAL, eliminating those tax preferences. We are only suggesting that they not be applied to other outside income.

It seems that there is a distinct difference there between that very attractive investment and ending all tax shelters. People are still going to have money they want to invest and real estate is going to be a good investment, and it is a good investment with virtually tax-free yields, and it seems to me that the incentives we are trying to develop are not incentives that give somebody back in New York the ability to pay lower taxes——

The CHAIRMAN. Anybody in New York who put money into that investment, lost it. He might have gotten a tax break at the going-in point, but he lost it at the coming-out point.

Mr. BRANDON. That is deductible.

The CHAIRMAN. Well, unless somebody can find ways to deduct things more times than once, there is no way he can deduct more than 100 percent of what he lost. So, if he is in the 70-percent tax bracket, he still has lost his other 30 percent.

Mr. BRANDON. But he gets to write it off under LAL. Those losses are real losses and he writes them off.

The CHAIRMAN. I understand that, but I have not yet been able, and I am sure there are arguments suggested many times, to buy this theory that the Government owns money regardless of how hard you worked for it, and if you invest that money that you earned because of the fact that the Government permits you to keep some of the money you earned, and if the thing goes well, if you take the risk that is all right, but if the thing does not go well, you lose your money.

Mr. BRANDON. It is different with shelters. People often put up maybe $10,000 and bring that up to $100,000 by leveraging the actual investment, they still only have a liability of $10,000, and it may throw off as much as $100,000 in artificial losses, and I would suggest that I do not feel the Government has the right to spend my money, either, automatically. And what happened with the tax shelter is that my money is going into some doctor's or lawyer's pockets for getting involved in uneconomic investments.

MINIMUM INCOME TAX

The CHAIRMAN. Well, take a look at it now: When you have a tax code that is a million and a half words long, and you back up that with regulations that work out to another 12,000 pages, and you have the tax court decisions, and it gets down to the point where it is made to order for the kind of thing you are talking about, for some good lawyers working hard in the hope of making a profit.

For all that endeavor, notwithstanding the new law that you wrote, they try to find some way where they are going to get more favorable tax treatment than we had in mind. That is why I feel when we write laws that undertake to say that if you do socially desirable things, you get better tax treatment than if you do not do the socially desirable things, that we nevertheless say that you are still going to pay a certain amount in taxes, even if you do give a great deal of money to education, to charity; even though you provide a great number of jobs and favorable concepts, regardless of how much money you made or used for your activities, maybe you ought to pay taxes because you made a lot of money.

Now, I am certainly willing to consider what you are advocating here. I was in on this minimum tax concept benefit in the beginning and it has been my thought all along that we ought to look at all these things and say that no matter how many good things you do, you are still going to pay something. I do have some doubts about whether you ought to apply that to someone who invests money in State municipal bonds.

Now, Secretary Simon is convinced that the man has been taxed already because if he bought bonds that were taxable, he would have made a lot more income on them. What is your reaction to the theory of Secretary Simon and his thoughts about taxable bonds, that he would have about 50 percent more interest if he bought ones that were not taxable?

Mr. BRANDON. That is probably true but at this point he is getting more like 70 percent of the taxable yield. That really shows, I guess, the weakness of the present tax-exempt bond market more than anything else.

It certainly would be beneficial for the Congress to adopt an optional subsidy so that the States could, in fact, offer these taxable bonds.

The CHAIRMAN. Thank you very much.

Senator Curtis?

TAX SHELTERS

Senator CURTIS. I did not get in on all of your testimony, but I have one question for you to develop in the record.

You stated that it was possible to take a $10,000 loss, turn it into a $100,000 tax benefit. Will you develop such a case and set it forth in the record and tell us just how that is done?

Mr. BRANDON. Senator, I said you could invest $10,000 and it would throw off $100,000 of artificial losses. I would be happy to show you that. We have some examples of leveraging in our testimony, I believe, but we will submit one for the record.

Senator CURTIS. If you get an actual case, you do not need to disclose the names, but if you can get an actual case of where that happens.

[The material referred to above follows:]

TAX REFORM RESEARCH GROUP,
Washington, D.C., March 30, 1976.

Hon. Senator CARL T. CURTIS,
U.S. Senate, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR CURTIS: In response to your request to supply you with some examples of leveraging in tax shelters to produce $10 of writeoffs for each dollar invested, I would like to submit the following material for the record:

I. Forbes Magazine (August 15, 1974, "A Loophole for (Greedy) Pigs"), described how a shelter (purchase of a completed film) can be magnified:

"Dirty Harry, the Danish porno master, makes Deep Audit for cheap and decides to sell U.S. distribution rights for $200,000 cash. Up steps a tax-shelter promoter and his wealthy limited partners. They inflate the deal to their own advantage. On paper, they agree to pay Dirty Harry $2 million over 20 years. Harry gets $200,000 as a cash down payment, plus a non-recourse note for the remaining $1.8 million payable in 1994. The note looks good, but it is really worthless and Harry knows it. He would never be able to collect on it. Internal Revenue does not know this. Exit Harry, happy with his $200,000 in cash.

"The partners hurry to their nearest IRS office and, following federal requirement, forecast with a straight face that Deep Audit will earn at least the $2 million they paid Harry for the film rights.

"Deep Audit does pretty good. That is, it earns the partners back the $200,000 cash they did put into it. But, why should they bother? Just to break even? Because of the tax gimmick, of course. In theory the partners paid $2 million for the movie. So, they have a loss of $1.8 million—in theory. On their individual income tax returns they write this off, saving themselves $900,000 in taxes—assuming they are in a 50% bracket, more if they are in a higher bracket. So, $200,000 gets them $1.1 million.

What about the note that Dirty Harry holds? Well, remember, that is a nonrecourse note, and, since the film only took in enough to repay the partners' down payment, there isn't anything left for Dirty Harry to collect his note against. The big profit was made on the individual tax returns of the partners, and Harry has no way of going after this. But Harry doesn't mind. He never expected to collect.

"How can anyone get away with this, what with all the auditing that goes on these days? It's certainly like fraud. But how do you prove it? How do you prove that the partners really weren't dumb enough to think Deep Audit could do $2 million? Look at The Godfather, The Sound of Music, even Deep Throat."

II. The New York Times (March 28, 1976, "For Best Performing Shelter . . ."), reported the following:

"Many of the reported abuses linked to movie tax shelters stem from the films at inflated prices that investors never intend to pay. They put 5 percent to 10 percent cash into a deal, perhaps $100,000 on a purchase price of, say, $2 million for the film. They deduct depreciation and investment tax credits based on the $2 million, but that's a fictitious price. The balance is owed to foreign distributors, but often is never repaid. The distributors may know they won't be paid the $2 million but accept anything to get some payment for a poor film."

I hope this information will be useful.

Very truly yours,

ROBERT M. BRANDON,
Director.

Mr. BRANDON. Senator, Mr. Pietz has spent 5 years, in fact, involved in the buying and selling of tax sheltered investments and he might answer you.

Mr. PIETZ. The 10-to-1 ratio is rather unusual, but there are such cases. It is very common to put up $1 and write off $4.

ABUSES OF THE TAX CODE

Senator CURTIS. I am talking about 10. You see, the tax burden is heavy on everybody. It is heavy on the middle-income bracket and it is heavy on every bracket. Some of the people know about our tax code and some of them do not. It is quite unfair to the Congress to tell everybody, in effect, that our tax code is corrupt and that if we just stop somebody else from doing something, their taxes could be greatly reduced and the budget would be balanced.

Now, as a matter of fact, if we confiscated all of the property of the wealthy, it would not last very long. If we taxed all the incomes over $25,000 a year at a rate of 100 percent for that above the $25,000, I dare say it would not run this Government a month.

Mr. BRANDON. Senator, I would agree with you.

Senator CURTIS. Therefore, to promote the gambit that these things that take place and to imply that they are commonplace just adds to the burden and unrest of the country. It offers no solution to this committee because, as I say, if we confiscated the property of the wealthy it would not be of a lasting benefit to the other taxpayers. Of course, in the long run, it would hurt them materially because you cannot have jobs without capital.

Mr. BRANDON. I share your point of view. We certainly do not suggest that in our testimony.

What we are interested in seeing is that the tax code is efficient, and that it does not distort. Let's not forget the tax shelters that are being packaged today are really the unintended results of some well-meaning laws.

The farmer who uses cash accounting is not the problem in this case; it is the city doctor or lawyer who takes advantage of that and buys into syndicated shelters which forces up the price of the farm lands, which creates wild price instability and hurts the legitimate farmer.

Senator CURTIS. But the provision in the code was put in there for a very sound and justifiable reason. Now and then someone pops up and works out a combination, and I think that those combinations should be called to the attention of the Congress so that we can see if something should be done.

It is like that is welfare. The people who are eligible for food stamps, if that goes into existence, are probably also the individuals who are drawing rent subsidies and maybe also the individuals who are drawing aid to families of dependent children, and everything else, and who are also the beneficiaries of earned income credit, if they have anything, and probably their children are being educated by grants and loans from the Government and they, in turn, are qualifying for food stamps.

The addition and combinations sometimes lead to some abuses, but is it not peculiar to the tax field.

Now, when there are combinations that only the clever and only the extremely wealthy could take advantage of, I think this committee should give consideration to that, but I definitely part company with the people who know better but give the public the impression that the tax code is corrupt and that the Congress has written it so that people with high incomes do not pay taxes.

Well, there are just very few ways to avoid paying taxes. I know of a few who give it all away. There are people who are qualified for unlimited charitable deductions. I am not sure that they are cheating. I think they are great benefactors; I think they are giving to causes that can spend money better than the Government can. Also, if somebody invests all of his income in tax-exempt bonds, on the face of it it might look like they were gaining, but if somebody bought a tax-exempt municipal bond 10 years ago for $5,000, he could probably sell it now for about $3,000.

If he had invested $5,000 in equity stocks that would probably be worth in the $3,000 range, and maybe his money would be doubled or more. In other words, it is extremely doubtful if he is beating the game. Tax-exempt bonds to the school district or to the municipalities, or to the hospital district, mean quite a thing. If this question is faced continually, and the attack that we have written a tax code deliberately to pick out some people and exempt them from taxes, that is not the case at all.

Mr. BRANDON. Senator, listening to your very fine speech on the Senate floor against the $2,000 housing credit, I know that we both agree that, that was a tax expenditure in the code that was a wasteful expenditure. What we are saying here is that we should be looking at these things in terms of whether or not they are efficient. The equity question is a separate question.

Certainly, we want the code to be equitable and I think you and I both would agree that it should be equitable. All we are looking for in this situation, and I hope you read our statement carefully, is to get back to the situation where investments will be based on realistic economic assumptions. All those tax preferences in the code on those investments still exist and will still provide very good tax treatment on that income. But we still want to make sure that capital is not diverted into wasteful kinds of investments that hurt the economy.

Senator CURTIS. Well, I will not prolong the discussion but I think we really need to rethink this. A man's earnings belong to him and he should pay his just share on the burden of the Government and the Government has got no business to see what he has left afterward.

The CHAIRMAN. I would like to ask that the record show immediately after Senator Kennedy's testimony, so those who look at it can see what we are talking about, the chart which Senator Kennedy made reference to and which is in the report prepared by the Joint Committee staff, prepared for the Ways and Means Committee and the Committee on Finance by the staff for the Joint Internal Revenue Taxation. That chart appears on pages 7 thru 9.

I would suggest that simply, just for the purposes of making it fit on the page, the part that applies to the years 1978, 1979, 1980, and 1981, and that being the case, it ought to fit on the page pretty well, so that the people can see what we are talking about.[1]

Thank you very much.

Mr. BRANDON. Thank you.

[The prepared statement of Mr. Brandon follows. Oral testimony continues on. p. 260.]

STATEMENT OF ROBERT M. BRANDON, OF PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP

SUMMARY OF MAJOR POINTS

Tax Shelters.—The House bill should be strengthened by applying LAL to real estate on a property-by-property basis and to exploratory oil drilling.

(1) Tax shelters are inequitable, wasteful, and inefficient.

(2) Eliminating tax shelter opportunities will not dry up investment capital. It will simply direct that capital into economically sound investments.

(3) To eliminate tax avoidance through tax shelters, all shelter opportunities must be foreclosed.

Minimum Tax.—

(1) The present minimum tax needs to be strengthened as in H.R. 10612.

[1] See p. 196.

(2) An alternative minimum tax *in lieu of* LAL and the House passed minimum tax would allow tax shelters to continue to flourish and be untouched by the minimum tax.

DISC.—DISC should be totally repealed.

(1) DISC is a wasteful and expensive export tax subsidy that does not promote increased exports sufficient to justify its enormous cost.

(2) DISC actually displaces more jobs than it creates by encouraging increased exports.

Foreign Taxation.—The favorable treatment of U.S. corporations' overseas earnings encourages the exportation of capital and jobs abroad.

(1) Excess foreign tax credits should be eliminated.

(2) In order to achieve tax neutrality, the profits of the overseas subsidiaries of U.S. corporations should be taxed currently.

Major reforms of our present tax structure are needed in order to restore a tax system that achieves the goals of equity, efficiency, and neutrality. We will not in this statement discuss those major reforms. Instead, we would like to focus on a modest first step—the reforms already considered by the House and contained, for the most part, in H.R. 10612, the Tax Reform Act of 1975.

TAX SHELTERS

Tax shelters do the most violence to the principles of sound tax policy. It is important to keep in mind that tax shelters are the unintended result of other tax preferences. When cash accounting was adopted to help the small unsophisticated farmer, it was never anticipated that city dwelling doctors and lawyers would use that cash method to avoid taxes on their medical and legal fees by buying into publicly syndicated limited partnerships involving rosebush or pistachio growing deals. Likewise, when Congress passed tax incentives for oil drilling or real estate construction, the intention was to increase the after tax rate of return of these investments. Indeed, because of the generous tax treatment presently accorded these investments, both promise a relatively tax-free return on equity—a return that is generally quite attractive to normal investors. Tax shelters go beyond this "no tax" situation to actually produce a "negative" tax—promising not only tax free treatment of the investment earnings but additional tax write-offs to lower taxes on unrelated earnings.

Essentially, a tax shelter operates with artificial or accelerated tax write-offs. These artificial write-offs, instead of being applied against income from the investment, are applied to unrelated income—sheltering otherwise highly taxed salaries or professional fees. This mis-matching of income and artificial losses results in a deferral of taxes to a future year—in effect, an interest free loan from the Treasury. These artificial deductions are usually expanded through the use of non-recourse loans. Leveraging produces large losses that reflect large investments even though the investor has no personal liability for most of his investment. When the investment is finally sold, the gain is often taxed at capital gain rates (half the ordinary rates) even though the losses sheltered ordinary income originally.

TAX SHELTERS GENERATE GREAT TAX AVOIDANCE

Tax shelters are unfair and undermine the average taxpayer's confidence in the tax system. A look at information published by the Ways & Means Committee taken from thirty-seven (37) representative actual tax returns of high income individuals demonstrates the enormous tax avoidance aspects of tax shelter partnerships. One individual with $427,000 of executive salary was able to shelter enough income from three syndicated real estate shelters and one farm shelter to reduce his federal income tax to 0.3%. (See Chart I on next page.)

Another individual with $388,000 of income from his business and $8,000 of other income used $225,000 in artificial losses from a cattle feeding tax shelter in which he invested $150,000 on December 21st to reduce his income tax for the year to 11.9%. (See Chart II on next page.)

These are just two typical examples of how very wealthy individuals abuse artificial tax write-offs.

TAX SHELTERS ENCOURAGE WASTEFUL INVESTMENTS

Aside from their effect on tax avoidance, tax shelters are a wasteful and inefficient means of stimulating investment. First of all, many tax shelters, worth billions of dollars annually, are "packaged" by brokers who get commissions for their services. Some of the investment dollars, even if these activities were economically sound, are siphoned off by middlemen who receive a good deal of the tax expenditure money themselves.

Secondly, because of the tax benefits of shelters, the investments don't have to be economically sound to be profitable to the high bracket taxpayer. Because of tax deferral and capital gains rates, the investment can lose money, while still providing significant economic benefits to wealthy taxpayers. The operation of tax shelters therefore directs vitally needed capital into economically questionable investments.

CHART I.—*Partnership return*

(Type of business: Real estate. Date of startup: Dec. 28)

Capital contributed by partners	$225,000
Liabilities of partnership	0
Income	0
Expenses	215,000
Interest	197,000
Depreciation	0
Real estate taxes	0
Management and syndication fees	0
Net loss	215,000
Net loss as a percent of capital contribution	95.6

Individual income tax return

(Occupation: Executive)

Wages and salaries	$427,000
Dividends and interest	4,000
Capital gains (100 percent)	0
Partnership profit and loss	−410,000
Real estate (3 shelters)	(−385,000)
Farm	(−25,000)
Other income	16,000
Economic income	448,000
Adjusted gross income	37,000
Itemized deductions	27,000
Taxable income	7,000
Income tax	1,200
Minimum tax	0
Tax credits	0
Total tax after credits	1,200
Tax as a percent of economic income	.3

ANALYSIS

The real estate partnership commenced operations on December 28 and lost $215,000. Expenses consisted of $151,000 of interest on a construction loan (presumably prepaid interest), $25,000 of commitment fees, $21,000 of guaranteed financing fees, and $18,000 for advertising and startup rental costs. For each $1.00 invested in this partnership, the partners were able to deduct 95 cents in the first taxable year, which was only 3 days in length.

This individual had wages of $427,000. Almost all of his income was sheltered by investments in real estate and farm partnerships.

CHART II.—*Small business corporation return*

(Type of business: Cattle. Date of startup: Dec. 21)

Capital contributed	$150, 000
Liabilities	431, 000
Income	0
Expenses	225, 000
Interest	16, 000
Depreciation	0
Management and syndication fees	0
Feed	209, 000
Net loss	225, 000
Net loss as a percent of capital contribution	150. 0

Individual income tax return

(Occupation: Businessman)

Wages and salaries	$7, 000
Dividends and interest	1, 000
Capital gains (100 percent)	−1, 000
Small business corporation and partnership profit and loss: Cattle feeding	−225, 000
Business income	388, 000
Other income	0
Economic income	396, 000
Adjusted gross income	170, 000
Itemized deductions	32, 000
Taxable income	135, 000
Income tax	47, 000
Minimum tax	0
Tax credits	0
Total tax after credits	47, 000
Tax as a percent of economic income	11. 9

ANALYSIS

This cattle feeding operation is a small business corporation. It was in business for only 9 days but incurred $16,000 in interest and $209,000 in feed expenses. Its assets consist entirely of $75,000 in cash and $281,000 in cattle. The business is highly leveraged, with $150,000 in capital contributed by the shareholders and $431,000 in liabilities.

The owner of the corporation had $388,000 in income from his business and about $8,000 of other income. He deducted the entire $225,000 loss from the small business corporation.

DISTORTING THE ECONOMY

Tax shelters distort the normal operation of the economy. The Nixon Administration first proposed an end to tax shelters in 1973. As the Secretary of the Treasury George Shultz said:

"... the widespread 'tax shelter' market introduces significant distortions into our economy. Preoccupation with tax manipulations—particularly tax deductible 'losses'—too often obscures the economic realities and can have the effect of discouraging profitable and efficient enterprise. Inefficient tax incentives available in the form of 'artificial losses' to investors in preferred types of properties may benefit only the promoters of tax shelter schemes without contributing effectively to the social objectives of the incentives.

"For example, there are those who invest in farms not for the purpose of efficiently producing food and fibre at a profit, but to produce an artificial tax 'loss' which will shelter their non-farm income from tax. These investors compete with full-time farmers to bid up the prices of the necessary land, livestock, and equipment. Somewhat perversely, over-reaction to existing tax laws may lead 'hobby' farmers to be lavish and wasteful in their expenses. The result can be a competitive increase in the operating costs of all farmers."

LIMITATION ON ARTIFICIAL ACCOUNTING LOSSES

To end the abuse of tax shelters, H.R. 10612 enacted a Limitation on Accounting Losses (LAL) similar to that proposed in 1973. LAL *in no way* limits real economic losses. It also allows all accelerated write-offs (accelerated depreciation, intangible deductions, expensed farm costs such as pre-paid feed, etc.) to offset income from the investments that generate those write-offs. Real estate, oil drilling and other investments currently receiving significant tax incentives wil continue producing relatively tax free return from the investment.

LAL simply does not allow artificial write-offs to be used to shelter other income.

ALL SHELTER OPPORTUNITIES MUST BE ENDED

To be effective in ending the unfairness, the wasteful investment and the economic distortions, LAL must apply to all tax sheltered investments. Closing most of the sheltering opportunities but leaving some open will simply drive all shelter seeking high income individuals into the remaining shelters creating more waste and greater distortion. All shelters must be closed.

Ending tax shelters will not affect the supply of capital.—The same capital will still be available. But instead of being misdirected by tax gimmicks into marginally productive promotional syndicates, it will flow into economically sound investments.

REAL ESTATE SHELTERS

The tax laws grant a number of special tax preferences to real estate developers. Even if LAL prevents use of real estate for sheltering income from other sources, real estate will remain a tax sheltered investment since real estate income will be received tax free—just like municipal bond income.

The following excerpt from a medical magazine showed doctors how to receive a 10% tax free return from real estate.

Here's an example of how some properties can be setup for tax protection: The price is $1,000,000 of which $500,000 is borrowed from a savings and loan for 20 years at 8 percent—to be repaid monthly in equal installments (cost is about $50,000 a year) and $200,000 is borrowed from the seller on a second mortgage at 9 percent—to be repaid as a lump sum in 5 years (annual payments of interest only but refinanceable) leaving $300,000 as the amount of cash required to complete the purchases. Net income is $100,000 a year before mortgage payments of $50,000 on the first mortgage, and $18,000 on the second, leaving $32,000 for the owner to put in his pocket.

But, taxable income works out to zero, since from $100,000 of operating net income you can deduct $58,000 ($40,000 plus $18,000) interest and $42,000 depreciation (20 year life, building value $840,000) leaving zero taxable income. The entire cash dividend is thus tax free for the first year.

Real estate tax shelters, however, push much needed capital into projects which are poorly planned and badly managed because promoters and absentee owners are overly preoccupied with creating tax losses and then quickly unloading properties. Further, they tend to foster overbuilding in some areas, particularly more profitable commercial properties, shopping centers and luxury apartments, while neglecting often needed moderate income residential units.

PROPERTY BY PROPERTY TREATMENT

As originally approved by the Ways & Means Committee, H.R. 10612 would have applied LAL to real estate investments on a property-by-property or venture-by-venture basis. This would have prevented wealthy individuals with large real estate holdings from using artificial tax write-offs from one property to shelter the income from other real estate ventures. However, on the final day of the two-month markup session, the Committee voted to apply LAL to real estate investments, not on a property-by-property basis, but instead, on a consolidated basis—allowing write-offs from one venture to shelter the income from a totally unrelated real estate venture. That action will allow continued sheltering of other real estate income, allow many wealthy individuals to continue to pay no tax on vast incomes and cut the estimated revenue gain of the provision by two thirds, or by a cumulative total of 2.3 billion dollars through 1981. To close tax shelters in real estate, LAL should be applied on a property-by-property basis—a position supported by the Treasury on the House floor.

Claims that this narrow amendment will somehow damage housing construction are unfounded. Interest and property tax deductions for individual homeowners and rapid write-offs and credits for apartment investors which now total over $11 billion—which is over twice the annual HUD budget—will remain. Investment income from new apartments will remain tax free or lightly taxed. There is little evidence that those wealthy investors who happen to be using deductions from one property to shelter income from another property are charitably passing along these savings in the form of below market rents for apartment dwellers. Our housing debacle arose from inflated building costs and interest rates and a scarcity of mortgage funds which have discouraged home buyers. Congress can best remedy this by showing a determination to reduce federal deficits by making necessary choices among expenditures including tax giveaways.

OIL TAX SHELTERS

As with other tax shelters, oil and gas drilling shelters produce enormous inequities, encourage wasteful expenditures and are unneeded to provide funds for sound oil and gas exploration.

Typically, a wealthy taxpayer will wait until the end of the year and then eliminate all of his income tax liability by buying into a drilling venture. The following appeared (appropriately) in Medical Economics Magazine on June 22, 1970:

"Oil participation units offer two kinds of tax shelter: the 100 per cent write-off of intangible drilling costs, and the 22 per cent depletion allowance. Although depletion gets all the publicity and attracts the fire of reformers, intangible drilling costs are more important to the drilling investor. Intangibles include expenses for salaries and some of the supplies required to drill a well. They're usually the major portion of the costs. Comparable outlays in other businesses—spending to build a plant, say—must be depreciated over a number of years. In the oil business, they can be deducted right away."

In one case studied by the Ways and Means Committee, a drilling partnership with $200,000 of investments commenced in November and generated "loss" deduction of over $400,000 by years end. This allowed one partner to pay a tax of 2.8% on economic income of $390,000 and another to pay a tax of 9.6% on income of $344,000. (See Chart III on following page.)

Partnership return

(Type of business: Drilling. Date of startup: November)

Capital contributed by partners	$200,000
Liabilities of partnership	207,000
Income	0
Expenses	404,000
Interest	0
Depreciation or depletion	0
Management and syndication fees	53,000
Intangible drilling costs	350,000
Net loss	404,000
Net loss as a percent of capital contribution	202.0

Individual income tax return

(Occupation: Businessman)

Wages and salaries	$186,000
Dividends and interest	2,000
Capital gains (100 percent)	−1,000
Partnership and small business corporation profit and loss	−158,000
Drilling funds	(331,000)
Small business corporation	(173,000)
Business income	27,000
Other income	2,000
Economic income	390,000
Adjusted gross income	59,000
Itemized deductions	16,000
Taxable income	39,000
Income tax	11,000
Minimum tax	0
Tax credits	0
Total tax after credits	11,000
Tax as a percent of economic income	2.8

Individual income tax return

(Occupation: Businessman)

Wages and salaries	$124,000
Dividends and interest	5,000
Capital gains (100 percent)	0
Small business corporations and partnership profit and loss	11,000
Small business corporation	(211,000)
Drilling funds	(200,000)
Other income	4,000
Economic income	344,000
Adjusted gross income	144,000
Itemized deductions	61,000
Taxable income	81,000
Income tax	33,000
Minimum tax	0
Tax credits	0
Total tax after credits	33,000
Tax as a percent of economic income	9.6

ANALYSIS

This drilling fund began operating in November. The partners contributed $200,000 and the partnership borrowed $207,000 on a nonrecourse basis. Intangible drilling deductions were $350,000 and management fees were $53,000 (15 percent of the drilling costs and 27 percent of equity capital invested). The partners, then, could write off $2 for each $1 invested.

One partner had wages and salaries of $186,000, and income from three businesses totaling $20,000. Economic income was $390,000. However, his losses in two drilling partnerships were $331,000, so he was able to shelter 85 percent of his economic income while paying only $11,000 in income tax.

A second partner had wages and salaries of $124,000, dividends and interest of $5,000, income from two businesses of $211,000, and other income of $4,000; his economic income was $344,000. Losses from drilling partnerships, however, were $200,000. His income tax was only $33,000, less than 10 percent of economic income.

OIL SHELTERS ENCOURAGE WASTEFUL INVESTMENTS

The dramatic increase in oil and gas prices provide enormous economic incentives to explore for oil. Intangible drilling deductions and percentage depletion will continue to ensure virtually tax-free treatment of oil and gas drilling income. But the additional advantage of sheltering ordinary income only distorts the workings of the free market system and tempts taxpayers to throw money away in unwise ventures. Many of the properties developed by drilling funds are known to be marginal at best. To some investors this doesn't matter for it is possible to make money tax wise even when the drilling venture loses every cent. Other unsuspecting investors will find themselves in real loss situations but most of those losses are being underwritten by the U.S. Treasury.

The tax shelter lure has attracted hundreds of promoters who rake off as much as 50% of the investors funds via padded charges for purchases of leases, drilling and well management. It does not matter to them if properties are marginal. Medical Economics Magazine (June 1970) has stated:

"Often the program is operating marginal properties that are barely breaking even. Why should the management company continue to operate these wells if they're not making any money for the investor? The explanation is simple when you dig it out of the fine print in the prospectus: Some management companies, give themselves an overriding royalty—from 2 to 9.375 per cent—on gross receipts; all the oil the well produces and sells—so they can make money even when the investor's not, or is losing what he's invested."

SHELTERS ARE NOT NEEDED TO PROVIDE CAPITAL FOR OIL DRILLING

In 1972, public oil and gas offerings reached $1.1 billion and in 1975 they dropped to about $700 million. By comparison, recent oil price increases have brought in over $10 billion in new revenues to the oil industry. Decontrol of old oil would bring in an additional $11 billion. This as well as increased profitability of domestic drilling means that there is a substantial amount of capital available for reinvestment that was not available a few years ago. Independent drilling that has utilized tax shelter financing the most is the most profitable sector of the industry.

A survey of 75 small over-the-counter and American Exchange listed corporations primarily engaged in North American crude oil and gas extraction showed that in 1974 they earned a return on equity capital which averaged around 23% (as compared with the 1974 average of 14% for all manufacturing industries).

A December 2, 1974 article in Barrons Financial Weekly describes the independent's advantageous position as follows:

"At the moment, the independents are enjoying their greatest prosperity within memory as the result of towering oil and gas prices. Unlike the big international companies, they do not have extensive interest abroad and are not prey to the grasping tax and royalty collectors of OPEC countries. Nor, since they are unburdened with refineries and marketing organizations, are they plagued by th mounting competition and crude allocation difficulties which, lately, have begun to erode the inventory profits piled up in the early months of this year by the integrated concerns."

This committee should end opportunities for all oil and gas tax shelters. H.R. 10612 allows "exploratory" wells to escape the requirements of LAL. Exempting one type of shelter will cause an explosion of syndicating drilling deals as shelter seeking high income individuals run for the remaining shelter opportunity. Oil drilling funds will become even more marginal without development wells that are now usually included and more money will be simply thrown away down dry holes by syndicators satisfied with large fees and inflated costs. Not only will needed capital be wasted but the Treasury will be largely underwriting the losses incurred by these tax wise investors. Without the wasteful shelters, exploration will continued based on realistic economic projections not widely promoted tax gimmicks.

FARM TAX SHELTERS

Farm tax shelters not only create the same inequities and inefficiencies of other shelters. Many investment advisors flourish on cattle feeding and breeding, vegetable rollovers or orchard growing tax shelters specially created and marketed solely for tax shelter purposes. The potential economic return from such investments is of secondary importance: the return can produce an economic loss and still yield a substantial tax profit for its subscribers. The annual revenue loss from such activity is estimated to be more than $840 million. This loss occurs despite limitations against "hobby losses" and certain other restrictions enacted in 1969 after the Treasury Studies demonstrated the scope of this tax expenditure. The Treasury Department's Individual Statistics of Income for 1972 show that American millionaires are still the world's worst farmers even though they continue to get rich through the magic of the tax code.

In that year, 40 millionaires made $4,298,000 from farm operations—but 125 managed to lose—generally for tax purposes—$16,444,000 on farm operations. In other words, these otherwise very successful business people lost an average of $131,552 each in farming. A House Report on the 1969 Tax Reform Act noted that the tax laws "have allowed some high income taxpayers who carry on limited farming activities as a sideline to obtain a tax loss (but not an economic loss) which is deducted from their high-bracket non-farm income." In the strange world of tax shelters, going broke for the tax-loss farmer really means making hay.

This tax loss farming has a very detrimental effect on legitimate farmers. The price of farmland has been artificially bid up by tax loss farm investors. Farm shelters can produce wide price fluctuations by encouraging over-production. Finally, these unfair tax rules create an unfair competition for the real farmer.

LIVESTOCK SHELTERS

"The feedlot operation provides the tax shelter for investors. Cattle feeding is considered farming, and the investor, for IRS purposes, so far can elect to report on a cash basis. While he can't expense the cost of a feeder steer (since it is considered an inventory item), feed expenses are deductible when paid. In many cases, the investor puts down only 10% of the purchase price; the banks finance the remaining 90%. Yet he deducts 150%, 200% or more of the entire amount." (*Barron's Financial Weekly*, Oct. 21, 1974)

Breeding investments can only be longterm (at least 4 or 5 years). Much of the investor money is used to buy high pedigree animals (e.g. Black Angus or Charolais cattle) with the objective of developing valuable animals (not beef for slaughter). The shelter depends heavily on depreciation and investment tax credits on these animals as well as feed and operating expenses, and capital gains on occasional sales.

The shelter gimmick has fostered absentee ownership and the entry of relatively unskilled (and, occasionally, dishonest) promoters and managers. In 1974, investors' equity of between $2 billion (as estimated by *Barron's Financial Weekly*) and $3 billion (as estimated by *Business Week*) was permanently wiped out in cattle deals. While the direct cause was a drop in beef prices, much of this loss could have been avoided but for *inexperienced and high cost management* and the *excessive borrowing* used to maximize tax leverage.

The *feedlot* industry has recovered and according to *Business Week* is now experiencing "healthy profit margins." But the reentry of shelter promoters could again jeopardize the industry. According to *Business Week*:

Custom lots are getting a different breed of customers than they did when fat profits were prevalent a few years back, too. "In the early 1970s, the speculators took over like a herd of blind elephants," recalls Wood, of the Texas Cattle Feeders Association. "The speculator is out of cattle feeding now."

According to many feeders, most of the cattle now in lots are owned by ranchers and meat packers, and they believe this will add stability to the industry. "We've gone from a business dominated by gamblers to one where sense about the cattle market may prevail," asserts one feedlot operator. Kershaw agrees. "We need the knowledgeable investor who is willing to risk his money to make a profit," he says. "We don't need the people who get in strictly for tax losses."

Many legitimate *cattle* owners are continuing to suffer operating losses. But at best the shelter lure can only benefit the owners of *feedlots*. It does *not* benefit owners of *cattle*. This view is supported by a report from the agricultural economists from the University of Missouri-Columbia. According to Joseph C. Meisner and V. James Rhodes:

"Investors in relatively high income tax brackets found cattle feeding a ready vehicle for deferring income from the current year into future periods when their other income and tax rate may be lower and thus allow a saving on total income taxes paid over time.

"The impact of the tax shelter investor on the industry may have deepened the present cattle feeding period of losses."

Of course, the Treasury foots the bill for all the excessive fees and real economic losses which tax shelters avarice has caused. Just how much of the 1974 loses of $2–3 billion can be so categorized is not discernible.

AGRICULTURAL SHELTERS

Advantages of the one year "rollover" was extolled in *Forbes* magazine (Sept. 1973) as follows:

"You can plant vegetables late in the year in Mexico on land owned by someone else and each dollar spent before December 31 will give you a quick tax deduction. Then the vegetables come to market in late January and February before U.S. vegetables are available so you can get premium prices. Or, closer to home, you can buy say $100,000 worth of young rosebushes and *lease* the land from a legitimate nurseryman who also tends your rosebushes and markets them for you. You borrow $80,000 and put up cash of only $20,000 and write off $100,000 immediately. This deduction could save you as much as $70,000 in taxes giving a temporary cash profit of $50,000 ($70,000—$20,000)."

Long term shelter investments combine the advantages of fast write offs with the conversion of ordinary income into capital gains. *Barron's Financial Weekly* (Jan. 6, 1975) described the shelter as follows:

"Operation of an orchard or a vineyard can provide a sound investment as well as an excellent tax shelter. Such ventures offer a steady flow of tax losses in the years before maturity, plus the potential for profits while the crops are being produced—profits which themselves will be sheltered from the IRS bite.

The basic tax advantage of developing your own orchard or vineyard is that you can take a current deduction for development expenses from the time the seedlings are planted until they are mature. Moreover, if the properties are sold, there is the possibility of capital gains after an orchard or a vineyard has lost its value as a tax shelter or a producer of tax-sheltered income. Since most vineyards have been developed with a minimum of costs being capitalized, a sale by the original developer should produce a substantial capital gain, even if there has been an operating loss."

Agricultural shelters have tended to foster absentee ownership and to attract relatively unskilled promoters and managers who lack the meticulous dedication of a farmer-owner. This fact, combined with the uncommonly large number of natural hazards to which an orchard or vineyard is subject over a period of years, usually produces economic disaster. Little contribution is made to farm output.

PRICE INSTABILITY

Aside from the wastefulness of these investments, they also have a serious effect on the small legitimate farmer. John Wallace, President of the United Egg Producers recently testified before the Ways and Means Committee. He said:

"The egg industry has attracted in recent years numerous outside investors whose primary concern in egg production has not been profit oriented but rather one of seeking special tax advantages. Such investments have worked to the detriment of egg producers who are attempting to make a livelihood in this agricultural enterprise. The basic nature of the commercial shell egg industry causes egg prices to be highly volatile to minor changes in supply and demand factors. In the commercial shell egg industry such investments have added producing units which were not warranted by economic conditions. Many small, independent and family-type egg producers have been forced out of business in recent years. Some of this has been caused, we believe, by the availability of 'soft' money which has been unwisely invested in new flocks of laying hens.

"All segments of agriculture need capital—both internal and external. But such capital should be attracted by a profit-oriented motive rather than the tax write-off motive. The former would promote a strong, viable agriculture in the future while the latter, we believe, may very well drive all small, independent and family-type operators from the farm."

THE MINIMUM TAX

Even where there is no "sheltering" of other unrelated income, tax preferences themselves provide substantial tax free income for many wealthy individuals. The minimum tax was originally designed to place some tax on this "loophole" income but it has been notoriously ineffective. Persons who incur liability under the present 10% minimum tax pay such tax at an average effective rate of only 4.4 percent, and, in 1973, 622 persons with adjusted gross incomes over $100,000 (including 7 with million dollar incomes) managed to pay no regular tax and no minimum tax at all.

It is important to note that even with the strengthening measures contained in the House bill, the minimum tax would only be paid by about 120,000 wealthy individuals (less than 15/100 of 1% of all taxpayers) with tax preference incomes in excess of $20,000. And the tax that they will pay will be at 14%—a rate comparable to the lowest rate paid by the poorest wage earner.

THE HOUSE PASSED MINIMUM TAX

The House bill makes three major changes in existing law: (1) The present flat rate of 10% is increased to a flat 14%; (2) Taxpayers will no longer be allowed to deduct the amount of regular income taxes paid from the preference income on which the minimum tax is based, and; (3) Several additional items of tax preference are made subject to the tax.

The flat 14% rate contained in the House bill has no particular conceptual justification and is merely the result of a political deadlock. The rate should obviously be graduated upward to complement the progressivity of the ordinary rate structure. (The 1974 Ways & Means tax reform bill contained a 14% to 20% progressive minimum tax rate.)

The 100% deduction for regular taxes paid, presently allows some wealthy individuals to escape minimum tax altogether by sheltering loophole income subject to the tax with regular taxes paid on ordinary income from e.g. an executive's salary. This deduction was never part of the minimum tax as originally proposed by the Treasury. It was added to the 1969 Tax Reform Act by an eleventh hour Senate floor amendment, and presently allows 55% of those otherwise liable for minimum tax to avoid paying any minimum tax whatsoever. It shelters tax loophole income of more than 2.5 billion dollars that would otherwise be taxable at a minimum tax rate. The fact that a taxpayer might pay regular taxes on other income, just like everyone else, does not justify complete non-taxation of loophole income. The minimum tax should impose a minimum tax on loophole income, and this can be achieved only by completely eliminating the deduction for taxes paid, as in the House bill.

THE MINIMUM TAX AND LIMITING TAX SHELTERS

The House bill refrains from applying LAL to certain tax shelter preferences such as exploratory drilling deductions and, also delays for a transitional period the application of LAL to certain other preferences. Because of these provisions in LAL, the minimum tax will also eliminate opportunities for tax shelters which might still exist after application of LAL. When an accelerated deduction is not deferred under LAL, either because LAL has not yet been phased in for that particular property or because the accelerated depreciation is deducted against related income, the deduction should be subject to the minimum tax. Aside from existing minimum tax preferences, the House bill adds: (1) construction period interest and taxes on real estate, (2) accelerated depreciation on personal property subject to a lease, (3) intangible drilling expenses, including those for exploratory and developmental wells but not for dry holes, and (4) depreciation on player contracts acquired in connection with a sale or exchange of a sports franchise. This application of the minimum tax to items left out of LAL would limit the tax benefits of existing tax shelters.

The minimum tax will raise $1.1 billion in 1976, $1.7 billion by 1981, and $8.2 billion cumulatively between 1976 and 1981.

THE ALTERNATIVE MINIMUM TAX

The House bill retains the existing status of the minimum tax as a tax paid *in addition* to regular income taxes. However, it has been widely reported that the Finance Committee may consider an *alternative* minimum tax, i.e. a tax paid *in lieu* of regular income taxes. Such an approach is conceptually sound. Indeed, when the present tax was enacted in 1969 it passed the House in the form of an alternative tax only to have the Senate opt for the present additive tax.

However, the alternative tax approach can be potentially hazardous. An alternative tax, as a substitute for both LAL and the existing additive minimum tax, was offered during the House floor debate over H.R. 10612. It would have reduced the bill's revenue raising impact by $900 million in 1976 and over $7.7 billion cumulatively through 1981, and was broadly rejected as an attempt to resurrect tax shelters.

RANDOM EFFECT OF ALTERNATIVE TAX

The principle defect of most versions of the alternative tax is that a person—such as an executive—who has substantial taxable income on which he pays his fair share of taxes is given a license entitling him to receive an equal amount of income which he may shelter completely from taxes. In other words, the taxpayer takes his taxable income and adds to it his preference (or sheltered) income and computes a tax, generally by using 50% of the normal rates. Only on the random chance this tax turns out to be greater than the tax otherwise due on his regular taxable income is he touched by the minimum tax.

Thus a single person with tax sheltered or preference income of $75,000 and no other income might pay a minimum tax of around $17,000. But an executive with the same preference or sheltered income of $75,000 who also has a regular income of $100,000 (on which he already owes a tax of $53,000) is untouched by the minimum tax. (A tax at half the ordinary rates on $100,000 and $75,000 is not larger than the ordinary tax on $100,000 so no additional tax is due.) This means that many people will be well advised to continue investing in tax shelters—the very abuse we should be eliminating. Roughly speaking it may enable them to cut their effective rate from say 70% to 35%—an understandably tempting objective.

CONTINUING TAX SHELTERS THROUGH THE ALTERNATIVE TAX

Yet unless tax shelters are eliminated, Congress will merely have added still more chapters to our voluminous tax code without producing tangible results which are clearly visible to the average citizen. So long as the average taxpayer continues to hear about his dentist, his boss or his favorite athlete investing in exotic tax shelters, we won't have restored public confidence in the fairness of our tax laws. And, of course, the misallocation and waste inherent in so many of these investments will go on unabated.

While the LAL adds a regrettable number of pages to the code, it actually has a clear and simple "bottom line" result. It eliminates shelters. But what if the Committee forsakes this clear approach in favor of the more haphazard alternative minimum tax? Then, at a minimum, it should include as preference items all of the preference items which are subject to LAL as defined in the House bill. It should also adopt the "Additional Tax Shelter Provision" contained in the House bill such as limitations on the use of non-recourse debt to enlarge write-offs and clarification of the rules as to pre-paid interest deduction. By these steps tax shelters would at least be curtailed, although not eliminated.

DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCS)

H.R. 10612 does contain a partial yet inadequate reform of the DISC export tax subsidy. This subsidy has been acknowledged to be a wasteful and unneeded export tax subsidy by two Administration studies, a staff study by the House Budget Committee and the weight of testimony from independent tax experts commenting on the subject. The revenue loss for this provision will be \$1.5 billion in FY 1977, projected to rise to \$2.4 billion in FY 1981.

DISC was enacted in 1971 to allow small U.S. manufacturing companies to set up export subsidiaries to encourage the export of American goods and create more jobs. The encouragement is in the form of indefinite tax deferral (in effect tax-free income) on one-half of the profits of the subsidiary. For DISC to encourage exports, companies would have to use the tax break to lower their prices to become more competitive world wide. Unfortunately, this expensive tax subsidy has not worked.

First, DISC has done little to stimulate exports. Several independent studies have concluded that DISC increased exports by about \$250 million in 1972 and 1973 (1973 DISC revenue loss was \$640 million). More favorable data supplied by DISC companies indicates increases of \$400 million to \$1 billion. In any case, the increase is less than 1% of total U.S. exports.

Exports increased from \$47 billion in 1972 to \$73 billion in 1973 and \$98 billion in 1974, but this was primarily due to a devaluation of the dollar, which made U.S. exports much cheaper abroad. Based on Treasury Department figures, DISC tax breaks, even if completely passed on, provide only a 1.7% decrease in DISC export prices (one-half DISC tax deferral × 48% corporate tax rate × 7.2% average DISC profit margin on sales). This compares, for example, with a 28% reduction in the value of the dollar vis a vis the West German Mark.

Common sense would also dictate that much of the exports under DISC would be sold anyway, because these U.S. products are in great demand world wide (items such as computers, jumbo jets, wheat, fighter planes, nuclear reactors and other utility plants, oil drilling equipment and large household appliances among others). In these areas as well as others where American companies have a relatively monopolistic position. DISC benefits need not go into lower prices but have undoubtedly simply increased corporate profits at the expense of the Treasury.

To the extent that some companies do reduce their export prices, DISC raises the purchasing power of foreigners rather than U.S. consumers and therefore the multiplier impact on our economy should be much less than for other forms of corporate or individual tax cuts.

Second, DISC is a bad bargain for creating jobs. The House Budget Committee staff study estimates, using Bureau of Labor statistics, that the \$400 million in increased exports (even if due entirely to DISC) created 15,950 new jobs in 1974. If the \$1.5 billion in DISC lost revenues were used in other federal expenditure programs, many more jobs could be created. The \$1.5 billion would generate 112,500 jobs in defense or 120,000 jobs in health, or 150,000 jobs in education, or potentially 240,000 public service jobs or 90,000 jobs if used to cut corporate taxes from 48% to 46%.

Third, since increased exports drive up the value of the dollar relative to other foreign currencies DISC makes imports cheaper, thereby increasing them and displacing jobs here at home. The irony here is that imports tend to consist of more labor intensive products (autos, clothing, and shoes), while exports consist of less labor intensive products (computers, ball bearings, and manufactured goods)—the result is that DISC displaces more jobs than it creates.

Fourth, even assuming DISC increases exports, in a world of floating exchange rates, DISC makes little sense. In the absence of DISC, the U.S. exchange rate would become lower than it is with DISC. This lower exchange rate would make exports less expensive and increase export sales, employment and profits for all companies—not just DISCs.

Finally, DISC benefits go primarily to giant corporations to pay them to do what they would do anyway. Mr. Lee Morgan, president of the Caterpillar Tractor Company, had these candid remarks on DISC for the Ways and Means Committee in tax reform hearings on July 21, 1975:

"I would like to say all in candor that although 50.2 percent of Caterpillar's sales were outside the United States last year and we did benefit from DISC to the extent of about $9 million on our tax bill, a figure that is put in our statement, I am not really sure that we did anything extra in order to generate additional exports, so that I suspect that I agree with one of Mr. Ross' contentions that not much has happened, at least at our company, in order to earn the tax deferral that has come from DISC."

Seventy-two percent of DISC benefits go to corporations with assets in excess of $250 million, and these firms tend to be already well-established in the export field.

DISTRIBUTION OF DISC'S NET INCOME BY SIZE OF PARENT CORPORATION

Asset size of shareholder (million)	DISC's reporting net income: Number	Amount (millions)	Percentage of net income
Returns with asset size information	1,510	$1,285.0	100.0
Under $1	231	23.8	1.9
$1 to $10	539	66.2	4.8
$10 to $50	336	80.3	6.2
$50 to $100	98	42.5	3.3
$100 to $250	120	154.5	12.0
250 or more	186	921.7	71.7

Source: Treasury report, table 4-4.

The reform of DISC contained in H.R. 10612 professes to remedy this latter problem by applying the tax break only to profits resulting from the net increase in export sales over previous years. However, the base period level is arbitrarily defined as 75% of the average sales in 1972, 1973 and 1974, with this low base remaining constant for 5 years and then moving up one year each year. This proposal lacks any conceptual justification other than placating DISC recipients and in 1976 will reduce the $1.5 billion cost of DISC to the Treasury by only about 1/3 or $600 million. Under this reform, DISC revenue losses will continue to exceed one billion dollars a year for the foreseeable future reaching $1.6 billion in 1981.

If DISC is retained for actual increases in sales, the more realistic approach would be to use 100% of the average for the immediately preceding three years. This amendment would cut the cost of DISC by 2/3 or $1 billion in 1976, and would raise an additional $4.3 billion dollars through 1981.

FOREIGN TAX CREDIT AND DEFERRAL OF OVERSEAS EARNINGS

Several recent independent studies indicate that the investment of $200 billion overseas by the United States in the last 25 years may have resulted in a slight loss of national income, a decline in American jobs and a shift in the distribution of income from labor to the multinational corporation, their employees and shareholders. (See e.g. Direct Investment Abroad and the Multinationals, by Dr. Peggy Musgrave, and a State Department Commissioned report by Robert Frank and Richard Freeman of Cornell University.)

There seems to be a great concern over capital formation expressed by the business community and some members of this committee. Any concern over capital formation should begin with a concern over the export of American capital triggered by U.S. tax policy. At least one of the new studies also argues that, in the long run, the large-scale export of American technology, managerial skills and capital amounting to more than 20 percent of annual domestic corporate capital formation in recent years, may be contributing to a decline in the nation's productive capacity and productivity and to a neglect of domestic investment opportunities.

Professors Frank and Freeman also conclude that most foreign investment directly displaces domestic investment and therefore results in a loss of American jobs. In 1970, for example, their analysis shows a net loss of 160,000 jobs attributable to overseas investment by United States-based multinational corporations, particularly in the machinery, electrical-equipment and chemical industries. Unfortunately, our tax system too strongly encourages overseas investment through the twin mechanism of deferral and the foreign tax credit.

"Deferral" refers to the present law that allows the earnings of foreign subsidiaries of domestic corporations to escape U.S. taxes until those earnings are brought back to the U.S. and distributed to the parent corporation. This allows corporations to defer, and often completely avoid, the tax by reinvesting the money overseas. However, these earnings are considered assets of the U.S. parent company for purposes such as obtaining credit and reporting income to shareholders. The deferral is therefore an incentive to U.S. corporations to build factories and locate operations overseas instead of at home where they would provide jobs for American workers.

Deferral is very much related to the other issue concerning foreign income before the committee—the operation of the foreign tax credit. Under present law, the U.S. taxes world wide income of U.S. corporations at a theoretical 48% rate. The tax credit, however, allows a company to subtract from that 48% taxes it pays to the country in which it is operating.

The tax credit achieves basic U.S. tax neutrality by ensuring that even with the operation of the U.S. tax on foreign and domestic subsidiaries, their tax burden will always be the same 48%. (Unless the foreign subsidiary chooses to move into a country with a tax rate above 48%.)

TAX NEUTRALITY TIPPED BY DEFERRAL

Deferral, however, tips the balance of neutrality back in favor of overseas subsidiaries when they operate in low tax countries. Take France as an example. A company's foreign subsidiary pays 40% tax to France, but can then defer indefinitely the 8% it owes to the U.S. (by not distributing the foreign income to the parent company in the U.S.). The very same U.S. corporation, then, could have one subsidiary in New York that pays 48% tax and another one in France that pays only 40% tax.

Depending upon how earnings were calculated and how the tax credit was applied, the elimination of deferral could raise between $320 and $620 billion for the U.S. Treasury.

REFORM OF THE FOREIGN TAX CREDIT

Reforms in the foreign tax credit area are complicated. The House bill represents some minor tinkering with the way the tax credit is calculated. This will raise about $80 million, but leave most multinational corporations free to shelter income in one country while taxes are paid in another.

Presently, the tax credit can be figured by two different methods—the overall limitation and the country by country limitation. In general, a company is allowed a tax credit against U.S. taxes on taxes paid to foreign countries. The credit is equal to the portion of its total income that comes from those foreign countries. More specifically, the per country limitation computes the income percent and resulting tax credit separately for each country. The overall limitation combines all foreign income and all foreign taxes to find the amount of the credit due.

UNFAIR ADVANTAGES

The overall limitation is an advantage for companies doing business in countries which have a high tax rate, since these high foreign taxes can be averaged out against another country's lower rate. So any foreign tax rate higher than the U.S. rate would not ordinarily be fully creditable against U.S. taxes. This permits companies which have excess credits from one country to apply them to countries with tax rates lower than the U.S. rate. This not only gives those companies a competitive advantage in the second foreign country, but in effect, allows the high tax countries—rather than the U.S.—to collect taxes on the income earned in low tax countries.

The per country limitation is an advantage for companies, that generate huge paper "start-up losses," such as those in oil and mining who can deduct drilling and mine development expenses immediately. The advantage here is that "start-up losses" in one country can be applied directly against U.S. income, instead of being applied overall to other foreign countries where profits are being made. These foreign losses shelter U.S. income.

ADVANTAGEOUS SWITCHING OF COMPUTATION

After the branch operation begins to make money, the company can switch to the overall limitation to take advantage of the generous averaging provisions between high tax and low tax countries. (Typically, the oil industry uses huge payments to oil producing countries to shelter huge income from shipping operations in zero tax countries that would otherwise be subject to 48% U.S. tax. Mobil Oil, for instance, sheltered some $400 million in shipping profits last year alone.)

There is some disagreement over what reforms are needed in this area. Many experts argue for a repeal of the overall limitation and an end to deducting foreign branch losses directly against U.S. income. Others favor leaving the overall, repealing the per country and limiting extraordinarily high taxes that are really royalty payments. Both groups premise their positions on an elimination of the deferral of whatever tax liability is left after the tax credit is calculated.

Either of these approaches is basically sound but largely meaningless unless coupled with repeal of deferral. In addition a special rule might be created to deal with the special ability of natural resource companies to characterize royalties paid to host countries for exploration of mineral rights as taxes.

ELIMINATE EXCESS FOREIGN TAX CREDITS

The Committee should eliminate the abuse of excess foreign tax credits generally, and, specifically, should address itself to the abuse that occurs when extractive industries (oil, gas and mining) operating and exporting capital overseas use disguised royalty payments to generate huge excess credits to shelter low taxes foreign shipping income. This latter problem could be eliminated by disallowing credits for the extractive industry of any "tax" paid in excess of 48%. This change would raise about $150 million in fiscal 1977.

ELIMINATION OF DEFERRAL

Of course, no amount of reform of the foreign tax credit will stem the tide of exported capital and jobs without the complete elimination of deferral. The argument that many other nations allow deferral is weak at best. Some nations such as Great Britain, do allow deferral but their definition of a domestic corporation is much broader than ours. Great Britain, for instance, in most cases will consider a British-owned company based in the Netherlands as subject to British tax on a current basis.

Finally, the existence of deferral is pointed to as the major reason to retain the costly DISC export tax subsidy. The 50% domestic deferral will equalize the deferral advantage overseas and keep exporting operations based in the U.S. Given the questionable relationship to DISC and increased exports, this argument is not very strong. But if one does buy this argument, the obvious answer to it would be to eliminate deferral *and* eliminate DISC. Not only would there be a restoration of tax neutrality, and an end to the subsidization of foreign consumers, but the Treasury would gain more than $2 billion in urgently needed revenues.

CONCLUSION

In sum, we feel that H.R. 10612 is a modest but good first step in restoring confidence and equity in our tax system and we would urge the Finance Committee to build on that foundation by strengthening the bill in the ways we have suggested.

The CHAIRMAN. As our next witness, we will call Roland M. Bixler, chairman, Committee on Taxation, National Association of Manufacturers, accompanied by Matthew P. Landers, chairman, International Taxation Subcommittee, and Edward A. Sprague, vice president and manager, Fiscal and Economic Policy Department.

We are happy to have you with us today.

STATEMENT OF ROLAND M. BIXLER, CHAIRMAN, COMMITTEE ON TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS; ACCOMPANIED BY MATTHEW P. LANDERS, CHAIRMAN, INTERNATIONAL TAXATION SUBCOMMITTEE; AND EDWARD A. SPRAGUE, VICE PRESIDENT AND MANAGER, FISCAL AND ECONOMIC POLICY DEPARTMENT

Mr. BIXLER. My name is Roland M. Bixler, president of J-B-T Instruments, Inc., of New Haven, Conn. I represent the National Association of Manufacturers as a director and as chairman of its Committee on Taxation. Accompanying me are Matthew P. Landers, treasurer of Pfizer, Inc., and chairman of our international taxation subcommittee, and Edward A. Sprague, vice president and manager of NAM's fiscal and economic policy department.

The NAM represents 13,000 members which employ a majority of our industrial labor force and which produce over 75 percent of the Nation's manufactured goods. Over 80 percent of our members are generally classified as small businessmen. I am a small businessman myself, as an owner of an electronics manufacturing firm employing less than 100 persons.

The first portion of this statement will deal with issues of domestic tax policy and capital formation. The second section will deal with the issues affecting U.S.-owned operations overseas.

We have submitted a longer statement for the record. May I ask that it be inserted in the record. That statement provides our views on a number of specific provisions of H.R. 10612, which I will not cover in my oral remarks, in the interest of time.

On capital formation needs, you heard a good deal on this topic from Secretary Simon yesterday.

All known forecasts agree that there will be very substantial capital requirements in the coming decade—not only to keep up some semblance of productivity growth, but to account for mandated environmental and personal safety standards and at least to get a start on energy self-sufficiency.

We believe that changes to reduce the anti-investment bias in existing tax law would result in significant increases in capital outlays and increased employment throughout the economy. The secondary or "feedback" effects of tax changes on investment, employment and output should be considered, and taken into account in determining a net revenue impact. The direction and magnitude of these effects generally will change the Federal revenue base in such ways as to diminish or reverse the initial impact estimate of gain or loss.

In our full statement, there are detailed types of employment and net revenue impacts with respect to changes in the investment credit and depreciation reform recommendations.

Although tax policy certainly is not the only factor affecting the adequacy of capital formation in the private sector, it can be critical at the margin and may well determine the success or failure of regaining a better productivity performance and achieving more satisfactory increases in real income for workers. For this reason, we recommend a number of basic tax revisions.

MAXIMUM CORPORATE TAX RATE

First, in the corporate structure, the maximum corporate rate of 48 percent causes a heavy drain on the earnings of American companies, substantially lessening the availability of internally generated funds as a source of capital. The President has proposed a reduction in this maximum corporate rate to 47 percent in 1976 and to 46 percent thereafter, which would be a very beneficial step. But the President's proposal would reduce only the corporate surtax, currently 26 percent on income over $50,000.

Small businesses have traditionally relied very heavily on internally generated funds as their primary source of capital, having little access to the debt and equity capital markets.

The existing $50,000 exemption for one-half of 1976 should at least be made permanent now. The proposed extension in H.R. 10612 for only 2 years falls well short of a commitment to provide permanent tax relief to the small business community. We, therefore, recommend that the $50,000 exemption be made permanent and that there be a gradual increase in the exemption to $100,000.

INVESTMENT TAX CREDIT

The investment tax credit has become an integral part of the cost recovery system in our tax law, but its checkered history and uncertainty about its future have tended to limit its contribution to a stable investment climate. The problems of order bunching, et cetera, that would attend a stepdown in the credit in 1977 can be avoided and the credit's beneficial effect maximized by enacting a permanent 10-percent credit as early as possible this year.

The proposal in H.R. 10612 to continue the 10 percent rate through 1980 is a step in the right direction, but the still temporary nature of the increase would cause some concern.

One economic analysis indicates that extension of the 10-percent credit on a permanent basis—but without other liberalizations—could result in an additional $24 billion in real fixed investment over the next 5 years and an additional 340,000 jobs. That is documented in appendix B of the statement which has been accepted for the record.

Furthermore, the net revenue impact would turn positive within this period. There would be an absolute gain to the Treasury even using very conservative economic assumptions as to the feedback effect.

DEPRECIATION ALLOWANCE

On the capital recovery allowances, the current methods of depreciation are based on the "useful life" concept rather than full recovery of invested costs. The problem with the useful life concept is that its theoretical recovery of invested capital does not work in the real world of today's inflationary pressures and technological change.

The longer the depreciable life assigned to an asset class, the more devastating the effect of inflation.

The Class Life System and ADR have increased somewhat the speed of cost recovery but their purpose can be frustrated by the inability of many businesses—particularly small businesses—to adopt them.

The NAM recommends a complete change in the cost recovery system in the Code through the enactment of a capital recovery allowance system which would be an optional alternative to the existing depreciation methods, such as in H.R. 7543. In outline form, it would include the following major features, which would be optional alternatives to the existing depreciation methods:

First, machinery, equipment and pollution control facilities would be subject to an accelerated 5-year writeoff; and, second, that industrial buildings used in the process of manufacturing, extraction, transportation, communication, et cetera, would be subject to an accelerated 10-year writeoff.

Now, as to double taxation, the economy has endured a long time with double taxation of corporate earnings—first through the corporate income tax and then at the shareholder level through the individual income tax on earnings paid as dividends.

In our view, the simplest and most equitable means of securing relief from the present penalty situation would be a deduction at the corporate level for dividends paid. This method would assure directly a much-needed increase in cash flow for productive investment for virtually the entire corporate sector. It would breathe new life into new issues markets, and correct the longstanding bias as to tax treatment of equity versus debt financing. It would avoid the problems of horizontal inequities which could result from providing credits or exclusions to shareholders with dividend income while taxpayers with equivalent wage income would remain fully taxable.

To phase out double taxation, the NAM recommends a 25 percent corporate deduction for dividends paid.

I noticed in the chart that Senator Kennedy had here earlier, for example, that President Ford's integration proposal would be called a $13 billion tax expenditure by 1981. But, this would be $2 billion less than the existing double taxation penalty.

ESOP

While the NAM does not have a position on specific programs to encourage Employee Stock Ownership Plans or ESOP's, we currently are studying this, the Broadened Stock Ownership Plan recommended by the President, and proposals affecting the savings and investments of private individuals. We believe there are substantial potential benefits to the economy and the enterprise system inherent in these concepts, and we hope that they can be considered as legislative subject matters in and of themselves.

TAXATION OF FOREIGN INCOME

Then, on taxation of foreign source and export income, the location of business operations involved in international trade is not a decision which can be made simply on the basis of one's national preference. There are very real outside pressures which control the ability of a company to develop a share of a given foreign market. These may well dictate that a plant be located overseas rather than in the United States if the company is to have the business.

We do not believe this substitutes foreign jobs for U.S. jobs because domestic operations could not compete in these market situations. Instead, these operations actually create U.S. jobs which otherwise could not be maintained.

Now, I differ quite a bit from the previous witness in this area. A 1975 report, The NAM/Business Roundtable Survey on Export-Related Community Employment, compiled the responses of 294 export trade firms to questions about their volume of exports, their customers and their export-related employment at each individual plant location throughout the United States.

These firms exported almost $27 billion in 1974, approximately 42.5 percent of U.S. exports of manufactured goods. Over one-half of these goods went to the companies' own subsidiaries or affiliates overseas. These firms employed about 530,000 persons whose jobs are directly related to their export sales. Based on the volume of sales to related companies, about 270,000 jobs in these 294 companies alone depend on the export-drawing power of the firms' overseas operations. In addition, the respondents identified another 125,000 domestic jobs which are supported by dividends, license income, royalties and technical service agreements from their overseas subsidiaries and affiliates.

In addition to the direct employment impact, overseas investment by U.S. firms is generating very significant contributions to our balance of payments and the pool of capital available for domestic investment. Many companies, in fact, could not sustain their current domestic capital spending programs without the contribution of foreign earnings.

Therefore, in our view, it would be a mistake to impose punitive tax measures on our overseas operations. We believe that the existing system is an equitable means of avoiding double taxation and giving further advantage to our aggressive foreign competitors. Therefore, we strongly recommend that the foreign tax credit be retained and U.S. tax be imposed only on actual receipt of earnings from foreign subsidiaries.

DISC

In addition, we believe, as small businessmen, and I say this with particular fervor, we believe that the DISC program is successful in all size firms at increaseing exports and creating additional domestic jobs. We see no reason to dismantle the present tax measure.

Mr. Chairman, I do have a conclusion, and I did hear the bell ring. Perhaps I could summarize that last paragraph.

If we do wish to preserve the integrity of the enterprise system, we cannot neglect the investing and producing sector. Our answer, in part, is to reduce tax obstacles to productive investment. Otherwise, we could allow the private sector to wither and ultimately look to Government to provide the capital for investment. In that case, I sincerely believe we would end up with a permanent rationing of scarcity instead of maximizing performance. Do the American people or the U.S. Congress really want that?

DEPRECIATION ALLOWANCE

The CHAIRMAN. Senator Byrd?

Senator HARRY F. BYRD, JR. Mr. Bixler, what is your view on the current depreciation schedule? Do you think the rates are adequate?

Mr. BIXLER. Senator Byrd, I feel that they are totally inadequate. We should be getting away from the concept of the depreciation ~~schedules,~~ because they relate to the useful lives. Where there are lives of 14 to 18 years, the inflationary factor which has taken place prevents business from ever getting costs back.

Here we are trying to compete in a world where other competitors in many other industrialized nations are getting much faster recovery allowances than we are.

Senator HARRY F. BYRD, JR. Canada, as I understand it, has greatly liberalized its depreciation schedule. I wonder if you had an opportunity to note what Canada has done, how it works. It has only been in the last several years, and I recollect it is about a 50-percent writeoff.

Mr. BIXLER. As I understand it. 2 years is the time period. I wonder if Mr. Sprague might have a little further information on that.

Mr. SPRAGUE. Senator, we have been interested with what Canada has been doing with their cost recovery system. We have been following developments up there quite closely. We hope that we might learn a lesson in that respect.

Senator HARRY F. BYRD, JR. Do you feel that it would work advantageously for the country as a whole?

Mr. SPRAGUE. Very definitely. There is, of course, one aspect of the Canadian system, it is quite limited in terms of the extent of that 2-year writeoff. It applies only to machinery and equipment used in the manufacturing process. That is a very key element, but it does limit the extent of the writeoff.

Senator HARRY F. BYRD, JR. I guess Canada is somewhat extreme in a position in which it is going on the depreciation.

Mr. SPRAGUE. No; there are others such as the U.K., but I do not know if they have the best example of a viable overall economy. I think what the Canadians did in relation to the rest of the tax system is something we should look at very carefully.

Senator HARRY F. BYRD, JR. In any case, you think the depreciation rates should be liberalized?

Mr. SPRAGUE. Very definitely.

Further, just to repeat what Mr. Bixler indicated, we believe we ought to try and get away entirely from the existing system of depreciation and go to a capital recovery allowance system where there is no attempt even to relate your allowance to a given classification.

Senator HARRY F. BYRD, JR. Could you give an example?

Mr. SPRAGUE. Under the proposal, you would group all your machinery and equipment into one classification. You would subject this to the accelerated 5-year writeoff, and you would do the similar——

Senator HARRY F. BYRD, JR. You would provide for a 5-year writeoff?

Mr. SPRAGUE. That is right, for equipment.

Senator HARRY F. BYRD, JR. Thank you.

Thank you, Mr. Chairman.

DIRECT FEDERAL EXPENDITURES

The CHAIRMAN. Let me just touch on this one point that was suggested by an earlier witness today.

It was suggested that if we want to encourage people to engage in certain lines of endeavor which we might feel this nation is interested in, we ought to consider doing it in direct Federal expenditures rather than through the tax law, under which an individual can decide for himself what he wants to engage in.

How do you, as business people, look upon this idea, that the Government would take your money and that you can make application to be paid government expenditures from the Treasury as grants or something of that sort to encourage you to do something that the Government might think desirable conduct? Between the two approaches, which one has the most appeal, and why?

Mr. BIXLER. I am glad you rephrased the question, because I could hardly answer the first part without using words like horrendous and terrible and awful, and the like. But it just seems to me that if the enterprise system is to continue to function as it has throughout our history, then the investor and the businessman finally have to make choices and decide what is the best employment of the capital available.

Having seen some government programs in operation at various levels, even on the school board, I have to say that a lot of those can lead to real gimmickry with respect to what you have to do to qualify to get this kind of money. In addition, the amount of money that gets lost in the transition process is indeed extensive.

The CHAIRMAN. It seems to me that the paperwork on that approach would be absolutely fantastic. In the first place, you come down here, and then you make application, then the letter goes to the wrong desk and then after a while you cannot get an answer to your letter until you come in personally down here to try to see who it was who should have granted the funds out of the Federal Treasury. Then you run into the bureaucrat that does not understand your business and is new at the job, and then it ends up so that you though you filled it out just fine, and it seems as though you failed to put a comma where you thought there should be a comma, instead of a semicolon. By the time you get through with all that, you find something else that looks like you are following hiring processes that are this and that, although you have tried to be fair and treat everybody right, it looks like at some point maybe someone was hired, when this government official though you should have hired a woman instead of a man for that particular job, and it looks to him that when you promoted somebody, you did not take into account that the person was not the correct person to have a raise. Therefore, you plan to see that every employee is not related to every other employee, or, in promoting someone, you might have promoted the wrong person instead of this person, and meanwhile, somebody has an amendment to offer on the bill where he thinks some other word would improve it. He objects or thinks that the government agency maybe ought to take into account in deciding whether you get the funds, or whether or not the Treasury should give you the funds, and by the time you get through with all that, you find that you are spending more time trying to deal with these people rather than doing the job.

I would think that the members of Congress would understand the businessman's problems, rather than passing this campaign law, telling Senators how to raise money, what they have to do with it if they want to run for office. You have to have about three people who work just as hard as you do getting all the information that Mr. So-and-So needs, so that every time you cast a vote, that you did it because of how much each one of them contributed, and how you spent your money.

We now have it fixed up so that a Member of Congress who runs for office has to provide all the information to the particular group that wants it, for whatever purpose—so maybe we can have a little sympathy for the businessman's problems. He reads Horatio Alger's stories and thinks he is going to do the same thing.

I think that if you had your choice between writing a tax law that is hopefully not too complicated to figure out, where it simply says if you do something the government thinks is desirable, you get a better tax break; as opposed to having some government "higher-up," who might understand your business, but probably will not, make that decision for you, you would choose the former?

Mr. BIXLER. Positively, Senator.

The CHAIRMAN. Of course, one advantage of using the tax law, if it says quite clearly that you would get the benefit, is that it spells it out rather than looking at so many government programs, where you may get some benefit out of it, but by the time you get to Washington, you find out that you do not get the benefit after all.

Mr. BIXLER. I have been down that route, too.

[The prepared statement of Mr. Bixler follows:]

TESTIMONY OF ROLAND M. BIXLER, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

SUMMARY OF MAJOR RECOMMENDATIONS

The National Association of Manufacturers encourages the Congress to take affirmative action to begin to correct the long-standing tax bias against the capital formation sector. We believe that positive steps to reduce tax obstacles to capital formation are essential to meet the capital shortage, create productive new jobs, and thereby help to *solve*, not *aggravate*, the problem of large federal budget deficits.

We recommend the following objectives for domestic and foreign tax policy:

Domestic

1. To help small business cope with its severe problems of capital generation, a permanent extension of the corporate surtax exemption level at $50,000 in 1976

and phasing up to $100,000 by 1981, and, for business in general, an across-the-board reduction in the corporate normal tax to 20%;

2. To help productive investment generally, a permanent extension of the investment credit at no less than 10% for all taxpayers with no basis adjustment, a liberalization of the 50% income tax limitation and of the used property limitation, and an end to the 3-5-7 rule;

3. To better enable industry to meet governmentally-mandated environmental quality standards with minimum disruptions of productive investment programs, allow an optional full deduction for capital expenditures on qualified pollution-control facilities in the year the costs are incurred, with a statutory clarification of the definition of such a facility;

4. Modernize our cost recovery system to more fully reflect obsolescence as well as replacement cost and make it fully competitive with treatment offered overseas, through a capital recovery allowance system such as proposed in H.R. 7543;

5. To infuse the whole corporate sector with needed cash flow and to help correct the long-standing tax inequity of double taxation of corporate earnings, allowance of a 25% deduction at the corporate level for dividends paid, eventually phasing up to a 100% deduction; and

6. A continuation of the 1975 individual tax reductions, with modifications.

Foreign

We believe that U.S.-owned overseas business operations are essential if U.S. interests are to develop and maintain foreign markets where economic and political factors prevent direct U.S. export service. Where direct export is feasible, U.S. tax law should recognize the existing foreign barriers to such exports.

We recommend, therefore:

1. To prevent the double taxation of foreign source income, continuation of the foreign tax credit;

2. To avoid unilateral imposition of additional tax costs on U.S.-owned overseas business operations, continuation of the practice of taxing the earnings of such operations only when received by a U.S. taxpayer; and

3. To reduce the impact of international barriers to U.S. exports, maintenance of the existing Domestic International Sales Corporation (DISC) provisions.

Testimony of Roland M. Bixler, on Behalf of the National Association of Manufacturers

My name is Roland M. Bixler, President of J-B-T Instruments, Inc., of New Haven, Connecticut. I represent the National Association of Manufacturers as a Director and as Chairman of its Committee on Taxation. Accompanying me are Matthew P. Landers, Treasurer of Pfizer, Inc., and Chairman of our International Taxation Subcommittee, and Edward A. Sprague, Vice President and Manager of NAM's Fiscal and Economic Policy Department.

The NAM represents 13,000 members which employ a majority of our industrial labor force and which produce over 75% of the nation's manufactured goods. Over 80% of our members are generally classified as small businesses. I am a small businessman myself, as an owner of an electronics manufacturing firm employing less than 100 persons.

This statement will present our views on a general range of tax policy issues of interest to industry. We will note one or two items of particular interest to small business, but most areas of the federal income tax are of concern to business in general. Distinctions by size are more illusory than real, and business representatives are well aware that a strong economy requires healthy businesses of all sizes.

The first portion of this statement will deal with issues of domestic tax policy and capital formation. The second section will deal with the issues affecting United States-owned operations overseas. The final portion will cover other areas.

DOMESTIC TAX POLICY AND CAPITAL FORMATION

Capital Formation Needs

During the last two years, capital formation in our economy again has become a critical concern. Much material and many studies have been developed indicating a serious capital "shortage," particularly as the current economic recovery matures.

Forecasting capital investment demands and available savings supply over the longer term is not a simple matter. Perhaps too much has been made of some attempts to aggrevate investment "needs" by sector. But the basic point remains that all known forecasts agree that there will be very substantial capital requirements in the coming decade—not only to keep up some semblance of productivity growth, but to account for mandated environmental and personal safety standards and at least to get a start on energy self-sufficiency. We can assume that growth in investment demands over the next decade will be *at least* as great as the average annual increase in the last ten years, and in all likelihood much greater. To our knowledge, no authoritative source has come to any different conclusion. In our view, we are going to have to fuel the production process with increased amounts of net new investment just to stay even in terms of *real per capita living standards* and to improve upon current unemployment rates.

We believe that the existing tax structure is strongly biased *against* savings and investment, and the results of this bias are reflected in the economy's low rates of capital formation and productivity increases. Despite all the arguments about loophole-closing and tax shelters, the individual income tax in this country is still progressive, the corporate income tax in its present form is still a double levy, capital recovery allowances are insufficient to account for inflation, and the combination of these factors constitutes a harsh penalty on the capital formation sector. Changes in the tax laws to reduce this anti-saving, anti-investment bias would result in significant increases in capital outlays.

This would have not only a direct impact in expanding output, jobs, and incomes, but also have a longer lasting effect in deepening the capital structure, increasing productivity and real wage rates. As business and individual incomes rise, the Federal government's tax base also expands. The initial revenue loss from the tax change, as traditionally estimated, diminishes and turns into a revenue gain.

Impact Analysis of Tax Proposals

Seen in this light, it is obvious that tax policy is economic policy. This relationship is understood instinctively with respect to reductions for individuals who are then provided with extra cash for purchases of goods and services. But less well understood is the fact that tax reductions for investors and business can have a similar or greater effect.

The traditional revenue estimating process, which results in the revenue "gain" or "loss" figures which accompany tax proposals, does not take this relationship into account. Instead, the estimate assumes that tax changes take place in a vacuum and that taxpayers' behavior is not altered as a result of such changes. Using this approach, the estimate produces a plus or minus initial impact figure which is then assumed to be the actual revenue effect that will be generated.

We believe that this presents an inadequate analysis of the economic impact of tax proposals. Because tax policy does affect the economy, the secondary or "feedback" effects on investment, employment and output should be considered. Of equal importance is the need to take these effects into account in determining a *net* revenue impact. The direction and magnitude of these effects generally will change the federal revenue base in such ways as to diminish or reverse the initial impact estimate of gain or loss.

Because we feel so strongly about the inadequacies of traditional revenue estimates, the NAM's Committee on Taxation undertook a special project to study the development of other approaches. The first product was our *Tax Impact Project Report (TIP Report)*, which was printed and distributed to your offices last year. The results with respect to a permanent 10% investment tax credit are presented later in this statement.

Specific Tax Policy Recommendations and Commentary

Tax policy certainly is not the only factor affecting the adequacy of capital formation in the private sector, but it can be critical at the margin and may well determine the success or failure of regaining a better productivity performance and achieving more satisfactory increases in *real* income for workers.

Congress obviously faces difficult choices right now when it comes to reducing tax obstacles to capital formation in the context of multi-billion dollar federal budget deficits and still very worrisome inflationary potentials in the economy.

Again, we believe the justification for reducing any taxes in periods of such substantial budget deficits to be simply the fact that estimated initial revenue impacts as related to these tax proposals are not realistic figures—particularly in periods of remaining economic slack such as the present. When real investment is made and people are put back to work, or new jobs created, as a result of the tax changes recommended, the federal income tax base will grow.

Where possible, therefore, we have obtained estimates of the feedback effect of proposed tax changes in terms of investment, employment, and the federal tax base itself. (See Appendices.)

(1) Corporate Income Tax Rate Structure

The rate.—The maximum corporate rate of 48% causes a heavy drain on the earnings of American companies, substantially lessening the availability of internally generated funds as a source of capital. The President has proposed a reduction in this maximum corporate rate to 47% in 1976 and to 46% thereafter which would be a very beneficial step. But the President's proposal would reduce only the corporate surtax, currently 26% on income over $50,000. A better approach perhaps would be to reduce the normal tax (currently 20% on the first $25,000 and 22% on all remaining income) to 20% across-the-board which would ease the tax burden on more small companies and smooth out the extra step of graduation created by the Tax Reduction Act of 1975.

Surtax exemption.—Small businesses have traditionally relied very heavily on internally generated funds as their primary source of capital, having little access to the public debt and equity capital markets.

In recognition of this situation, the corporate surtax exemption was created to provide small and growing businesses with relief from the maximum corporate tax rate. From 1950 to 1975 the $25,000 exemption was not changed. In addition, the Tax Reform Act of 1969 phased out the use of multiple surtax exemptions for affiliated companies. In attempting to remove a very specific type of alleged abuse, the Act included a sweeping provision which forced many small companies owned by the same family members or associates to split one exemption among unrelated businesses where before they had two or more exemptions.

Jumping from a 22% rate to 48% rate on all profits above $25,000 is a sobering prospect for the small corporate businessman. A permanent increase in the exemption to $100,000 (proposed by Sen. Tower in S. 949 and by Rep. Archer in H.R. 2288), phased in over a number of years, would be most beneficial to those firms that are struggling to grow through the $25,000 to $100,000 taxable income range. This change would provide the breathing room for which the exemption was originally enacted.

The existing $50,000 exemption for fiscal 1976 should at least be made permanent now. The proposed extension in H.R. 10612 for only two years falls well short of a commitment to provide permanent tax relief to the small business community.

The initial impact revenue estimate for a full year, $50,000 exemption is $1.6 billion in 1976 and $1.8 billion in 1977.

(2) Investment Tax Credit

The rate.—The investment tax credit has become an integral part of the cost recovery system in our tax law, but its checkered history and uncertainty about its future have tended to limit its contribution to a stable investment climate. Past attempts to "fine tune" the economy by varying the availability of the investment credit probably have been destabilizing on balance—that is, they have produced wider swings in net new investment than otherwise would have occurred with a stable policy. The problems of order bunching, etc., that would attend a step-down in the credit in 1977 can be avoided and the credit's beneficial effect maximized by enacting a permanent 10% credit as early as possible this year.

The proposal in H.R. 10612 to continue the 10% rate until 1980 is a step in the right direction, but the still temporary nature of the increase would cause some concern.

Progress payments.—The NAM supports allowance of the credit as progress payments are made on qualified property, such as was enacted on a limited scale in the Tax Reduction Act of 1975. The underlying policy of a modern cost recovery system should be to recover quickly the taxpayer's invested capital, not to spread that recovery out over a long period of time, thereby sanctioning the eroding influence of inflation on our capital base.

While we question the need to phase in this provision over a five-year period, the principal problem with the existing progress payment system is its limitation to property with at least a two-year normal construction period and a seven-year estimated useful life. Such limitations are inherently arbitrary and will discriminate against property which falls just outside the rules. Since in actual practice it is not likely that progress payments will be made very often on property which would not fit within these limits, consideration should be given to making the credit available as expenditures are made on any qualified property. We believe that the direct revenue consequences of removing these limitations would be minimal.

Income limitation.—The 50% income limitation on the credit in effect discourages new investment, particularly in times of general economic slack and declining profits, such as in 1974–1975. Liberalizing the limitation or repealing it altogether for all taxpayers would remove this problem and make the credit more effective.

Used property.—The NAM welcomed the Tax Reduction Act's increase from $50,000 to $100,000 in the cost of used property that is subject to the investment tax credit. In fact, we would favor a larger increase in the allowance because, in many cases, used assets are the only type available to an interested buyer, particularly small and medium-sized firms and new businesses, which often have to purchase used equipment either because of availability or cost considerations.

The proposed extension through 1980 in H.R. 10612 would be helpful. Making this a permanent feature of the credit would improve the planning capabilities of those firms needing to purchase used equipment.

3–5–7 rule.—The repeal of the 3–5–7 rule—which allows 100% availability of the credit for assets with 7 year or longer lives, two-thirds availability on 5 to 7 year lives and one-third on 3 to 5 year lives—would increase the credit's effectiveness and reduce its discrimination against necessary, but short-lived, assets.

We encourage the permanent enactment of all of these proposals without any adjustment to the depreciable basis.

The *Tax Impact Project Report* indicates that extension of the 10% credit on a permanent basis (but without other liberalizations) could result in an additional $24 billion in real fixed investment over the next five years and an additional 340,000 jobs. Furthermore, the *net* revenue impact—that is, the result of additional investment and jobs on the tax base netted against the direct revenue loss—would turn positive within this period. There would be an absolute gain to the Treasury even using very conservative economic assumptions as to the "feedback" effect. (See Appendix B.)

(3) Deduction for Pollution Control Facilities

Governmentally-mandated standards for pollution control may serve worthwhile purposes, but they result in relatively nonproductive expenditures of capital by American industry. Funds which otherwise could be spent to expand and modernize plant capacity and employment are diverted to pollution control uses.

To ease the impact of such expenses on the level of productive investment, all costs for governmentally-mandated pollution control facilities should be fully deductible in the year incurred on an elective basis. The existing five-year amortization provision, without the investment tax credit, is a wholly inadequate measure.

Also important in this area is the question of what a pollution control facility actually is. Industry has encountered problems in obtaining regulatory clarification on this matter. A better legislative definition would be helpful.

The initial revenue impact of full deduction in the first year (without an investment tax credit) would be approximately $1.9 billion in 1976, $1.6 billion in 1977 and $1.5 billion in 1978.

(4) Capital Recovery Allowances

Current methods of depreciation are based on the "useful life" concept rather than full recovery of invested costs. The problem with the useful life concept is that its theoretical recovery of invested capital does not work in the real world of today's inflationary pressures and technological change. The longer the depreciable life assigned to an asset class, the more devastating the effect of inflation. This is particularly true with regard to manufacturing industries because the bulk of their assets have minimum depreciable lives of at least nine years. The principal result is insufficient internal capital formation.

The Revenue Act of 1971 introduced the Class Life System and ADR, and these reforms have increased somewhat the speed of cost recovery for companies which can handle the complexities of the ADR system. However, they are still tied to the useful life concept and their purpose can be frustrated by the inability of many businesses—particularly small businesses—to adopt them. In fact, based on responses to a 1973 survey, the Treasury's Office of Industrial Economics notes that only 1.5% of all corporations elected ADR in 1972. In general, these were larger firms with the resources available to maintain the records and to pay the experts to decipher ADR. About 34% of the companies not electing ADR said that it did not materially shorten depreciation periods and about 22% said that it was too complicated to adopt.

Eroded as they are by the effects of inflation, depreciation allowances are still critically important for meeting our capital needs. In fact, at $84 billion in 1975, corporate capital consumption allowances accounted for well over half of total business saving available for investment. Therefore, any changes in this area can make very substantial differences in our capital formation picture.

H.R. 7543.—The NAM recommends a complete change in the cost recovery system in the Code through enactment of a capital recovery allowance system which would be an optional alternative to the existing depreciation methods, such as in H.R. 7543. In outline form, it would include the following major features: Machinery, equipment and certified pollution control facilities would be subject to an accelerated five-year write-off; industrial buildings used in the process of manufacturing, extraction, transportation, communication, etc., would be subject to an accelerated ten-year write-off; taxpayers would elect deductions of 0% to the maximum allowed for any year as costs are incurred and unused deductions would be carried forward indefinitely; and a full year convention could be applied for all costs.

Detailed estimates of the estimated direct revenue impact and feedback effect of increased investment and employment under this bill have been made by Dr. Norman B. Ture, Inc., Economic Consultants in Washington, D.C. They show that the program could be self-sustaining even in the first year—that is, the revenue generated by increased economic activity immediately could offset the direct revenue loss. (See Appendix A.) However, the program could be implemented in stages to minimize the direct revenue impact if necessary. The total employment effect from implementing the system at once could amount to 3.4 million additional jobs in the first year rising to 5.2 million new jobs in the third year.

The President's proposal.—The President's proposal for rapid cost recovery in areas of 7% or higher unemployment, H.R. 11854, indicates a recognition of the direct relationship between industry's capital availability and the creation and maintenance of jobs. We applaud the thrust of this proposal. However, it does raise questions both as to policy implications and practical effects. Tax policy is an important factor in planning major investments, but the availability of raw materials, energy sources, transportation facilities and labor all are equally important, if not more so. Attempts to override these factors through selective applications of federal tax policy could result in decisions which are economically unsound over the long term.

As a practical matter, the one-year time limitations outlined in the program itself would greatly restrict its effectiveness. Major new facilities generally are planned for particular locations, and these plans are not readily portable. Even additions to existing facilities in the specified unemployment areas are likely to require longer lead times for planning purposes.

(5) *Double Taxation of Corporate Earnings*

The economy has endured a long time with double taxation of corporate earnings—first through the corporate income tax and then at the shareholder level through the individual income tax on earnings paid as dividends. Because of this, some claim it just doesn't matter, and most efforts to enact relief from such double taxation have fallen largely on deaf ears. Even the very limited 4% credit for dividends received by individuals was repealed as part of the 1964 general tax reduction legislation.

We believe it does matter—that the apparent indifference has been a case of learning to walk with a limp. Perhaps this didn't become really noticeable until the equity and new issues markets collapsed in the 1970's, and the vital public utility sector ran into its financial crunch. Nevertheless, the problem has been with us right along.

There are a number of ways to approach the double taxation problem. One is a split rate method where retained earnings are taxed at a higher rate than earnings distributed as dividends. Obviously, this does not eliminate the problem, it only reduces it. The pass through method would treat shareholders like partners who are taxable on all earnings while the corporation is not taxable. The record-keeping problems would be significant, and taxpayers would be liable for taxes on undistributed retained earnings as well as on distributed dividends. A shareholder credit for corporate taxes paid on dividends has also been proposed. Problems here include "horizontal equity" among different taxpayers with equal amounts of income, but various mixes of wages and dividends. They would pay widely varying taxes because of the credit for dividends paid.

In our view, the simplest and most equitable means of securing relief from the present penalty situation would be a deduction at the corporate level for dividends paid. This method would assure directly a much needed increase in cash flow for productive investment for virtually the entire corporate sector. It would breathe new life into the equity markets, and correct the long-standing inequity as to tax treatment of equity versus debt financing. It would avoid the problems of horizontal inequities which could result from providing credits or exclusions to shareholders with dividend income while taxpayers with equivalent earned income would remain fully taxable.

To phase out double taxation, the NAM recommends a 25% corporate deduction for dividends paid, to be increased to 100% thereafter. Based on Treasury figures for 1977 and beyond, a 25% deduction would have an initial revenue impact of about $4.25 billion.

(6) Individual Rate Reductions

On the individual side, a great deal of attention in recent years has been given to reducing taxes for low income persons. The Tax Reduction Act of 1975 provided a rebate of 1974 taxes which gave full tax refunds to more than 4.3 million taxpayers in adjusted gross income classes of $0 to $5000 and to only 600,000 in higher groups. It created a refundable 10% earned income credit on $4000 of earned income, phased out at $8000. If eligible individuals paid no taxes against which to take the credit, they received the credit as a cash payment. A $30 credit for each personal exemption was created, in lieu of an increased exemption, and in effect limited its impact to low income groups. The low income allowance was raised also. The tax cut extension, enacted as P.L. 94-164 last December, is expected to render over 3.2 million returns in the $5000 or less category non-taxable in 1976 (over 5.2 million if extended to a full year).

While cutting many low income persons off the tax rolls, these reductions have not provided much relief to middle income groups. As more and more persons are moved into higher brackets by inflation, they often pay higher taxes without real increases in income. Future tax reductions should be spread more evenly over all income groups. A simple reduction in *all* rates across-the-board would be an equitable approach.

The provisions of H.R. 10612 affecting tax reductions for individuals would be improvements over the 1975 Act, which was extremely bottom-weighted in its application. The 1975 Act provided a far greater percentage of reductions to low income taxpayers than the percentage of total taxes paid by such persons. Under H.R. 10612, middle income taxpayers would realize a larger percentage of the relief, although still less than would be the case with across-the-board reductions.

(7) Tax Incentives for Individual Savings

The NAM has not taken a position on the following items.—But they are of interest to the capital formation process, and they should be given serious study.

ESOP's.—The Employee Stock Ownership Plan (ESOP) is a concept designed to increase the ownership of a corporation by its employees while providing a less costly method of corporate capital formation than straight debt financing.

The use of an ESOP to provide shares of stock to employees and cash to the corporation, with full deductions for repayment of the amount plus interest, is appealing to many.

NAM does not now have a position on specific ESOP programs such as the 1% investment tax credit ESOP. However, we strongly favor approaching ESOP as a legislative issue in itself, rather than linking it to other tax reduction provisions, such as the investment tax credit. That is, we believe that a complete ESOP program would be preferable to an array of specially created ESOP's in various pieces of legislation and that the use of other tax provisions should not be conditioned on adoption of an ESOP.

BSOP.—The President's proposed Broadened Stock Ownership Plan would expand slightly on ESOP's by allowing more types of employees to use it and by broadening the scope of permissible investments. Broadening corporate ownership certainly is desirable and should be encouraged, but the expected BSOP limitations on taxpayers in high income levels suggest that the concept may not be a particularly potent spur to capital formation.

Tax credit for savings.—Another concept affecting individuals is the allowance of a tax credit, with a maximum percentage and dollar limit, for their net annual increases in private savings. This would be available to all persons and would apply to a much wider range of investments than ESOP's or BSOP's. Problems of recordkeeping may be troublesome here but it is a very broad concept which would apply particularly to low and middle income persons and deserving of serious consideration.

(8) Other Provisions of H.R. 10612 Relating to Individuals

Minimum tax.—In our view, if there is to be a minimum tax, it should be an alternative tax—not an additional tax burden. But H.R. 10612 would repeal the deduction for regular income taxes paid, add to the list of preference items, weaken the exemption, and raise the rate. This would leave a pure additional tax to be paid, regardless of the ordinary tax liability. The House provisions should be dropped, or substantially revised. In particular, full deduction for regular taxes should be maintained as a matter of simple equity.

Interest deduction limitation.—The provision of the House bill further limiting the deductibility of personal and investment interest could have the unintended result of restricting new risk ventures financed by individuals. It's unnecessary and should be dropped.

Moving expenses.—The moving expense liberalizations in H.R. 10612 are a step in the right direction. The NAM encourages the adoption of an even broader provision which would allow full deduction for all legitimate moving expenses.

Stock options.—The proposed sec. 83 treatment for qualified stock options presents a new, unneeded complexity to the Code. Tax treatment of employee benefits surely is complicated enough now and adding another problem with potential for discouraging employee motivation should be avoided.

TAXATION OF U.S.-OWNED OVERSEAS OPERATIONS AND EXPORTS

In General

Increasing public awareness of business entities with operations in several different countries around the world has popularized the term "multinational corporation" and has focused a good deal of attention on these companies. While such operations are widespread and their activities very complex and affected by many factors—just as are very large domestic operations—public discussion of the multinational corporation issue generally is rather simplistic and narrow in scope. Both within and without the Congress, one hears an alarmingly uniform view to the effect that U.S.-based multinational corporations are damaging the domestic economy by "exporting" jobs to foreign locations where they establish manufacturing operations and by "exporting" capital which could have a better domestic impact if invested in the U.S.

The NAM does not accept this scenario. Rather, we believe that the overseas operations of U.S. companies have significantly benefited the domestic economy by creating and maintaining U.S. jobs and by providing sources of capital which otherwise would not exist. The imposition of punitive taxation on such operations would be counterproductive to our own domestic economy and should be avoided.

The Importance of Overseas Operations and Exports

The location of business operations involved in international trade is not a decision which can be made simply on the basis of one's national preference. There are very real outside pressures which control the ability of a company to develop a share of a given foreign market. These may well dictate that a plant be located overseas rather than in the U.S. if the company is to have the business. Among these pressures are:

Evolution.—High technology products may continue to have their roots in U.S. manufacture and be exported to foreign countries. But such products often require local technical sales personnel, familiar with foreign language and customs, to prove adaptability to a foreign business use. A service function for continuing operation is needed. A warehouse of spare parts (inventory) is also required. Hence, a U.S.-owned foreign industry, essential to protect and expand U.S. exports, is born.

Economic.—Some new products become relatively easy to duplicate. Where foreign laws do not provide patent protection unless domestically manufactured, it is only a matter of time before a new U.S. product is copied. Also, where a product is bulky, heavy or subject to spoilage, the economics of transporting such products from the United States can be an insurmountable barrier as compared to local manufacture. Because of such economic factors, foreign manufacture is the only alternative if access to the foreign market is to be maintained.

National Policy.—In many countries, national policy imposes high barriers to imports. These include import quotas, high import tariffs, denial of monetary exchange to importers, or subsidization of local manufacturers in the form of economic concessions or purchasing preferences. Under such circumstances, local foreign manufacture by U.S. interests is the only defense to loss of all access to the foreign market.

Domestic Employment Effects.—We believe that in the significant majority of these situations, overseas operations are responsible for maintaining a U.S.-owned presence in the market. This does not substitute foreign jobs for U.S. jobs because domestic operations could not compete in these market siutations. Instead, these operations actually create U.S. jobs which otherwise could not be maintained.

This is readily seen in the case of administrative and home office personnel who work with the overseas operations. What is certainly even more significant, in many cases, is the increased production employment associated with the exporting of materials and component parts to overseas subsidiaries or affiliates.

A number of studies have established the existence of this favorable domestic employment impact of multinational operations. A 1975 report, The NAM/Business Roundtable Survey on Export-Related Community Employment, compiled the responses of 294 export trade firms to questions about their volume of exports, their customers and their export-related employment at each individual plant location throughout the U.S. These firms exported almost $27 billion in 1974, approximately 42.5% of U.S. exports of manufactured goods. Over one-half of these goods went to the companies' own subsidiaries or affiliates overseas. These firms employed about 530,000 persons whose jobs are directly related to their export sales. Based on the volume of sales to related companies, about 270,000 jobs in these 294 companies alone depend on the export-drawing power of the firms' overseas operations. In addition, the respondents identified another 125,000 domestic jobs which are supported by dividends, license income, royalties and technical service agreements from their overseas subsidiaries and affiliates.

A recently released third report in a series by the Business International Corportation on The Effects of U.S. Corporate Foreign Investment, 1970–1973, notes domestic job creation performance of firms with substantial foreign investments. Using responses from 116 companies, the report for the period 1970–1973 shows that the most intensive foreign investors increased their domestic emplovment almost one-third faster than the least intensive investors (7.1% versus 5.4%). The sample's net U.S. employment (excluding the results of acquisitions) increased at twice the rate of increase by all U.S. manufacturers (2.6% versus 1.3%).

Financial effects.—In addition to the employment impact, overseas investment by U.S. firms is generating very significant contributions to our balance of payments. With respect to U.S. direct investment abroad, Commerce Department figures show balance-of-payments income from interest, dividends, branch earnings, royalties and fees in 1973 and 1974 exceeded net capital outflows by $8.3 billion and $13.2 billion in those respective years. These were significant contributions to overall sources of capital for use domestically. Historically, multinational firms have had positive contributions, even when the overall U.S. balance was negative.

Foreign Tax Credit

Most of the industrialized nations have long recognized the potential problem of double taxation of foreign income and either have instituted a foreign tax credit to solve it or have exempted all foreign source income from domestic taxation. The foreign tax credit provisions of the Internal Revenue Code reflect our recognition of the superior right of a foreign country to tax any income which is generated within that country, even if the taxpayer is a U.S. person. By allowing foreign taxes paid to be credited against U.S. income taxes on foreign source income, the foreign tax credit prevents double taxation of such income. However, since the credit may not exceed the foreign taxes paid, a U.S. tax must also be paid if the foreign tax rate is lower than the U.S. rate, thus assuring the taxpayer will pay the higher of the U.S. or foreign rate.

Contrary to a widely-held view, the foreign tax credit does not allow foreign taxes to be credited against U.S. taxes due on income from U.S. sources. The credit is specifically limited to offsetting U.S. taxes done on foreign source income. In determining the origin of an item of income, one must apply the source rules in the Internal Revenue Code. Thus, if a foreign country taxes a U.S. person on income which U.S. law nevertheless classifies as being from a U.S. source, the taxpayer receives no credit for such taxes.

Until recently, the foreign tax credit was a totally neutral provision of the Internal Revenue Code which was available to all U.S. citizens and domestic corporations for income taxes paid to any foreign country with regard to any foreign source income. However, the Tax Reduction Act of 1975 fragmented foreign source income into different types for purposes of applying different limitations on the amounts and the uses of the credit with respect to oil-related income from foreign sources. In addition to being inherently arbitrary and unfair, a credit based on fragmented income can become an administrative nightmare, particularly if more and more distinctions are made.

Due to the addition of highly technical new regulations following adoption of P.L. 94-12, the existing complexities and administrative difficulties in the foreign source income area will be increased significantly. Further fragmentation by extending such provisions to foreign source income in general would destroy the integrity of the credit, complicate the Code and damage the competitive ability of companies in foreign markets.

Taxation of Earnings of Overseas Operations

Many U.S. companies have overseas operations (commonly called controlled foreign corporations or CFC's) which extract, process, manufacture, or assemble various materials and products in other countries. The income of these CFC's is taxable initially under the laws of their host countries. Their earnings become subject to the U.S. tax law when dividends are distributed to the U.S. shareholders, generally one parent company. Under this system, the U.S. taxes the domestic shareholder only when the income is received by that shareholder, not when it is earned by the CFC (except for certain types of income taxable under Subpart F).

The concept of taxing CFC earnings only when repatriated is popularly, but inaccurately, called "deferral," implying a delay in paying taxes due on such earnings. This is a misnomer. As a general rule, the Internal Revenue Code does not impose tax burdens on amounts which have not been actually received by the taxpayer. Rather, tax liability is created only when the taxpayer realizes the income. So-called "deferral" is not an aberration in the law, but various proposals to tax 50% to 100% of CFC income prior to its distribution to U.S. shareholders would be very significant abberrations.

A United States-imposed law, only applicable to CFC's of U.S. corporations, requiring the current U.S. taxation of all earnings while foreign-owned competitors are not similarly affected obviously would subject U.S. companies to competitive disadvantage.

Proposals for taxing 50% of CFC earnings currently are also undesirable. While many CFC's do distribute about 50% of annual earnings, many others do not. Growing companies and companies in countries where currencies are blocked or where withholding rates are high, cannot afford such payments.

In many cases the prime benficiaries of a U.S. law forcing current taxation of CFC's will be foreign treasuries whose withholding taxes and retaliatory measures would increase payments to them while limiting revenues available to the U.S.

Domestic International Sales Corporation (DISC)

The creation of DISC in 1971 was welcomed by the business community as a belated recognition by the federal government of the vast array of direct subsidies, quotas, and other devices used by foreign governments to restrict imports.

Since 1971, U.S. exports have increased tremendously. While some of this impact can be attributed to dollar devaluations, much of it is due to the DISC program which has provided thousands of American companies with enough additional cash flow incentive to finance the creation or expansion of foreign markets.

For many companies which did not have any export business, DISC has opened altogether new doors. This is particularly true of small businesses which previously did not seriously investigate export business because of the start-up expenses, the difficulty of locating markets, compliance with various domestic and foreign regulations, etc. In the process, DISC has stimulated employment and economic activity both by exporters and by their supply and support industries.

The decision by the House in H.R. 10612 to redefine the income to which DISC would apply was very fortunate. In attempting to "compensate" for the effects of dollar devaluation by creating an income base of 1972-1974 DISC income, the bill would cut the effectiveness of DISC significantly. Those companies which utilized DISC to increase their exports during those years would be told that their earlier work was being largely discounted and that they must move back several steps and start again. It is difficult to assess the chilling effect such a change would have, but it surely would reduce the ability of many companies to continue their expansion of export markets.

No change should be made to further restrict the application of DISC. In fact, with the success story of the DISC program in encouraging exports, consideration should be given to eliminating the 50% restriction on DISC income quaifying for the tax benefit.

Other Provisions of H.R. 10612

Sec. 911.—The NAM opposes repeal of Sec. 911, which permits the annual exclusion of up to $25,000 of income earned for services performed while living or residing abroad. The incentive of Sec. 911 is still needed to persuade U.S. citizens to work abroad. In developed countries, living expenses are very high, and in developing countries, the living conditions often are very difficult. In order to roughly equate these standards of U.S. employees overseas with their counterparts in the states, U.S. companies must often provide, either by allowance or directly, for the municipal-type services of education, transportation, health, and public safety, thereby increasing the costs of hiring U.S. citizens as employees.

The repeal of Sec. 911 would only add to the cost of present allowances by forcing employers to increase wages to cover the taxes on amounts not currently taxable. This increased cost would damage the competitive position of U.S. business vis-a-vis foreign competitors, whose own countries generally do not tax income earned abroad.

Per country limitation and foreign loss recapture.—The provision in H.R. 10612 repealing the per country limitation would limit the flexibility of U.S. taxpayers to utilize the credit as it best suits their business circumstances. A principal argument for repeal is that the per country limitation allows a "double benefit" in conjunction with the ability to deduct foreign branch losses from U.S. source income currently and then claim a foreign tax credit with respect to income generated by that branch in later years. To the extent that a double benefit is created, the best approach is to create a loss recapture rule, which H.R. 10612 would do. This mechanism would require foreign losses to be fully recaptured out of future foreign income before a credit could be claimed on income from the country. This would be a sufficient mechanism. Repeal of the per country limitation itself would have little added effect on recapture, but it would restrict taxpayers' flexibility to respond to business circumstances.

Sec. 367.—In general, the sec. 367 provision requiring advance rulings on taxfree liquidations, incorporations and reorganizations involving a foreign corporation tends to delay transactions for several months while IRS prepares a ruling. Due to familiarity with past IRS rulings and practices, many companies can predict that they will receive a favorable response. For this reason, a mandatory advance ruling is often an unnecessary waste of sevral months' time and may even result in the loss of a favorable circumstance of the transaction.

Under the proposed change, it would be the taxpayer, and not the government, who would bear the consequences of undertaking a transaction without prior IRS approval. So the risks created under this change would be entirely of the taxpayer's own doing. The provision represents a highly desirable change.

OTHER TAX REVISION ISSUES

State Taxation of Interstate Commerce

The state taxation of interstate commerce (including income, sales and use taxes) presents difficult problems for business of all sizes. Large firms which do some form of business in virtually every state are plagued by the various rules and regulations and must expend considerable time and effort attempting to comply with varying structures. Smaller firms using sales representatives or agents in only a few states are troubled in particular by the states' tax collection procedures on sales therein. The smaller companies are less able than larger ones to handle the administrative burdens.

The NAM supports federal legislation for a uniform system of state taxation of interstate commerce. The bill proposed by Sen. Mathias (R-Md.), S. 2080, is an excellent approach to the problems in this area. We urge its consideration and enactment soon to alleviate a very disorderly situation affecting interstate commerce.

Estate and Gift Taxation

The federal estate and gift tax structures are essentially taxes on capital in the form of a person's accumulated savings during a lifetime. While their impact on federal revenues is not significant (estimates for fiscal 1976 are $5.1 billion, or 2.5% of non-Social Security budget receipts), their effects on the estates of many Americans—particularly owners of small businesses and farms—can be very significant. As an ultimate objective, the NAM urges their elimination from federal use. Short of elimination, a number of specific proposals should be studied.

The principal problem in the estate tax area is the size of the tax liability. The rate structure is steeply progressive in the $0 to $100,000 brackets and should be lowered. An increase in the $60,000 exemption would also be appropriate. While the President's stretchout proposal could be helpful, reducing the *size* of tax liability is more important than changing the timing of payments.

As long as the state tax is imposed, a stepped-up basis should be provided to reduce the incidence of double taxation of capital.

APPENDIX A.—ECONOMIC IMPACT OF A CAPITAL RECOVERY ALLOWANCE SYSTEM (H.R. 7543)

[Dollar figures in constant 1974 dollars]

	Year (dollars in billions)		
	1	2	3
Private capital investment	+$19.0	+$23.9	+$24.0
Total employment (thousands)	+3,430	+4,550	+5,220
Private GNP (billions)	+$58.6	+$79.8	+$93.9
Initial impact Federal revenue estimates	+14.8	−25.8	−31.7
Net Federal revenue impact	+8.3	+7.4	+7.9

This table has been developed from an economic analysis by Norman B. Ture, Inc., Economic Consultants, Washington, D.C., as revised in January 1976. It assumes a capital recovery allowance system as described in H.R. 7543, effective January 1, 1975. It should also be noted that these estimates were originally based on continuation of a 7% investment tax credit.

Again, the figures are intended to show the direction and order of magnitude of the economic impact of the proposal, not precise forecasts.

APPENDIX B.—ECONOMIC IMPACT OF A PERMANENT 10 PERCENT INVESTMENT TAX CREDIT FOR ALL TAXPAYERS

	Year 1	2	3	4	5	Annual average (percent)	5-yr cumulative total
Real fixed investment:							
Percent	+3.06	+3.89	+3.85	+3.88	+4.05	+3.73	
Dollars (1958, billions)	+3.44	+4.77	+5.04	+5.36	+5.87		+24.48
Manufacture employment:							
Percent	+.90	+1.00	+.92	+.98	+1.01	+.96	
Jobs (thousands)	+180	+210	+190	+210	+220		
Total employment:							
Percent	+.10	+.24	+.28	+.33	+.37	+.27	
Jobs (thousands)	+80	+200	+250	+300	+340		
Real GNP:							
Percent	+.41	+.51	+.55	+.62	+.67	+.56	
Dollars (1958, billions)	+3.82	+4.99	+5.63	+6.59	+7.38		+28.41
Federal tax receipts:							
Percent	−.46	−.37	−.30	−.14	+.05	−.24	
Dollars (current, billions)	−1.83	−1.61	−1.42	−.72	+.28		−5.30

[1] Compared to a 7 percent credit for nonutility taxpayers and 4 percent for public utilities. This excludes all other liberalizations.

This table has been excerpted from the NAM's Tax Impact Project Report, dated August 1975. The figures are estimated changes in investment, employment, GNP, and net federal tax receipts for 1977–81 from what otherwise would occur. This assumes roughly an eighteen-month period for the 10% credit to be fully effective.

These results were generated by inputting survey responses from over 300 industrial and utility companies into the Data Resources, Inc. macroeconomic model. The figures are intended to show the order of magnitude of the impact of a 10% credit and not intended to represent precise economic forecasts.

APPENDIX C.—INITIAL IMPACT AND NET FEDERAL REVENUE ESTIMATES FOR PROPOSED TAX REVISIONS

[Millions of dollars]

	1975	1976	1977	1978	1979
$50,000 surtax exemption initial impact		−1,649	−1,810		
Permanent 10 percent investment credit:					
Initial impact			−3,255	−3,395	−3,566
Net impact			−1,830	−1,610	−1,420
Pollution control expensing initial impact		−1,900	−1,600	−1,578	
Capital recovery allowances (see app. B)					
Dividend deduction initial impact			−4,250		

It should be noted that, while the Ture study (Appendix A) and the *Tax Impact project Report* (Appendix B) both worked to generate overall economic impact data including *net* revenue estimates, the two studies used somewhat different methodologies and basic economic assumptions. The difference is most striking in terms of potential feedback effects on the federal revenue base and net federal revenues—the capital recovery allowance proposal indicating possible immediate net revenue gains owing to its stimulative effect on the economy. While the extension of the 10% investment credit is projected to have a considerably less dramatic effect, it should be noted that, under the Tax Impact Project methodology, *repeal* of the 7% investment credit would have the following estimated effects which, in order of magnitude, are more in line with the results of the capital recovery allowance analysis (although, of course, in the opposite direction).

	Year 1	2	3	4	5	Annual average (percent)	5 yr-cumulative total
Real fixed investment:							
Percent	−4.17	−5.31	−5.25	−5.30	−5.54	−5.11	
Dollars (1958, billions)	−4.68	−6.52	−6.88	−7.32	−8.03		−33.43
Manufacture employment:							
Percent	−1.25	−1.32	−1.25	−1.37	−1.45	−1.33	
Jobs (thousands)	−250	−270	−260	−290	−310		
Total employment:							
Percent	−.15	−.34	−.38	−.44	−.51	−.36	
Jobs (thousands)	−120	−290	−330	−390	−470		
Real GNP:							
Percent	−.58	−.70	−.74	−.85	−.95	−.81	
Dollars (1958, billions)	−5.40	−6.85	−7.58	−9.04	−10.46		−39.33
Federal tax receipts:							
Percent	+.62	+.52	+.43	+.22	−.03	+.35	
Dollars (current, billions)	+2.46	+2.27	+2.04	+1.13	−.17		+7.73

Note: This table assumes the existence of a 7 percent investment tax credit (4 percent for utilities). Similar but greater results could be expected to occur if the credit (now 10 percent under Public Law 94-12) were to be repealed.

The CHAIRMAN. Thank you, very much, gentlemen.

The next witness we will hear from is Mr. William C. Penick, chairman of the Federal Tax Division, American Institute of Certified Public Accountants.

We are happy to have you with us today. We have had you here before, and I welcome you.

STATEMENT OF WILLIAM C. PENICK, CHAIRMAN, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PENICK. Thank you, Mr. Chairman.

My name is William C. Penick and I am appearing today as general chairman of the Federal Tax Division of the American Institute of Certified Public Accountants. I am also a tax partner in the Washington office of Arthur Andersen & Co. With me today is Joel Forster, director of the Institute Tax Division.

We are pleased to present our views on the important tax issues under consideration by your committee. Aside from our comments on substantive issues, we have reviewed in some depth the technical aspects of H.R. 10612, "The Tax Reform Act of 1975," as passed by the House. Our specific comments on this bill are being accumulated and will be submitted separately to members of your committee, your staff, and the Joint Committee on Internal Revenue Taxation. Since these comments are quite voluminous—roughly 200 pages—they are not included as part of this testimony.

The CHAIRMAN. We will print as much of this in the record as you would like to have, and we will let you go ahead at your own pleasure.*

Mr. PENICK. Fine. We will send that in later. Thank you.

CAPITAL NEEDS

Much has been said about our need for capital investment over the next few years. A number of estimates of our capital shortage have been made and even the more conservative ones indicate a gap of

*Printed elsewhere in these hearings.

many billions of dollars each year. We have one of the largest percentages of obsolete industrial facilities of any leading nation. We are currently dedicating a smaller portion of our gross national product to the replacement and expansion of productive facilities. Environmental expenditures continue to require tremendous capital outlays. Without the development and preservation of capital to meet these needs, our whole economic structure is vulnerable to stagnation.

The tax system by itself will not solve these capital problems. On the other hand, there are aspects in our present system that can be corrected which would at least reduce the bias against savings and more particularly the bias against equity investments.

Traditionally about two-thirds of the capital needed for replacement and expansion of plant facilities has been obtained from retained earnings and from capital recovery allowances such as depreciation and investment tax credit. The balance has come from other sources, primarily the sale of corporate securities.

To develop capital in the hands of individuals for investment in securities, funds must come from savings or from the conversion of other forms of capital. In one sense, all new capital must come from savings. For the most part, savings are derived from income sources after the payment of at least one level of taxation.

Our present tax system tends to retard the formation of capital through the multiple taxation of corporate earnings and through the loss of existing capital by capital gains taxation. Furthermore, our present estate tax system decreases the pool of accumulated capital when assets pass from one generation to another.

Another major factor in our consideration of capital needs is the effect of inflation. All of us have experienced personally the impact of greatly increased prices in our daily lives. While we did not have the double digit of inflation for 1975 that we did in 1974, nevertheless our rate of inflation creates substantial problems in our entire economy and certainly in our tax system. Inflation has been referred to as the secret tax which in its impact may be greater than those imposed by the Internal Revenue Code.

Through the erosion of existing capital, as well as the taxation of artificial levels of income under our progressive tax rate structure, a substantial part of our real capital is dissipated each year.

Because of our concern with capital needs and the impact of inflation, the institute has developed tax policy statements on capital gains and on the elimination of the double tax on dividends.

Copies of these statements have been, or will be, furnished for the consideration by your committee and staff. We urge that you review them since they provide in some detail our analysis of these important subjects.

CAPITAL GAINS TAX

With regard to capital gains, we recommend legislation that would: Extend the holding period requirement from more than 6 months to more than 12 months; provide a sliding scale of exclusions for longer holding periods; extend the capital loss carryback provisions to individual taxpayers; increase the $1,000 limitation on deductibility of net capital losses against ordinary income.

DIVIDENDS TAXATION

As to elimination of the double tax on dividends, we recommend the adoption of either a dividends-paid deduction for corporations or an imputation system that would allow a tax credit to shareholders for taxes paid by the corporation which are attributable to income distributed as dividends.

Since such a significant part of the capital needed for business entities is derived from retained earnings and capital recovery allowances, we urge that the corporate tax reduction approved last year be continued and that the investment tax credit at the 10 percent level provided in the House bill be adopted on a permanent basis.

These are very important elements in the preservation of capital needed for our economy.

TAXATION OF FOREIGN INCOME

I would like to turn next to foreign issues.

A great deal of attention was devoted by the Ways and Means Committee to proposed changes in the taxation of foreign income. H.R. 10612 did not disturb our traditional concept of not taxing currently unremitted foreign earnings, but it did make certain changes in the calculation of the foreign tax credit. We commend the House for its decision not to change the present system for taxation of unremitted foreign earnings, and we generally approve the changes made in the foreign tax credit provisions.

Because of the importance of foreign markets to U.S. business and to a great extent the creation of U.S. jobs, we urge that no further significant changes be made in our present system for taxing foreign earnings.

TAX RETURN PREPARERS

Another matter that is of concern to us is the regulation of tax return preparers.

Because of the great complexity of the Internal Revenue Code, many millions of taxpayers must seek outside assistance in the preparation of their tax returns. Over the last few years there have been cases of improper conduct by tax return preparers and misleading advertising and promises. While we do not believe that regulation is needed for professional preparers, such as attorneys and CPA's, we generally support the approach to regulation adopted in H.R. 10612 as a practical and workable means of establishing control by the Internal Revenue Service over tax return preparers.

DISCLOSURE OF PRIVATE RULINGS

Disclosure of private rulings; a lot of controversy has arisen over the last few years about the application of the Freedom of Information Act to private rulings. Substantial litigation has taken place to force the Revenue Service to disclose the hundreds of thousands of private rulings that have been issued in prior years. We have been very concerned over the impact this would have on the entire rulings process, which we think is important to the proper administration of our complex tax system.

Section 1212 of the House bill proposes legislative changes that would permit an orderly program for the disclosure of private rulings. Subsequently, changes to the House bill have been discussed by a number of groups who are interested in resolving the matter.

The net result of this is an agreement in principle among these groups which we understand has been brought to your attention. We strongly support legislation along the lines of the agreement that has been reached, and urge that it be given priority consideration by your committee so that taxpayers, practitioners, Internal Revenue Service itself, and other interested parties can proceed in an orderly manner with the rulings process.

TAX RETURN SIMPLIFICATION

Simplification; in our review of the 670 odd pages of H.R. 10612, we were again amazed and concerned at the incredible complexity that has now become our tax system. Many people have urged the need for simplification of the law, and we wholeheartedly agree. Since ours is a self-assessment system, continuing lack of understanding by the general public must lead to serious dangers of a breakdown in the system.

We think the time has come for an organized attempt under the sponsorship of Congress but including labor, business, public interest and professional groups, and certainly the Internal Revenue Service and Treasury Department, to work together toward the development of a more understandable and simpler system.

Whether this can best be handled by a commission appointed from the various interested groups by Congress or the president, or whether it should be set up in some other manner we have no strong feeling one way or the other.

However, we do urge that this be given serious attention in the very near future.

I think that I have covered the main points that I can cover this morning.

The CHAIRMAN. Thank you so much.

I am going to give your full statement the attention that it deserves, and I am going to instruct both staffs to do the same thing so that all the worthwhile suggestions that you have will get the attention they are entitled to.

Now, since you have come from Louisiana, as do I, it might interest you to know that I talked to a man who was in charge of collecting taxes in Louisiana and he showed me what he has done for Louisiana in income tax work. He changed it in more than 70 respects to make it conform to the Federal law, and he wanted to make out a simplified form where you just put down on the form what you paid the Federal Government in taxes, and then put down whether that is a joint return or a single one, and how many exemptions you are claiming.

From that point forward, all you do is take a chart and you go down and find your income and the number of exemptions. You do not even do any calculating at all, all you do is just simply put down what you paid the Federal Government and you see where you fall on the chart.

Several years ago, a poll showed that 64 percent of the people thought that the Revenue Department of Louisiana was not doing a good job; today 85 percent say they are doing a good job. I would hope that we could profit by that example in working on this tax legislation.

I thank you and the members of your profession who have made some good suggestions and will be making some more as we go along.

We are going to have an open executive session, and you are invited to sit in on that process. If you want to, you can send up some suggestions as we go along.

Mr. PENICK. We share your views completely.

One of the great concerns we have had in viewing the House bill and the LAL concept is the incredible amount of complexity it introduces and it isn't really necessary to accomplish the basic objectives.

The CHAIRMAN. That gets us down to what I would like to do about it, which is parallel to what the tax collection in Louisiana has done. Even though I did not go on record and say it before he did, I have been thinking for years that it would be a good idea. It seems to me you ought to just gear your State tax laws to the Federal income tax laws and look at how much you paid the Federal Government. When a person sees how much he owes the Federal Government, all he has to do in Louisiana is look at a chart and he can fill out the form in 5 minutes or less once he fills out the Federal form.

Now, what we have to do is to try to keep people from going absolutely out of their minds and using half of their effort to do their taxes.

We have had substantial success in this area.

What is going to happen in your office? It seems you might need some unemployment program for accountants?

Mr. PENICK. A number of bills have been referred to as lawyers and accountants retirement acts.

I can assure you we can find some productive things to do. Very candidly, handling the preparation of tax returns is not in my view really productive use of our time.

The CHAIRMAN. What I would like to do is start out by making about 90 percent of the people use the short form. Then only the other 10 percent would be required to engage in the complexities of the other form.

When we then go and work to reduce the complication on that form—and let us face it, most of the clients pay you a large amount of income to do a large amount of work—they would still be using the itemized deductions. In that area I would like to see this law right here on the tax code wind up 500 pages shorter instead of 500 pages longer. You might make suggestions on how to do that. Instead of pursuing the LAL approach as an added on complexity of that sadly named Tax Reform Act of 1969, which was 585 pages itself, including some absolutely mind-boggling language, we should proceed in the other direction to try to make it 500–600 pages shorter.

Mr. PENICK. That is correct.

The CHAIRMAN. It is only some poor soul like myself who might not have worked on it for years, and who might go into it and come stumbling into the "deadwood" section and stay with it all night.

Thank you very much. I would like for you to identify yourself.
Mr. FORSTER. Joel Forster. I am the tax director of the Institute.
The CHAIRMAN. Thank you very much.
[The prepared statement of the American Institute of Certified Public Accountants follows:]

PREPARED STATEMENT OF THE FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SUMMARY

Capital Formation

The Institute believes that the most urgent factor that must be considered in the current tax reform hearings is the impact of the tax system on capital formation and the preservation of existing capital. We have previously testified on the importance of accelerated depreciation and the investment tax credit in preserving capital for business entities. With the rate of inflation experienced in the last few years, continuation of these provisions is essential and, if anything, should be expanded. Neither depreciation nor the investment credit fully offset the erosion of capital investment caused by inflation, but they do provide some relief.

The Institute has issued a series of Statements of Tax Policy which bear upon capital formation. The subjects of these individual statements are: 1. Taxation of Capital Gains; 2. Value-Added Tax; 3. Elimination of the Double Tax on Dividends; and 4. Estate and Gift Tax Reform.

We would be pleased to make copies of these statements available to you. They are described in more retail on the following pages and have provided much of the background material included in this statement.

Capital Gains and Losses

After careful consideration of the impact of inflation, the need for capital formation, and the retention of incentives for investment, it is the Institute's view that continuation of the present rules for taxing capital gains is desirable, subject to certain sugestions for modification.

Wtih regard to capital gains, we recommend legislation that would:

Extend the holding period requirement from more than 6 months to more than 12 months.

Provide a sliding scale of exclusions for longer holding periods.

Extend the capital loss carryback provisions to individual taxpayers.

Increase the $1,000 limitation on deductibility of net capital losses against ordinary income.

These recommendations and additional background material are included in our Statement of Tax Policy—Taxation of Capital Gains.

Elimination of the Double Tax on Dividends

Our traditional system of imposing at least two levels of taxation on corporate earnings creates a bias against investment and encourages consumption. A number of other highly industrialized countries have recognized this problem and have changed their tax laws to reduce or eliminate the double tax effect.

The Institute recommends that serious consideration be given to the integration of corporate and individual income taxes with the objectives of permitting either a dividends-paid deduction to the corporate entity, or some form of tax credit to the individual shareholder when dividends are paid.

These proposals and several other alternatives are discussed in detail in our Statement of Tax Policy—Elimination of the Double Tax on Dividends.

These proposals and several other alternatives are discussed in detail in our Statement of Tax Policy—Elimination of the Double Tax on Dividends.

Foreign Source Income

The Institute does not favor any change in the present treatment of unremitted foreign earnings. We support continuation of the foreign tax credit, rather than treating foreign taxes as dductions for U.S. tax purposes.

The Institute supports the Administration proposal that withholding on foreign investment in United States securities investments should be eliminated.

We do not agree with the House of Representatives decision to eliminate the earned income exclusion under Section 911. This would create a further disadvantage for many U.S. companies competing abroad.

Small Business Tax Problems and Certain Expiring Provisions of PL 94-164

Corporate Tax Rates.—The Institute agrees that reduction of the corporate tax rat provides a stimulus to the economy and is helpful to small business. Accordingly, we support extension of the corporate rate reductions which were extended until June 30, 1976, by the Revenue Adjustment Act of 1975 (PL 94-164).

Investment Tax Credit.—The Institute agrees with the provisions of HR 10612 extending until 1980 the temporary increase in the credit to 10 percent and also agrees with the temporary increase in the credit to 10 percent and also agrees with the temporary increase to $100,000 in the maximum amount of used property qualifying for the credit. The investment tax credit should be made permanent to provide certainty for business planning.

Estate Tax Problems.—The Institute has recently completed a Statement of Tax Policy on Estate and Gift Tax Reform. This policy statement, which will be distributed to members of your Committee, is contained in the Committee Print of Background Material on Federal Estate and Gift Tax Reform of the Ways and Means Committee dated March 8, 1976. The policy statement provides an indepth analysis of the AICPA positions concerning: Generation-Skipping Transfers; The Marital Deduction; Appreciated Assets Transferred at Death; Unified Transfer Tax; and Liberalization of Deferred Payment of Federal Estate Tax.

However, we believe there is little likelihood that comprehensive estate and gift tax reform can be accomplished during this session of Congress. As an interim measure, we generally favor the proposals included in the Estate and Gift Tax Reform Act (S 2819) and S 2394 which would increase the estate tax exemption and extend the time for payment of estate taxes.

We also direct your attention to the increase in interest charged on deferred estate taxes as a result of the passage of PL 93-625. We urge that this rate be restored to its prior level of 2/3 of the regular rate on tax deficiencies.

Regulation of Income Tax Return Preparers

The Institute agrees that there have been improprieties associated with advertising by commercial tax return preparers and problems with preparers who are incompetent or unethical.

The Institute does not believe that regulation is needed for professional preparers such as attorneys and Certified Public Accountants. In general, we support the approach adopted in HR 10612 as a practical and workable solution which would provide the Internal Revenue Service with adequate capability to oversee income tax return preparers.

Disclosure of Private Rulings (Section 1212 of HR 10612)

Section 1212 of HR 10612 prescribes conditions under which past and future private rulings will be made available to the public. Discussions have been held involving representatives of the Internal Revenue Service, Tax Analysts and Advocates, the Public Citizen Litigation Group, the Tax Section of the American Bar Association, and the AICPA, with the objective of reconciling different viewpoints.

Litigation of the private rulings issue under the Freedom of Information Act is presently before the courts. In our view, the matter should be resolved by legislation within the framework of the Internal Revenue Code.

While we support the concepts of Section 1212 of HR 10612, we believe the legislation would be improved if it incorporated the recommendations of the parties listed above. These recommendations can be found in a Memorandum of Understanding dated March 4, 1976 and published in the March 15, 1976 issue of Tax Notes.

Limited Technical Matters (Title XIX of HR 10612)

The so-called Deadwood Bill has come before Congress for consideration previously, but was never enacted. We urge your Committee, during this major reform effort, to give serious consideration to these non-controversial proposals now contained in Title XIX of HR 10612.

In addition, the Institute has prepared a booklet entitled "Recommended Tax Law Changes" which contains many technical recommendations that would eliminate unintended benefits and hardships. This booklet has previously been distributed to your Committee and to all members of Congress. We would be pleased to discuss the recommendations contained therein which we hope will provide greater equity and simplification.

STATEMENT

The American Institute of Certified Public Accountants is pleased to present the following comments and recommendations regarding proposed tax reform.

The American Institute of Certified Public Accountants is the sole national organization of professional CPAs. It was established in 1887 and currently has more than 110,000 members.

Our Statement covers the following subjects:

1. Capital Gains and Losses.
2. Elimination of the Double Tax on Dividends.
3. Foreign Income Issues.
4. Small Business Tax Problems and Certain Expiring Provisions of PL 94-164.
5. Regulation of Income Tax Return Preparers.
6. Limited Technical Matters.

PART 1. CAPITAL GAINS AND LOSSES

After careful consideration of the impact of inflation, the need for capital formation, and the retention of incentives for investment, it is the Institute's view that continuation of the present rules for taxing capital gains is desirable, subject to certain suggestions for modification which follow:

Extend the Holding Period Requirement

The present six-month holding period requirement for long-term capital gains treatment creates opportunities for speculators to realize quick profits at lower tax rates. One of the principal reasons for continuing present rules is the need for capital formation and the assumption of long-term risk. Lower taxation of profits realized in as little as six months does not seem compatible with that objective. Accordingly, the Institute favors extension of the holding period for long-term capital gain treatment to one year.

Provide a Sliding Scale of Exclusions

The Institute recommends the adoption of a sliding scale of exclusions, increasing with the holding period for capital assets, for two reasons. First, this would recognize to some extent the impact of inflation. If a smaller percentage of gain is taxed, based on a longer holding period, this would tend to offset the loss in purchasing power of the dollar. Second, by adopting a sliding scale of exclusions, if the scale is gradual enough, the lock-in effect would be reduced. The investor could give greater weight to the value of the use of money in deciding when to sell an asset.

For individual taxpayers, an exclusion scale starting at 50 percent after one year and increasing by 5 percent each year thereafter, to a maximum of 80 percent after seven years, might be appropriate. Since the present method of taxing capital gains realized by corporations is in essence a flat 30 percent rate, a graduated rate scale for corporate gains consistent with that for individuals would be equitable.

Extend the Capital Loss Carryback Provisions to Individuals

The present rule prohibiting capital loss carrybacks to individuals is inequitable. If the exclusion ruls discussed above are adopted, an overall net loss from sales of capital assets in a particular year would be applied first against other income of the year. If this creates a net operating loss, it should be subject to the regular operating loss carryback rules. Alternatively, if Congress believes this too great a liberalization of the capital loss provisions, the net capital loss in a particular year should b allowanble as an offset against ordinary income to the extent of $5,000, as recommended below, and any excess should be allowed as a capital loss carryback for individual taxpayers, as is now the case for corporations.

Increase the $1,000 Limitation on Deductibility of Net Capital Losses

In lieu of the ordinary loss treatment of net capital losses described in the preceding proposal, the Institute believes that the $1,000 limitation on the deductibility of net capital losses from ordinary income of individual taxpayers should be increased to $5,000. The $1,000 amount was established in 1942, and in view of the inflation that has been experienced since that time it seems appropriate to grant an increase in relief to those taxpayers who enjoy no capital gains against which to apply their losses. Furthermore, it is recommended that this treatment be extended to corporate taxpayers.

Conclusion

The subject of capital gains taxation has been and will continue to be controversial. There are opposing forces and philosophies that are difficult, if not impossible, to reconcile. The present capital gain tax structure may be too lenient, and some changes therefore seem appropriate. On the other hand, current economic conditions and problems justify retention of preferential treatment for true capital gains despite the fact that considerable simplification could be achieved if the special rules applicable to capital gains were abolished.

PART 2—ELIMINATION OF THE DOUBLE TAX ON DIVIDENDS

The Institute believes that the present tax treatment of corporate-source income does not measure up to accepted standards of tax equity, and that such treatment inhibits the growth and development of not only the corporate sector but all phases of the U.S. economy. Furthermore, the double-taxation of corporate-source income has added to the complexity of tax law administration. And finally, since the incidence of the corporate income tax is unknown, the present system has hindered the Congress's ability to predict the effect of proposed legislation and to thereby design the legislation that most accurately and effectively accomplishes its social and economic purposes. We believe that some measure of integration of the corporate and individual income taxes would alleviate these problem areas.

Based on our analysis of the various alternatives available, we urge the adoption of either a dividends-paid deduction for corporations or a "gross-up" method of calculation that would allow a tax credit to shareholders for those taxes paid by the corporation which are attributable to the income distributed as dividends. Properly structured, either alternative would be feasible from an administrative standpoint and would correct many of the shortcomings of the current system of taxing corporate-source income.

The Dividends-Paid Deduction

Allowing a corporation to claim a deduction for dividends paid to its shareholders would achieve integration but would require corollary modifications in the present tax system.

Adoption of a dividends-paid deduction should carry with it the repeal of IRC Section 243 and related provisions dealing with the dividends-received deduction (85 percent in most cases) allowed to corporate distributees.

Attendant with the repeal of the dividends-received deduction, there appears to be no reason why the tax treatment of property distributions to corporate distributees (IRC Section 301(b)(1)(B) and related provisions) cannot be simplified. Since a step-up in basis can no longer be achieved by only a 15 percent inclusion in gross income, why not treat corporate and individual distributees equally? Thus, the fair market value of the property would be the measure of the dividend income, and such value would become its basis in the hands of the distributee shareholder—whether individual or corporate. The deduction of the distributing corporation should be limited to the corporation's adjusted basis in the property distributed.

The Institute believes that the dividends-paid deduction should be denied with respect to dividends distributed to tax-exempt organizations.

Advantages

Corporate-source income *that is distributed* to shareholders would be taxed equitably—both from a horizontal and vertical standpoint. The tax disparity between debt and equity financing would be considerably eased. Since dividends paid would become deductible, one important reason for choosing the debt route disappears. As dividends become deductible, equity financing becomes more attractive both to corporate management and to potential investors. By shifting to an equity source of funds, corporations can avoid the potentially hazardous commitment that accompanies debt obligations. During periods of low or nonexistent earnings, dividend distributions can be postponed. Interest and debt repayments must continue, however, if the business is to survive.

Making dividend distributions deductible undoubtedly would increase the flow of funds from corporations to shareholders. With respect to lower-income shareholders, these additional spendable funds would lead to increased consumption power.

Although the dividends-paid deduction has not had wide application in the United States, it is used with various modifications in other developed countries. For example, the "split-rate" system in effect in West Germany is a partial deduction for dividends paid. This does not imply that the United States should pattern its tax laws after other nations. However, in the international market setting, we must remain sensitive to the possibility that our tax system may place domestic corporations at a competitive disadvantage.

The adoption of the dividends-paid deduction alternative would ease certain tax problems inherent to closely held corporations. Once both dividends and interest become deductible, the motivation leading toward "thin" capitalization weakens, although it does not disappear. Shareholders may still wish to withdraw some of their investment in the corporation without income tax consequences (that is, by means of the repayment-of-debt principal). Perhaps more pronounced will be the resolution of the unreasonable compensation issue. Except for limited situations where excessive salaries may be paid in order to qualify a shareholder-employee for the maximum tax on earned income (IRC Section 1348), preference for salaries over dividends would be neutralized. The same can be said for the current practice of shareholders' leasing property to a corporation in order to generate a rental deduction. At the corporate level it does not matter whether the distribution is characterized as interest, salaries, or rent because all such legitimate expenditures are deductible.

Disadvantages

Several objections can be raised against the adoption and implementation of the dividends-paid deduction as a vehicle toward achieving partial integration.

Complete integration is not achieved within the dividends-paid deduction alternative as it is in the partnership approach, since the corporate income tax would continue to apply to undistributed corporate profits. It would seem feasible, however, to partially rectify this inequity by allowing some type of carryback and/or carryforward procedure for dividends paid in excess of earnings. Thus, a corporation which chose not to make a dividend distribution in one year and accumulated its profits instead would be penalized only temporarily. The corporation would be able to make excessive distributions in later years with carryback relief against the corporate income tax originally imposed. Obviously, such a procedure would require certain safeguards to prevent manipulation directed toward tax avoidance. If a carryback procedure is established, a cut-off date must be set to preclude dividends in excess of current earnings from leading to the refund of prior corporate income taxes paid. To illustrate, if the enacting legislation is approved in 1976, the carryback could be made applicable only to earnings and profits accumulated for tax years beginning after 1975.

Another major objection might be that the dividends-paid deduction will penalize growing firms that need funds for expansion and development and accord preference to mature firms that do not. The answer might lie in a consent dividend procedure such as is currently provided for by IRC Section 565 (relating to the penalty tax on the unreasonable accumulation of earnings and the personal holding company tax). Under such a procedure, a shareholder could agree (on a timely basis) to include in gross income as a dividend a pro rata share of current undistributed corporate profits. As a result, the corporation would be allowed a dividends-paid deduction even though it retains the amount of the consent dividend. The shareholders who agreed to the consent dividend, in turn, would increase the basis of their stock investment by the amount taxed but not received. However, the shareholders would have to use funds from other sources to pay the tax on the dividend.

The dividends-paid deduction places a premium on distributions to shareholders that could conceivably impede economic growth within the corporate sector. Thus, if corporations maximize the deduction, what is left for capital spending? (The answer involves comments stated above plus a consideration of the vagaries of the securities markets.) First, presuming the inclusion of an effective carryback/arryover procedure, the dividend distribution could be postponed with only interim tax consequences. Second, a consent dividend procedure would permit an immediate tax benefit to the corporation with the advantage of the retention of the funds. Third, with the increase in dividend output that the proposal will generate, further investor interest in equity securities might well be encouraged. There is, of course, no way to know whether the inflow of equity funds would match the outflow of actual dividend distributions.

Suppose a corporation making a dividend distribution has tax-free and/or preferentially taxed income for the year. Should the dividends-paid deduction be allowed in full or should it be reduced by the portion attributable to the nontaxable or preferentially taxed income? As long as the deduction did not exceed the corporation's taxable income (as determined under present law) for the year, there should be no need to make any such adjustment. If the distribution exceeds current taxable income, a carryback or carryover would be in order.

Would not the provision for a dividends-paid deduction cause an immediate and severe revenue loss to the U.S. Treasury? That there would be a revenue loss can hardly be doubted. But then, any integration scheme, whether partial or complete, by definition must carry a similar effect. The only question is the severity of the loss and what can be done about it.

First, one would expect the deduction to be available only for the distribution of corporate profits earned after the effective date of the enacting legislation. Distributions of earnings accumulated prior to this date would not qualify. It would seem appropriate that the present source of dividend rules continue to apply where current earnings and profits would be deemed to have been distributed first. Second, recall that the dividends-paid deduction alternative does not envision the repeal of the corporate income tax—it would still apply to undistributed corporate profits. Third, the immediacy of any substantial losses might be avoided by some sort of phase-in period. For example, if the deduction is to become operative in 1976 it could be limited to 20 percent of the dividends paid, with progression to 40 percent in 1977, 60 percent in 1978, and so until 100 percent is reached. Fourth, and perhaps most important, are the long-range effects of the proposal. If it is true that the dividends-paid deduction leads to economic stimulation and growth, any initial revenue loss might well be compensated for once the phase-in effect has passed.

What effect, if any, would the dividends-paid deduction have at the state level? In those states imposing an individual income tax, it is doubtful that the result could be anything but an increase in revenue. Because the prospect of the federal deduction will stimulate dividend distributions, more income will be subject to state and local taxes in the hands of recipient shareholders. Unless states levying corporate income taxes also permit a dividends-paid deduction, there should be no offsetting loss from this source.

The "Gross-Up" Method

Like the dividends-paid deduction alternative, the gross-up method depends on retention of the corporate income tax. But instead of focusing on the corporation, relief is provided at the shareholder level. Under this proposal a shareholder includes in gross income the net dividends received plus the corporate income tax attributable to such dividends (that is, the dividends would be "grossed up"). The shareholder then computes the income tax in the regular manner but is permitted to claim as a tax credit the amount of the gross-up. In effect, the corporate income tax is withheld by the corporation on behalf of its shareholders then passed through to them as a credit when dividends are distributed. Several observations, both pro and con, can be made about this attractive method of partial integration.

In terms of tax equity, the result would parallel that achieved under the dividends-paid deduction alternative. Thus, vertical and horizontal tax equity would be achieved for distributed profits but not for those accumulated.

Under the gross-up method, dividends would become more attractive to the investor than interest. The taxpayer, in addition to receiving dividend income, also would receive a tax credit that would more than offset the additional tax liability attributable to the inclusion of the grossed-up amount. Thus, since dividend income is preferred by the investor over interest income, some easing of the preference for debt over equity financing would seem bound to occur. But, because dividends are not deductible to the corporation, those in control of corporate policy are still apt to lean toward debt and the accompanying interest deduction. One might surmise, therefore, that the gross-up method would lessen disparity between debt and equity investments but not to the extent anticipated under the dividends-paid deduction alternative.

In comparing the gross-up method with the dividends-paid deduction alternative, one important advantage in favor of the former is the effect on corporate accumulations. Since the corporate income tax must be paid whether profits are distributed or not, the incentive to distribute dividends would not be nearly as compelling. Thus, the gross-up method would be more advantageous for new and growth corporations planning little or no dividend payout.

The gross-up method should do much to ease the problem of accumulations by closely held corporations which are motivated by the avoidance of tax at the shareholder level (that is, the matter dealt with in IRC Secs. 531–537 and 541–547). In other words, shielding shareholders from dividend income is less apt to occur if the distributions entitle them to a tax credit.

As has been suggested for the dividends-paid deduction, provision should be made to preclude retroactive application to years prior to the effective date of the enacting legislation. Thus, corporate taxes paid and attributable to profits accumulated before that date would not be eligible for gross-up and credit treatment.

Some form of the gross-up method has been adopted by other developed countries (for example, France, Canada, and the United Kingdom).

If the United States denies integrated tax treatment (except on a treaty basis) to foreign shareholders, the gross-up method would be preferable to the dividends-paid deduction alternative. This is true from a compliance and administration standpoint, since the corporation, under the gross-up method, would be spared the burden of having to determine the citizenship status of each of its shareholders.

One problem posed by the gross-up mthod arises with respect to determining the corporate tax attributable to the dividend distribution. An exact allocation approach, seemingly the most equitable in terms of its result, could become very complex if adjustments are to be made for income from tax-free sources.

In the interest of taxpayers in similar situations, the credit allowed for the amount of the gross-up should not be limited to overall tax liability. Any other approach would penalize shareholders in low marginal tax brackets. Although certain policy considerations may dictate otherwise, the gross-up procedure should not be available to shareholders that are tax-exempt organizations.

The withholding alternative could cause some instability at the shareholder level when determining the final income tax in any one year. Later modifications of corporate income tax liability, either by action of the IRS or through other events, might well change the gross-up computation of previous distributions. In such cases, affected shareholders may be required to file amended returns. In this regard, the dividends-paid deduction would create less difficulty, since only the corporation is affected by subsequent adjustments to prior tax years.

PART 3. FOREIGN INCOME ISSUES

Multinational Corporations

The multinational corporation (MNC) has become a popular topic of debate among American and foreign politicians, businessmen, economists, labor leaders, academicians and journalists. Opinions vary from complete support of the MNC to complete rejection of its function on the erroneous grounds that it adversely affects the balance of payments, the growth of input, investment and employment in the United States, and that is it otherwise one of the most exploitive institutions of capitalism. An examination of the evolution of the MNC is necessary in order to understand the reasons for such divergent views and to place each one in proper perspective. This is the only way it is possible to demonstrate the importance of the MNC to the economic well-being of the United States.

Evolution of the MNC.—Following World War II, the changes in international relations set the stage for the MNC. The United States had improved technology so extensively that new markets for mass-produced goods were required. Europe, on the other hand, was destitute. It needed goods and services. Thus, the solution was obvious: exports of U.S. produced goods to foreigners. Initially, the greatest demand abroad was for tools, construction equipment, heavy machinery—those items necessary in order to facilitate the transition to peacetime production. The post-war period was also a period when the U.S. supplied substantial economic assistance abroad in the form of grants rather than loans. The Marshall Plan, for example, channeled over $10 billion in aid to Europe. However, as the European economy recovered, it gave rise to a huge demand for purchases of U.S. produced goods. The reconstruction of the post-war years attempted, however, to do more than simply restore the pre-war economic structure. Economic integration of the Western European nations was desired. This led to the establishment in 1958 of the European Common

Market. The post-war period also saw the emergence of developing countries. Essentially for the first time, the U.S. began to appreciate the attitudes of the underdeveloped nations towards their economic circumstances. The new nations, lacking the industry necessary to sustain their populations, sought ways to build up their weak economies, i.e., they invited foreign companies with new capital to invest in new industries.

With the economic revival of Europe and Japan, it became evident that there would no longer be sole dependence on the United States. Goods and services could now be supplied internally or from other nations and the technology that the U.S. had developed was spreading to the other developed nations. This posed difficult questions in the U.S.A. Should U.S. business withdraw entirely from international competition? Should U,S, business compete in world markets by establishing manufacturing plants closer to the markets? Should U.S. business merely license technology to foreigners? Generally, the business community decided to directly compete in the foreign markets by establishing operations close thereto.

Taxation and Economic Considerations in General.—One complaint is that MNCs, by operating outside the U.S.A., take advantage of tax loopholes. Naturally, in using their capital resources and management to undertake foreign investment, MNCs are interested in carrying on viable business operations with a satisfactory return on investment. Taxation is ordinarily an important factor in any business decision; however, its significance with regard to the development and operations of MNCs has frequently been magnified out of proportion. The relative merits of one tax jurisdiction over another is significant only after a basic decision is made to set up foreign operations.

Most MNCs are not in business to earn quick returns, recover capital and then withdraw business operations from a country, but rather decisions to invest additional capital are likely to be made after the initial capital outlay. For example, the manufacturing industry will often invest abroad if certain competitive cost conditions and other market factors exist, i.e., availability of qualified labor, transportation costs and proximity to low cost materials and supplies. In the case of extractive industries, for example, the location of raw materials will trigger the investment.

We are of the opinion that the economic interests of the U.S. and the world would best be served if the free flow of goods, services, ideas and capital is not obstructed by national boundaries. Accordingly, we believe that it should be U.S. policy, as well as the policy of other nations, to exercise taxing authority in a manner which will encourage this free flow. In general, tax policies should be adopted which are neutral and non-discriminatory. Only in this way will the world's economic resources achieve maximum utility.

A basic premise of neutrality is that business decisions to invest at home or abroad should not be affected by tax considerations. A major deviation from neutrality would occur if income earned by a foreign subsidiary is subjected to tax by both home and host country. The elimination of international double taxation thus becomes the foundation for neutrality.

Industrial nations have generally eliminated double taxation by following the "territorial" principle (i.e., exempting all foreign source income from tax) or by granting a credit for foreign income taxes paid on the foreign source income subject to tax. Both methods acknowledge that the host country has priority in taxing domestic commercial operations, since the host country is the source of the financial, social and economic stability which permits profitable commercial activity. It should be noted that the foreign tax credit is simply a device to avoid double taxation of earnings. It is not a form of tax preference or loophole, nor does it reduce the tax on domestic earnings. We believe that attacks on the foreign tax credit are generated only from misunderstanding of its purpose and application.

Many who support proposals for reversing the traditional concepts of taxing foreign income either ignore or regard as insignificant the fact that U.S. business would be placed at a serious disadvantage vis-a-vis its foreign competition. In their view, the disadvantages are justified as a necessary result of the application of the concept of tax neutrality. They contend that a dollar of foreign earnings (in a foreign subsidiary) should bear U.S. tax if a dollar of domestic earnings bears such tax. Such arguments lose sight of the fact that the application of domestic neutrality in an international context would work to the advantage of our overseas competitors. True international neutrality exists only when a U.S. owned foreign manufacturing company pays taxes no more burdensome in total than a foreign competitor. Is it a true manifestation of neutrality if a locally owned company in the Netherlands, for example, pays a tax of 48 percent on its profit while a U.S. owned company operating there pays 73 percent on its profits? It seems clear that there is no way U.S. business can compete on such terms. Thus, MNCs would cease making foreign investments and perhaps dispose of existing investments.

Without a competitive atmosphere, U.S. business would be forced to withdraw from the foreign scene. Anxious foreign owned companies would step in to fill the void. They would invest in new productive facilities, as well as acquire the facilities (perhaps at a bargain) relinquished by the retrenching U.S. businessman. The idea that foreign markets could be serviced by U.S. exports alone is totally unrealistic. U.S. capital was invested abroad only when it became obvious that such investment was absolutely essential to retrain the markets once serviced by exports. The withdrawal at this time of such capital would result in the loss of our overseas markets for all types of goods and services. A reduction in output of products, due to lost markets, could result in an increase in per unit production costs in this country, since fixed costs would have a smaller volume over which to be allocated. U.S. products would thus become even less competitive.

It is clear that foreign competition would grow stronger as it continued to benefit from its broader base and increasing productivity. This would be reflected in lower prices for their goods, which would logically result in the loss of U.S. export markets and greater vulnerability to constantly increasing import pressures. The foreign corporation, having replaced the U.S. corporation in foreign markets, would be in a position to build up greater financial reserves and power with the final prospect of using such financial strength to acquire large (perhaps controlling) interests in U.S. industry. It is doubtful that this is the result we want. Certain economists have reported that should additional restrictive legislation be enacted, if only one percent of the estimated U.S. multinational assets were to be liquidated, it would provoke an international monetary crises.

Despite governmental and private studies which show that MNCs create American jobs, contribute strongly to the balance of payments, and are instrumental in developing new technologies, there are still doubtful critics. Organized labor is one of the leading opponents of the MNC. With continued high unemployment, many supporters of labor have called for restrictions on business through limits on the operations of the MNC. The basic weakness in this position is that it assumes all MNCs are alike. The motivations for investing abroad, the problems faced abroad, and the effects on the U.S.A. are different for each industry and corporation. A principal concern relating to the MNCs is the effect on domestic employment. MNCs are accused of being one of the major causes of U.S. unemployment because they export capital which it is claimed could have been invested in the U.S.A. The results of a Department of Commerse study of 298 U.S. based MNCs for the period 1966–70 suggests that multinationals have helped rather than hindered the growth of domestic employment. The study shows that while overall U.S. private sector employment grew 1.8 percent a year during this period, domestic employment attributed to MNCs grew by 2.7 percent a year. In addition, the 1973 U.S. Tariff Commission found that MNCs create an annual net gain in U.S. employment of about one-half million jobs. This study concludes that only on unrealistic assumptions can it be said that MNC operations cause a reduction in total U.S. employment.

Why Companies Invest Abroad.—In 1973, the Conference Board prepared a study for the Department of Commerce on reasons why companies invest abroad. Businessmen were interviewed in 76 companies. The results are shown below. The importance of each reason is measured by the frequency of mention by the individual business executives. It is interesting to note that this report shows no evidence that foreign tax benefits or incentives represent an important reason for foreign investment. Inducements (perhaps tax holidays) connected with host government investment promotion programs was the least important reason.

Importance of reasons for foreign investments

	Mentioned by number of companies
1. Maintain or increase market share locally	33
2. Unable to reach market from United States because of tariffs, transportation costs, or nationalistic purchasing policies	25
3. To meet competition	20
4. To meet local content requirements and host government pressure	18
5. Faster sales growth than in the United States	15
6. To obtain or use local raw materials or components	13
7. Low wage costs	13
8. Greater profit prospects abroad	11
9. To follow major customers	10
10. Inducements connected with host government investment promotion programs	8

On occasion, in certain countries, adverse tax legislation has had the tendency to force companies incorporated therein to seek refuge in other jurisdictions. It is not unreasonable to speculate on whether or not certain U.S. based MNCs would consider this alternative, if across the board current taxation of income from foreign sources becomes law. When contemplating foreign investments, MNCs are concerned that the basic rules affecting their foreign operations will remain stable or at least predictable, and, in our view, MNCs are entitled to rely on such rules.

Foreign Tax Credit

The foreign tax credit is the only unilateral device under U.S. tax laws for preventing international double taxation of income. It is also the mechanism by which the U.S. attempts to mitigate double taxation under tax treaties. This system or an equivalent exemption system is a prerequisite for international trade and business, without which the United States would be programed for isolation. It is thus almost absurd to hear arguments in recent years in favor of its demise. Under these proposals, foreign taxes would be allowed as a deduction only, similar to state and local taxes in the U.S.A. The argument that the elimination of the foreign tax credit would result in equality with state and local taxes is specious. State and local taxes range up to 11 percent, while foreign income tax rates (ignoring tax havens) are frequently equivalent to the U.S. corporate rate. It would be more appropriate to argue that state and local taxes should be granted credit status. Although in theory this argument is logical, its application would likely have the tendency to increase state corporate income tax rates, perhaps to the federal level, causing a substantial depletion of the U.S. tax revenues.

It appears to us that there is no justification for the repeal of the foreign tax credit. It has generally been acknowledged that repeal would result in international double taxation of such a substantial nature as to virtually terminate all U.S. business transactions abroad. However, there has been continuing debate on the issue of whether taxpayers should be permitted a choice between the overall and the per-country limitations, and this issue surfaced once again in the proposed repeal of the per-country limitation in H.R. 10612.

In general, we support the retention of the overall limitation method, and we would not be adverse to the elimination of the per country method which is more complex and of use to only a relatively small group of taxpayers.

In the usual situation U.S. firms operating overseas regard their foreign business as a single operation. It has been said that many firms set up their organizations on this theory. The application of the credit relief to foreign income as a unit is generally consistent with business realities. Today's MNC is not merly a sum of parts each operating autonomously. Most MNC's operate as one integrated unit, dividing operations functionally into domestic and international setments. Accordingly, it becomes appropriate to allow a taxpayer to treat its U.S. operations as one business and its entire foreign operations as another business, thus averaging the high and low taxes of the various countries in which it is operating.

The overall limitation is administratively simple for the Internal Revenue Service and the taxpayer. The majority of U.S. corporate taxpayers have elected this method. Allocation and apportionment of expenses is necessary for computation of taxable income from sources within the U.S.A. and from other sources. This is necessary in order to compute the credit limitation. It is an administrative burden to require a proration of such expenses to the income from each country in which the taxpayer operates. On the other hand, to allocate these deductions between domestic income and foreign income is much simpler.

Deferral of Income of Controlled Foreign Subsidiaries

A foreign corporation can insulate foreign earnings from U.S. taxation until the earnings are actually repatriated, unless it comes within the controlled foreign corporation (Subpart F) provisions or the foreign personal holding company provisions.

The immediate taxation of the income of controlled foreign subsidiaries, a position advocated by many, would unquestionably trigger some retrenchment of U.S. business from the international business scene. Such proposals call for the extension of Subpart F treatment to all income earned by foreign subsidiaries, regardless of whether or not the income is distributed.

We favor the continuation of the policy which has generally resulted in a policy of taxing the earnings of foreign corporations only as dividends are paid to U.S. shareholders. Our reasons for this position are set forth in the following sections.

Foreign Plants.—Ordinarily, the principal reason for establishing foreign plants is to provide MNCs an opportunity to effectively compete with foreign owned businesses. Competition is a way of life abroad, as it is in the U.S.A., and thus it becomes the main factor in making an investment. It becomes easy then to relate to the feelings of U.S. businesmen operating in countries where other businesses are paying lower taxes. Although taxation is only one of the many factors which determine the ease or difficulty of competition, any penalty experienced or benefit waived materially alters the ability of a trading corporation to maintain its bargaining posture in the international market. It is generally known that tax revenues are seldom improved through punitive taxation. Taxation should be a method for financing government activities rather than an arbitrary device to exercise discipline and control.

The Internal Revenue Code currently contains many provisions to prevent abuse in the form of leaving excessive profits abroad. Intercompany prices must be based on an arm's length standard and it is necessary to pay for a U.S. parent's "know-how." Profits of foreign plants must generally by reinvested in further business expansion or repatriated and taxed, particularly in view of the recent change in the Subpart F rules noted below. If the foreign subsidiary maintains a U.S. office to sell products on the U.S. market, profits from U.S. sales are taxed in the same manner as any foreign corporation engaged in a U.S. business, including sales consummated (title passed) abroad if attributable primarily to the sales efforts of the U.S. office. In addition, recent legislation (Tax Reduction Act of 1975) eliminated or reduced sveeral important relief provisions to Subpart F, particularly the repeal of the minimum distribution provisions.

As we have previously stated, available statistics indicate that the establishment of foreign plants provides products for foreign markets and does not result in a loss of existing U.S. jobs, but rather an increase, unless a plant in the U.S.A., previously producing such goods, is closed. If, for example, foreign plants are relinquished by U.S. owners, this would not cause an increase in production in the U.S. and would not improve the labor situation. This is based on the premise that the initial decision to establish foreign operations was based essentially on the inability to compete on the foreign market with U.S. exports alone. Foreign investment would not generally be replaced by investments in the U.S. to serve the same markets.

An analysis of the international tax issues would not be complete without examining the question of establishing foreign plants to sell products in the U.S. market. This situation is typical of products easily transported and manufactured by unskilled labor. The U.S. government has encouraged such overseas production, for example, in Puerto Rico, a policy which has reduced chronic unemployment and has established a viable economy. Certain assembly-line operations have also migrated to Mexico, where unskilled labor is employed in towns from which migratory labor would otherwise flow to the United States. There are also U.S. owned plants established in the Far East, including Taiwan and Korea, for which the U.S. takes some economic responsibility. In these countries the U.S. owned plants are in competition with Japanese owned facilities. Production in Japan has been to a not insubstantial extent a matter of supplying the U.S. market. If these U.S. owned plants cease to operate, the entire U.S. market would be relinquished to enterprises controlled by foreigners. We are of the opinion that this result would be directly attributable to the imposition of any punitive taxation, such as a past proposal known as the "runaway plant." Under this proposal, a U.S. shareholder would be currently taxed on all earnings of the foreign subsidiary if 25 percent or more of its gross receipts are from the export of manufactured goods to the United States and the foreign tax rate is less than 80 percent of the U.S. tax rate.

Taking into consideration the relative tax rates around the world, it would seem that the current taxation of undistributed foreign earnings would result in little or no additional U.S. income tax revenue after allowance of the foreign tax credit. This may well be true when viewing the U.S. business community as a whole. However, when viewed on a taxpayer by taxpayer basis, many taxpayers would be burdened with additional current taxation in not insignificant amounts.

Special attention has been drawn to the role which tax factors play in attracting capital to certain countries, even through nationwide or regional tax incentives. Although this is generally true in the less developed countries, many of the industrialized nations also offer incentives for activities in so called depressed areas. Current taxation of income generated by foreign subsidiaries operating pursuant to these incentives would result in a greater U.S. tax liability. For a tax incentive to be effective, the nature of the circumstances must be such that the investment must not have been made in the absence of the incentive. It is clear that current taxation of earnings would essentially negate the tax reduction incentives offered by these countries.

A classic example is Ireland, which has attempted to reduce its chronic unemployment by encouraging foreigners to establish plants. A company which exports goods manufactured by it in the Republic or exports wholesale goods manufactured in the state by another concern obtains substantial relief from income tax and corporation profits tax. Although these incentives are temporary, admittedly they provide for discriminatory and inequitable treatment in furtherance of the economic objectives of a developing country; however, it is clear that the result is consistent with the U.S. policy of aiding the economic development of the less developed countries. It is important to note that the Japanese, for example, have been establishing plants in Ireland and thus availing themselves of the incentives.

Foreign Tax Consequences.—Host country incentives could readily be rendered meaningless, if the U.S. effectively denies such incentives to subsidiaries of U.S. MNCs by currently applying the full U.S. rate to all income from abroad. In this case, the U.S. would simply be attracting the tax revenue given up by host countries in their attempts to attract investment. It is likely that the direct effect would be to encourage an increase in the local taxes, i.e., a tendency to eliminate existing tax holidays, at least insofar as U.S. investment is concerned. Many of these countries cannot afford to offer costly incentives, unless these programs result in the investment of foreign capital.

In addition, if the U.S. parent needed foreign funds to meet its U.S. tax liability, dividends subject to foreign withholding taxes would have to be paid. Accordingly, to the extent that these taxes are creditable, the U.S. tax revenue would be reduced.

Competition and Relationship with Host Country.—There is little doubt that the current taxation of earnings of foreign subsidiaries would adversely affect our competitive position in world trade vis-a-vis the other prinicpal trading countries. The existing system has not been abused. Funds which are required by the U.S. parent are repatriated as soon as possible, without regard to U.S. tax considerations.

Host countries are likely to be less hospitable to companies which withdraw local earnings annually in order to contribute to the payment of the parent's U.S. tax liability. Certainly, it would shatter expectations of growth and financial stability. The success to date of MNCs in operating in many countries has been attributable, to a substantial extent, to the MNCs' responsiveness to the national priorities of host countries. A change in attitude by U.S. companies could very well trigger retaliatory action by the host country against U.S. interest. It would not be surprising if the U.S. suddenly finds itself cut off from certain foreign markets or supply centers.

It should be noted that the fact that companies are basically economically motivated does not preclude tnem from being good corporate citizens. Among the most common ways in which the operations of MNCs have a positive influence on host countries is by the introduction of more advanced technology and the training of nationals in new technical or managerial skills.

Other Foreign Tax Issues

Two other issues that relate to foreign income or foreign investors may be considered by your Committee this year. These are (1) the proposal to eliminate U.S. withholding tax on dividends and interest from investments in U.S. securities by foreign investors, and (2) the gradual elimination of the earned income exclusion under Section 911.

Withholding Tax on Foreign Investors.—We support the Administration proposal that withholding on foreign investment in United States securities investments should be eliminated. The present system of withholding generates very little tax revenue to the United States but it is clearly a deterrent to substantial capital investment in the United States from foreign sources. Accordingly, consistent with our concern for this country's capital requirements, we support the elimination of this provision.

The Earned Income Exclusion—Section 911.—We do not support the House decision to eliminate the earned income exclusion under Section 911. This would create a further disadvantage for many U.S. companies who are competing with foreign companies for contracts with low profit margins. This is particularly true in the construction industry where margins are relatively low and the slightly lower compensation levels, that are acceptable to U.S. personnel working abroad due to the tax savings through Section 911, helps in meeting foreign competition. The amount of total revenues generated, which translates into export sales of U.S. goods and jobs for U.S. labor, far outweighs the tax revenues lost through Section 911.

PART 4. SMALL BUSINESS TAX PROBLEMS AND CERTAIN EXPIRING PROVISIONS OF PL 94-164

The Institute previously testified before the Select Committee on Small Business on February 28, 1975, and again on November 13, 1975. On each of these occasions, it addressed its testimony to the tax problems of small business. While we believe that the tax problems of small business are somewhat broader than the problems enumerated below, we have confined this portion of our statement to th provisions of HR 10612 which relate to small business. We would point out that our comments on capital formation which permeate this entire statement are in most cases equally applicable to small business.

Corporate Tax Rates

The "Revenue Adjustment Act of 1975." (PL 94-164), extended through June 30, 1976, the temporary changes made to the corporate tax rate and surtax exemption by th 1975 Tax Reduction Act. These changes increased the corporate surtax exemption to $50,000 and reduced the normal tax rate on the first $25,000 of corporate income to 20 percent. HR 10612 would extend these changes through 1977.

The Institute agrees that reduction of the corporate tax rate provides a stimulus to the economy and is helpful to small business. We feel, however, that the stimulus provided should be reviewed and adjusted periodically as conditions warrant.

Investment Tax Credit

The Ways and Means Committee in HR 10612 has provided for the following changes in the investment tax crdit:

Extension to 1980 of the temporary increase in the credit to 10 percent made by the Tax Reduction Act of 1975.

Extension also to 1980 of the temporary increase in the maximum amount of used property qualifying for the credit to $100,000.

The Institute supports the general concepts of extending the increase in the investment tax credit. The need for capital investment by both large and small business is acute, and the investment credit has proven to be an effective incentive. We suggest, however, that the investment tax credit be made *permanent*, rather than merely extending the credit on a temporary basis as provided in the proposed legislation.

Estate Tax Problems

A very real problem of liquidity exists for many small businesses when an owner dies and the business must go through an estate. In many cases sales of businesses are forced by the burden of estate taxes and sometimes the beneficiaries do not realize full value. Numerous proposals have been advanced for estate tax relief for small businesses. These proposals primarily center around increasing the exemption level and providing more liberalized rules regarding payment of the estate tax.

The Estate Tax Exemption.—With regard to the current estate tax exemption level of $60,000, both the Administration and Congress appear to be in agreement that it is too low. Under the Administration's proposal the exemption would be increased to $150,000. This increase would be phased in over a five-year period, raising the exemption level by $18,000 per year. On the congressional side, we make note of two bills that could prove advantageous for small business. The "Small Business Estate and Gift Tax Reform Act" (S. 2819) introduced in December 1975 by Senators Nelson, Mondale, Brooke, Packwood, and Dole, among others; and S. 2394 introduced a little earlier in the session.

S. 2819 would increase the estate tax exemption from its current level of $60,000 to $120,000 to be phased in over a three-year period. S. 2394 would increase the exemption to $150,000. In addition, S. 2819 would increase the gift tax specific exemption to $60,000 from its present $30,000 and then in effect "unify" these two exemptions to make them available, in total, for offset either or both gifts made and the estate subject to tax.

We agree with the concept of increasing the exemption level and unifying the two exemptions to make them available either for gift or estate tax purposes. We recommend substitution of a unified transfer tax deduction in the amount of $150,000 for the current estate tax exemption of $60,000 and the current specific gift tax exemption of $30,000, such unified deduction to be available, at the option of the taxpayer, either against inter vivos gift tax liabilities or against transfer tax imposed at death.

Extension of Time for Payment of Estate Tax.—There have been numerous proposals to liberalize the rules allowing extended payment of the estate tax. The Administration has called for a five-year moratorium on payment of estate taxes from family farms and small businesses valued up to $300,000. After expiration of the five-year moratorium, the deferred tax would be due in annual installments over the next 20 years with interest at the rate of 4 percent. Relief would also be available, to a lesser degree, for farms and businesses worth between $300,000 and $600,000.

The Small Business Estate and Gift Tax Reform Act (S. 2819) would extend to 15 from the present maximum of 10 the number of annual installments over which the estate tax liability could be spread where a certain percentage of the decedent's estate comprises an interest in a closely held business. In addition, S. 2819 would liberalize the current provisions regarding the situations where an estate can undertake a redemption of part of the stock of a closely held business without suffering certain adverse tax consequences.

S. 2394 would eliminate the "undue" from the present statutory requirement that "undue hardship" be shown in order to get an extension of time to pay the estate tax (in situations not qualifying under the closely held business rules), and would provide for a 4 percent interest rate in lieu of the present higher adjustable rate.

We agree in general with these provisions which would liberalize the situations in which the estate tax liability can be paid out over a period of time. We feel that presently many hardship situations exist which do not qualify for relief under present law.

Our specific recommendations on increasing the exemption level and liberalizing the deferred payment provisions, along with other estate and gift tax proposals, are contained in our Statement of Tax Policy on Estate and Gift Tax Reform which will be published this month. Copies of the printed statement will be submitted to your committee and staff. In the interim you may find our statement at pages 643–711 of the Committee Print of Background Materials on Federal Estate and Gift Taxation prepared by the staff of the House Ways and Means Committee, dated March 8, 1976.

Interest on Deferred Payment of Estate Taxes.—Section 6166 of the Internal Revenue Code permits deferral of the payment of estate taxes if certain conditions are met. Unfortunately, when Congress changed the traditional pattern of interest rates to be charged on tax deficiencies and late tax payments, proper recognition was not given to the effect this would have on the deferred payment of estate taxes. Accordingly, effective July 1, 1975, the rate on deferral of tax under Section 6166 increased from the statutory 4% rate to 9%. If the 4% rate was appropriate when the general rate was 6%, it seems to us equitable that whatever statutory rate applies to deficiencies normally should be reduced at least 1/3 when applied to taxes deferred under Section 6166.

PART 5. REGULATION OF INCOME TAX RETURN PREPARERS

We believe that some form of regulation of *commercial* tax return preparers is desirable. There have been improprieties associated with advertising by commercial preparers and problems with preparers who are incompetent or unethical.

In the case of certified public accountants, protection is already provided the public through state laws, violation of which can result in loss of license; through the requirements of certification as a CPA; through continuing education; through the AICPA's Code of Professional Ethics and the similar codes strictly enforced by the state professional societies; and through the promulgation of Statements on Responsibilities in Tax Practice by the Federal Tax Division of the AICPA.

While we do not believe that regulation is needed for professional preparers such as attorneys and certified public accountants, we support the approach adopted in HR 10612. It offers a practical and workable solution which would provide the Internal Revenue Service with adequate capability to oversee commercial income tax preparers.

Coments on H.R. 10612

The basic provisions of HR 10612 with regard to income tax-return preparers and our comments thereon follow:

1. Each prepared return, statement or other document must contain the identification number of the return preparer and other data sufficient to identify the preparer.

Comment.—We agree that identification of return preparers is vital to the IRS's efficient oversight of this area.

2. Each preparer must furnish to taxpayers a copy of the return or claim for refund prepared by the tax return preparer at the time the return is presented for the taxpayer's signature.

Comment.—We agree with requiring return preparers to furnish copies of the returns to the taxpayers.

3. Each return preparer or every person employing a tax return preparer must file an annual report listing the name, address, identification number, and place of work of each preparer they employ. This report is to be filed by July 31 for a 12-month period ending June 30.

Comment.—We agree with this proposal as an effective and uncomplicated way to regulate the performance of commercial tax return preparers. Utilizing its computer capability, the IRS could process the information returns to identify all returns prepared by a particular tax return preparer. This would enable the IRS to determine whether the returns were done in a competent manner and whether any "pattern of abuse" exists. In addition, this filing requirement would have the psychological effect of impresing on tax return preparers that a workable enforcement is in effect and that improper practices could easily be detected.

4. Each return preparer or employer of return preparers must retain for three years either a list of taxpayers for whom returns were prepared or copies of their returns and claims for refunds.

Comment.—Tax return preparers should be required to make copies of all returns they prepare and retain for them at least three years. We suggest, however, that safeguards be imposed to prevent the IRS from conducting "fishing expeditions."

5. Penalties are provided for negligence or fraud on the part of the tax return preparer. A $100 penalty is provided for negligent or intentional disregard of Internal Revenue Service rules or regulations by a tax return preparer. A $500 penalty is provided for a willful attempt to evade, defeat or understate any tax by a tax return preparer.

Comment.—Negligence penalties should be imposed on persons who prepare returns for compensation. The burden of proof, however, should be on the Service as distinguished from the burden on the taxpayer in negligence cases. Unless the burden of proof is on the Service, preparers could be placed in a very tenuous position because of the many uncertainties that exist in our tax system.

6. In order to prohibit a tax return preparer from continuing to prepare returns when it is determined that he has engaged in improper conduct with

respect to the preparation of tax returns, an injunctive proceeding could be brought against such a preparer.

Comment.—The Service should have authorization to obtain judicial injunctions to prevent future preparation of tax returns for compensation in cases of consistent or willful preparation of false or deficient returns.

7. The Internal Revenue Service would be authorized to provide the names, addresss, and taxpayer identifying numbers of preparers to State authorities charged with enforcing State provisions regulating tax return preparers.

Comment.—This provision relates to the broader issue of making tax return information available to various State agncies. This subject is also encompassed in the recommendations made by the Administrative Conference of the United States which were released in December 1975. Since the matter is currently under consideration by the Privacy Protection Study Commission, we suggest that it may be appropriate to defer legislation on this point until the Commission concludes its study.

PART 6. DISCLOSURE OF PRIVATE RULINGS

SECTION 1212 OF H.R. 10612

A matter which demands immediate legislative attention, is the subject of private ruling letters and technical advice memoranda which are issued by the National Office of the Internal Revenue Service.

Private ruling letters are issued by the National Office in response to formal written requests submitted by taxpayers, and generally relate to transactions which are still in proposed form and yet to be consummated. The private ruling letter briefly summarizes a specific set of facts describing a proposed transaction, and sets forth ruling paragraphs detailing the tax consequences which flow from the transaction. A copy of each ruling letter is provided to the district director having jurisdiction over the taxpayer in question, and a copy of the private ruling letter generally accompanies the taxpayer's return for the year in which the transaction is consummated.

Technical advice memoranda are issued by the National Office upon request by district directors in connection with the examination of taxpayers' returns or claims for credit or refund. As in the case of private ruling letters, technical advice memoranda interpret and apply the tax laws to specific sets of facts, but always involve completed transactions with respect to which tax returns have already been filed by specific taxpayers. Technical advice memoranda are furnished to district attorneys, who may provide copies to the taxpayers being examined, unless instructed otherwise by the National Office.

Both private ruling letters and technical advice memoranda could be considered part of a taxpayer's tax return information which should be exempt from disclosure, but both have been the subject of recent litigation involving requests to compel Internal Revenue Service disclosure of these documnts under the Freedom of Information Act. [See *Tax Analysts and Advocates v. Internal Revenue Service.* 505 F. 2d 350 (D.C. Cir. 1974), mod'g and rem'g. 362 F. Supp. 1298 (DC D.C. 1973); and *Robins & Weill, Inc. v. U.S.*, 74–1 USTC 9299 (DCMD N.C. 1974) and *Fruehauf Corp. v. IRS*, (CA 6, No. 74–1474, 6/9/75).] Consequently, because of the potential overlap in this instance between the Freedom of Information Act and the confidentiality of tax information in general, we believe that additional legislation is necessary to insure that the mandats of the Freedom of Information Act are invoked without infringing upon the fundamental rights of taxpayers to have remain confidential their tax return information submitted to the Internal Revenue Service.

The House has recognized the problem, and has attempted to deal with it in Section 1212 of HR 10612. That section prescribes conditions under which past and future private rulings will be made available to the public. While we suport the concepts of Section 1212, we believe the legislation would be improved if it incorporated the recommendations included in a Memorandum of Understanding arrived at by representatives of the Internal Revenue Service, the ABA Tax Section, the AICPA, Public Citizen Litigation Group, the Tax Analysts and Advocates. The memorandum was published in the March 15, 1976 issue of *Tax Notes*, a publication of Tax Analysts and Advocates, and is included here for the record.

IRS Rulings Disclosure Agreement

[Memorandum of Understanding]

In re Proposed Legislation Relating to Public Inspection of Rulings and Related Documents.

This memorandum lists the basic understanding arrived at by represntatives of the Internal Revenue Service, the ABA Tax Section, AICPA, Public Citizen Litigation Group, and Tax Analysts and Advocates with respect to proposed legislation for inspection of rulings and related documents. References appearing herein are to section 1212 (relating to public inspction of written determinations by Internal Revenue Service) of H.R. 10612.

1. *Terminology.*—The vague and little understood term "written determination" would be deleted. In lieu thereof, the commonly used terms "ruling", "determination letter", and "technical advice memorandum" would be used.

2. *Documents Open to Public Inspection.*—

a. Rulings, determination letters, and technical advice memorandums (hereinafter described as rulings, etc.);

b. Background files:

(1) Future Rulings, etc.—only pursuant to a written request;

(2) Prior Rulings, etc.—Only pursuant to a written request available with respect to prior reference rulings and even then disclosure would only be available when the prior reference ruling to which the background file relates is, according to the priority of release, itself available.

(3) Aside from the request for ruling, and correspondence between the Servive an dthe taxpayer, the background file includes third party submissions by persons outside of the Treasury Department, e.g., Congressional correspondence, submissions by agencies (other than the Treasury Department) of the Executive Branch, and trade association briefs.

3. *Index.*—The Service will prepare an index of rulings, etc., which are disclosed. The fact of disclosure prompts the requirement of indexing. Such index shall be similar to that required by 5 U.S.C. § 552(a)(2).

4. *Related Documents that Would Not Be Disclosed Under Section 6110.*—

a. The district director's request (including taxpayer's submissions) for a technical advice memorandum,

b. The transmittal memorandum accompanying a technical advice memorandum,

c. The Service's reference index digest card system, control card system, and other indexes currently maintained by the Service,

d. Requests and background files with respect to documents issued in summary form,

e. Background files to unissued rulings, determination letters, and technical advice memorandums, e.g., where a ruling request is withdrawn,

f. Any document subject to disclosure under section 6104.

5. *Amendment of Section 6103.*—Section 6103 would *not* be amended to prevent disclosure of certain nonsection 6110 documents, e.g., closing agreements, offers in compromise, opinion letters, and information letters. See section 6103 (h) deleted from H.R. 10612. It would be provided that all section 6110 documents, and related documents, would be subject to the disclosure rules of section 6103, so that disclosure, other than pursuant to section 6110, would be governed by section 6103.

6. *FOIA Exemptions.*—The FOIA exemptions in current law (with slight modifications) would be restated in the bill. Since identities of taxpayers will be deleted, the Committee Report should note that, as a practical matter, FOIA exemptions will be used sparingly in making deletions.

7. *Identifying Details.*—

a. Future Rulings, etc.—Identifying details would be deleted from all future rulings, technical advice memoranda, and determination letters open to public inspection. There would be, however, a procedure which could be followed for the purpose of determining the identity of the ruling recipient but only if a particular ruling was the subject of a contact (written or otherwise) by some person in the Federal establishment (outside the Department of the Treasury). In that event the Service would initially flag that fact, at the time of the publication of the ruling, by identifying such contact person by category, e.g., Congressional, White House, Department of Agriculture, etc. (Other third party contacts on behalf of a ruling applicant—e.g., by a trade association—will be flagged on the disclosed ruling but there will be no right to identification). If any person was interested in obtaining further information regarding the identity of the contacting party and the nature of the contact, a request could be made of the Internal Revenue Service for access to the background files. Upon the payment of search, copying, and sanitization costs, the Service would make available to the third party information in the background file relating to the contact by the person within the Federal establishment, including the identity of the contacting party. Such material would be made available with identifying details of the ruling applicant deleted. If a third party remained desirous of obtaining information regarding the identity of the ruling applicant, application could be made to the Tax Court or the United States District Court for the District of Columbia for disclosure of the identity of the ruling applicant. In considering such application the court would be allowed an *in-camera* inspection of the documents involved. The person to whom the ruling was issued would be permitted to intervene in the proceeding. In order to permit the disclosure of the identity of the ruling applicant, and the background files without identifying details deleted, the court would have to find that it was reasonable to asume that impropriety or undue influence may have contributed to the holding set forth in the ruling, etc. A statute of limitations for bringing such an action would be incorporated in the statute.

b. Prior Rulings, etc.—Identifying details would be deleted in all cases (the procedure in (a) above does not apply).

c. Required Rulings—Because the rules for deletion of identifying details apply to voluntary rulings, required rulings, and technical advice memorandums, there is no longer a need for a definition of the term "required ruling".

See subsection (d).

8. *Pending Cases Seeking Disclosure.*—Section 6110 would apply to any document included within the scope of a pending judicial proceeding, pursuant to 5 U.S.C. 552, which was commenced prior to January 1, 1976 except that such disclosure would be in an orderly fashion shortly after date of enactment (and not subject to the priority rules of paragraph 16(c) herein).

9. *Disclosure in Summary Form Not Necessary.*—Since identifying details are to be deleted, disclosure in summary form becomes meaningless. Consequently it is recommended that only those rulings and determination letters relating to changes in accounting periods and methods, etc., which are classified as reference rulings, shall be disclosed. Access to those rulings and determination letters in this category which are non-reference would be available on written request and upon payment of fees (no indexing required).

10. *Time for Disclosure.*—Basic agreement with subsection (g).

11. *Technical Advice Memoranda to be Furnished to Taxpayers.*—Technical advice memoranda would be furnished to taxpayers in all cases except in instances where the taxpayer is not notified that the District Director is seeking technical advice because it would be prejudicial to the interests of the IRS (e.g., cases involving fraud or jeopardy assesments.) Issuance to the taxpayer will be a prerequisite to disclosure under these rules.

12. *Manner of Making Disclosure.*—

a. Fees—Specific authorization to charge fees for the search, copying and sanitization costs associated with the disclosure of background files and pre-1967 non-reference rulings, would be provided. The waiver of charges provision of the FOIA would be incorporated. No provision in H.R. 10612.

b. Records Disposal Procedures—The bill would provide specific authorization for the destruction of rulings and related documents in accordance with established procedures of the Service. With respect to future rulings, etc., such documents would not be destroyed earlier than 3 years after the documents are first made available for public inspection. No provision in H.R. 10612.

13. *Precedential Status of Documents.*—The Service would be authorized to establish by regulations, the extent, if any, to which rulings, determination letters, or technical advice memorandums may be used or cited as precedent.

14. *Judicial Resolutions of Disputes Relating to Disclosure.*—For clarity judicial remedies would be gathered in one subsection.

a. Action to Obtain Additional Disclosure.

(1) Jurisdiction. Both the Tax Court and the United States District Court for the District of Columbia would be given jurisdiction for an action to obtain additional disclosure. Any judicial review of such an action, however, would be limited to the Court of Appeals for the District of Columbia Circuit.

(2) Period of Limitation. For future rulings, etc., there would be no period of limitation for an action to obtain additional disclosure. For prior rulings, etc., a 3 year period of limitation would be provided.

b. Action to Restrain Disclosure. Any recipient of a ruling or determination letter, or the person to which a technical advice memorandum pertains and any other person who claims, and is determined by the court to have, a direct interest in maintaining the confidentiality of information would have standing to file a petition with the United States Tax Court, or to intervene, to restrain disclosure. The Service would be required, however, only to notify the recipient of the ruling or determination letter, or the person to which the technical advice memorandum pertains, of the filing of such petition. Appeal would be limited to the Court of Appeals for the District of Columbia Circuit.

c. Action for Failure to Follow Procedures. It has been urged that the IRS should be liable for any damage sustained as a result of not following proper procedures (e.g., placing in the reading room a non-deleted version of the ruling). We are currently determining the extent to which present law would provide such a remedy and the appropriateness of providing a new action in this bill.

15. *Exclusive Remedies.*—Public inspection of section 6110 documents would be accomplished pursuant to the rules and procedures ofthat section and not those of any other provision of law, e.g., the FOIA. However, section 6110 would not be construed as excluding production pursuant to a discovery order made in connection with a judicial proceeding. Therefore, the exclusive remedy provision deleted from H.R. 10612 would be restored, in appropriately modified form (see paragraph 5 above).

16. *Special Rules for Disclosure of Prior Documents.*—

a. Definition of Prior Ruling—All rulings, etc., requested prior to a date 90 days after enactment.

b. Notification of Disclosure of Pre-1976 Documents—The bill would provide for public notice in the Federal Register that prior rulings, etc., are to be opened for public inspection, and the manner in which this disclosure was to be accomplished.

c. Order of Release—Prior rulings would not be disclosed until the Service received a specific appropriation for the purpose of preparing prior rulings for publication. When the appropriation became available, prior rulings would be made available in the following order: (1) prior reference rulings (including those issued prior to 1967) on a LIFO basis; (2) non-reference rulings issued during the 1967–1976 period, on a LIFO basis; and (3) pre-1967 non-reference rulings (not to be obtained, in any event, prior to 1980 and then only on a specific request basis).

d. Exclusions—EP and EO prior determination letters and qualification rulings would not be disclosed.

PART 7. LIMITED TECHNICAL MATTERS TITLE XIX—H.R. 10612

AICPA's Recommended Tax Law Changes

Copies of the Institute's booklet of recommendations for amendments to the Internal Revenue Code, Recommended Tax Law Changes, were previously distributed to all members of Congress.

Keeping in mind the objectives of equity, simplicity, and revenue needs, the Tax Division has recommended in this booklet over one hundred changes in the Internal Revenue Code which would clarify and simplify complex sections and remove inequities where they exist.

While we believe that all the proposals contained in our booklet have merit and are worthy of your consideration, we have recently met with the staff of the Joint Committee on Internal Revenue Taxation and have enumerated to them those proposals included in the booklet which we believe to be non-controversial in nature in the sense that they are strictly technical and have no major revenue impact.

We believe these proposals, which are approximately 50 in number, could be easily included in any bill which is now drafted and would contribute to everyone's objective of simplification.

The CHAIRMAN. We will meet again at 10 o'clock tomorrow.

[Whereupon, at 12:40 p.m., the committee recessed to reconvene at 10 a.m., Friday, March 19, 1976.]

TAX REFORM ACT OF 1976

FRIDAY, MARCH 19, 1976

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

The committee met at 10 a.m., pursuant to notice, in room 2221 Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Byrd, Jr., of Virginia, Curtis, Fannin, and Hansen.

The CHAIRMAN. The committee is now in session.

Our first witness this morning will be the Honorable James L. Buckley, the Senator from New York.

Senator, we are happy to have you before us today.

STATEMENT OF HON. JAMES L. BUCKLEY, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator BUCKLEY. Thank you, Mr. Chairman.

I want to thank this committee for giving me the opportunity to add to the pile of testimony you will be accumulating over the next few weeks from many other witnesses whose suggestions will make this committee's work in the area of tax reform a herculean effort. Although I am confident that, of all the committees of the Senate, this one is equal to its formidable task, I will keep my remarks brief so as not to impose upon your time and patience.

I am here today to testify to two very different tax proposals, which may seem, on the surface, to be utterly unrelated. The first is the concept of indexing, that is, tying the tax tables and the financial obligations of the Federal Government to the cost of living index, so that all the financial transactions between citizens and their Government will be conducted in terms of constant dollar value in order to prevent the Government from profiting at the people's expense through inflation.

The second proposal is much simpler: It is the idea of tax deductions for tuition payments made to public or private schools.

The unifying factor underlying both proposals and giving me the courage to present them to this committee in tandem is the elementary fairness they would insure for all Americans in their roles as taxpayers and as consumers.

INDEXING TAX TABLES

The most important and familiar forms of economic contracts between the Federal Government and the ordinary citizen that would be addressed by my legislative proposals are in the fields of Government taxing and borrowing. In the private sector of the economy, buyers and sellers can agree on a set of private arrangements which would take into account the effects of inflation. But in his dealings with the Federal Government, the ordinary citizen is presently at an overwhelming disadvantage in trying to protect his savings and income in the face of persistent inflation. In point of fact, under present circumstances, Government actually profits from inflation at the expense of the private taxpayer and lender.

By way of illustration, let us examine a case familiar to us all: The personal income tax system. Suppose an individual is earning $5.000 per year in 1975, and that inflation causes prices to rise at an average rate of 7 percent per year—the current rate of inflation—from 1975 through 1985. If the individual receives cost of living pay increases sufficient to keep pace with inflation, his income would be $10.000 in 1985. Yet he would be no better off in 1985 than he was in 1975 in terms of what $10,000 will buy, but he would be significantly worse off wit hregard to his personal income tax.

Assuming he is head of a typical family of four, he would be required to pay 2 percent of his earnings in Federal income taxes in 1975. However, because inflation would have the effect of lifting this same individual into even higher tax brackets, by 1985, when he would be earning $10,000 merely to stay even in terms of purchasing power, he would be required to pay over 10 percent of his earnings to the Federal Government. Though his "real income" in terms of purchasing power remains unchanged, his increase in "money" income will cause him to pay five times as much in taxes.

Moreover, the tax of inflation is particularly regressive, hitting those in low- and middle-income tax brackets hardest. I have listed below some calculations concerning the effect on tax collections at current tax rates between 1975 and 1985, assuming the current rate of inflation, 7 percent, remains unchanged over the 10-year period—prices and incomes double.

1975 income:	Percent of income paid in taxes	1985 income:	Percent of income paid in taxes
$5000	2	$10,000	10
$10,000	10	$20,000	15
$20,000	15	$40,000	25
$50,000	29	$100,000	42
$100,000	42	$200,000	54
$1,000,000	67	$2,000,000	68

I believe the Congress must enact appropriate legislation to protect the individual taxpayer from the consequences of inflation under circumstances where he is compelled to deal with the Federal Government—the agency in our society primarily responsible for inflation.

To deal with two aspects of this problem, I have introduced S.2737, which would index the personal income tax, and S.2855 which would adjust interest and principal payments on personal savings bonds to offset the effects of inflation on them.

I am specifically offering my tax proposal to the committee now as an alternative to the administration's tax reduction proposals. If no tax reduction legislation is passed this year, we will, of course, revert to the tax rates which obtained under the 1975 law. If the administration's proposals are adopted, the cost to the Treasury over the 1975 law would be $21.9 billion, whereas the cost of my proposal, according to a Treasury estimate would be $12.5 billion in fiscal year 1977. A simple extension of the existing law would cost the Treasury $14.22 billion.

Between July 1, 1976 and September 30, 1981, my proposal would save individual personal income taxpayers an estimated $110 billion; this figure represents the windfall profit which the Federal Government would reap from anticipated inflation. My proposal would reduce the size of the Federal deficit for the current fiscal year over that recommended in the President's budget its cost to the Treasury is smaller, but over the long term it would provide a restoration of equity in our tax system that does not exist today. Indexing the tax system, as I have proposed, would restore the true legislative intent of the Congress by taxing an individual's real income at the originally intended statuatory rates rather than permitting these rates to be changed b ystealth in favor of the Government by Government-induced inflation.If we intend to raise real tax rates, let us at least have the honesty to do so in the open, instead of relying on the so-called "inflation bonus" to the Government that is paid by those least able to afford it.

The indexing principle restores equity not only to tax rates, but to the computation of capital gains and depreciation. For example, enactment of my bill would correct an inequity which is arising with greater frequency in recent years, what might be called the taxing of capital-gain-that-isn't-there.

Let us say an individual purchased a home 20 years ago for $20,000 and sells it today for $40,000. Let us further assume that the dollar has lost some 50 percent of its value in the intervening years. Therefore, in real terms, the owner has broken even. Yet, under existing tax laws, the owner is compelled to pay a capital gains tax on the illusory profit that represents nothing more than inflation. He realized no "real" capital gain in the transaction and, as a consequence, he is actually subjected to a capital levy which is contrary to the intent of the law. This is becoming an especially burdensome problem as many of our older citizens whole homes often represent their major assets, and who are forced to sell in order to move into smaller quarters that are easier to maintain. This bill would adjust the cost basis of an asset to reflect changes in the purchasing power of the dollar. Thus, an individual would pay a capital gain only on a real "capital gain" rather than a fictitious inflationary gain.

The legislation also deals with the standard deduction and the personal exemption, and corporate income tax in a similar manner by simply adjusting the statutory deduction or exemption level to reflect changes in the price level as measured by the Consumer Price Index.

Although S. 2737 deals only with personal income taxes, I recommend that the committee also apply the principle to the computation of corporate income taxes. This would have major beneficial effects by allowing businesses to adjust depreciation deductions to reflect the current replacement cost of capital assets. The net effect of existing tax laws is to tax fictitious profits, thereby compounding the problems of capital formation we now face.

My companion bill S. 2855 would index United States savings bonds. Its purpose and effects are self-evident, and I won't elaborate on them here beyond making the following observations:

One: There is an element of fraud involved when the Federal Government sells bonds to the public as prudent investments while the Government at the same time pursues inflationary policies that will guarantee that the holder of those bonds will receive back, in real dollars, substantially less than he originally invested. We would all be up in arms if a private borrower attempted to practice the same deception.

Two: The average citizen today has no way to protect himself against the effects of inflation. Nor are private pension funds able to provide their beneficiaries with the cost of living adjustments that the Federal Government now provides its own pensioners. The issuance of indexed savings bonds would enable citizens and private pension funds for the first time to protect themselves to at least some extent against the terrible attrition of inflation.

Yes, this proposal would add substantially to the nominal cost of servicing the Federal debt; but that cost would do no more than reflect the true cost of Federal programs and would assure greater prudence in their enactment.

TAX DEDUCTION FOR EDUCATION

My remaining proposal for the consideration of this committee is much easier to explain. Much has been said about the problems of private education in the United States, but little has been done to remedy them.

If current trends continue, private schooling in America, on all levels from elementary grades to gaduate school, will become a costly luxury reserved for the very rich or, in the case of college, for the very poor who qualify for full public assistance or scholarships.

A series of decisions by the Supreme Court has made second-class citizens out of all students who attend a private elementary or secondary school, whether it be a parochial institution, a neighborhood school, or an ethnic academy. The right of parents to supervise their children's education is rendered meaningless when they must pay twice to exercise it once through taxes to support public schools and again through private tuition to a school of their choice.

Less than two centuries ago, many Americans suffered much the same burden. Their neighbors allowed them freedom of worship and choice of their own ministers, but first they had to pay taxes to support an established church. The ecclesiastical illogic of yesteryear has become today's educational orthodoxy. It is as specious now as it ever was.

We hear much talk in the Congress about the need to protect consumers. And, yet, there are no more dissatisfied and frustrated consumers than those who must pay for public education and who find it is often faulty and occasionally shoddy. One thinks of the many parents who unavailingly object to the subject matter, textbooks, and teacher attitudes to which their youngsters are exposed; the parents of modest means across the country who cannot afford the private tutoring that would allow their gifted children to develop their talents and their handicapped children to make the most of their abilities.

In higher education, we face the rapid development of conditions which most fair-minded people would consider intolerable in any other segment of American life: monopoly. The effects of an educational monopoly consisting of State institutions are sure to be the same as the effects of any monopoly. By its very nature, monopoly tends toward arrogance and abuse. It discourages innovative criticism and becomes complacently contented with itself. It tolerates no diversity.

As the cost of public education has soared, its performance has plummetted. The quality of its product seems to be in inverse proportion to its expense. Across the Nation, test scores are falling. If such conditions prevailed in the business community, then the Congress, the press, and the people would together rise in anger against them. And rightly so.

For anger, let us substitute remedial action. I propose to allow a taxpayer an income deduction for tuition payments, up to $1,000 annually for each person whose tuition he pays at any private or public school, from the first grade to graduate education. This uncomplicated and obviously constitutional measure—for the Supreme Court has never found fault with tax deductions, as opposed to tax credits—would tend to strengthen parental control over education, would safeguard the consumer rights of indiivdual students, and guarantee to America's schools the benefits of vigorous competition in an open marketplace.

It is difficult to estimate the precise cost of this proposal. A rough estimate—it might better be called a guesstimate—from the Department of the Treasury sets its annual cost as approximately $2 billion. That figure, it should be noted, does not take into account the tremendous savings which private education provides to States, localities, and to the Federal Government. Every student who attends a nonpublic institution of learning saves the taxpayers the considerable amount of money which would otherwise be expended to support him in a public school. And, so, that $2 billion figure must be counterbalanced by the significant savings that would be safeguarded by S. 2356.

If the individual rights we celebrate in this Bicentennial year still mean anything, they must mean that Americans have the right to preserve their own religious, educational, and cultural institutions. Members of every minority have the right to hand over to their children their own values and beliefs, their own religious traditions, ethnic identity, and racial pride. Once these rights are swallowed up by publicly funded monopolies, then little is left of the boasted freedoms to which our Bicentennial is dedicated.

That is why, although I am fully aware of the heavy schedule this committee faces in grappling with tax reform legislation, I would urge my colleagues to give due consideration, if not necessarily to my specific bill, S. 2356, then to the general idea of tax relief for the educational expenses of parents and students.

69-460—76——21

S. 2356 has the cosponsorship of several of our colleagues: Senators McClellan, Helms, Baker, Brock, Schweiker, Thurmond and Tower. Moreover, several related bills, generally of a more limited scope, have been introduced by other members of the Senate, including members of this committee: Senator Hartke, S. 2002, and Senator Bentsen, S. 666.

Representative James Delaney, the universally respected dean of the New York Delegation, has introduced a similar bill to S. 2356 in the House, H.R. 9865. I am pleased to present to the committee his statement in support of S. 2356.

The CHAIRMAN. Without objection, it will be included in the record at this point.

[Statement of Representative James Delaney follows:]

STATEMENT OF HON. JAMES J. DELANEY, U.S. REPRESENTATIVE FROM NEW YORK'S NINTH CONGRESSIONAL DISTRICT

Mr. Chairman, I appreciate this opportunity to testify before you and strongly urge your endorsement of a measure to provide tax relief for those Americans who must allocate such a large percentage of their hard-earned dollars for tuition expenses. On September 26, last year, I introduced House bill H.R. 9865. It is in major respects similar to S. 2356 currently pending before your Senate Committee. Both measures would grant a tax deduction up to $1000 itemized for tuition paid by any taxpayer to educate himself or his dependents. Both bills apply to students in primary, secondary, and vocational schools, as well as to those in institutions of higher education.

Mr. Chairman, while every citizen is feeling the effects of the current economic crunch, it is lower and middle income Americans who are especially hard-pressed during these difficult times. It is crucial that some measure of tax relief be afforded them to insure that our Nation's youth are not denied the quality education they so rightly deserve.

Such a tuition tax-deduction represents more than simple tax justice—from a rigorous cost-benefits economic perspective, it makes sound economic sense. Good education is an absolute necessity for the welfare and future of our country. Not only would a tuition deduction provide short-term relief to overburdened taxpayers of modest means and bring short-term indirect benefits to our educational institutions being forced to cut back or close down, it would also improve our country's secular economic and tax base trends.

Although the cost of public education has risen dramatically in recent years, numerous experts indicate that the product purchased by the people's taxes—the measurable level of knowledge among students—has tended to deteriorate. For example, test scores of 1975 public school students on the Scholastic Aptitude Test (SAT)—a requirement for admission to many universities across the Nation—highlighted a 12 year decline that began in 1963 according to statistics released by the College Entrance Examination Board.

Mr. Chairman, under current law, a rich contributor to an educational institution can take deductions for his or her generosity. Average Americans, however, cannot deduct their own hard-earned dollars when they "contribute" them for a quality education for themselves or their children. The present system actually favors rich benefactors and institutions, rather than the average American working man and woman.

The right to educational choice is a natural, civil, and constitutional right, protected by the first, fifth, and ninth amendments to the U.S. Constitution. Quality education can only be assured through diversity, excellence achieved through a healthy competitiveness among scholars and institutions. Democracy is predicated upon diversity. Our Nation was built upon diversity. How often in the past have we seen its opposite become the hallmark of totalitarian states . . .

Three times in recent years, the Senate has seen fit to include an education tax credit in legislation it has passed. Even those Constitutional scholars who have raised doubts about such a tax credit, have not questioned the propriety of tax deductions. The tax break proposed by H.R. 9865 and S. 2356 would go to any parent or student who pays tuition. It encompasses *all* "users" of education who contribute to the educational process through the additional donation

of a tuition payment beyond their general tax dollars. It does not inject the Federal Government into the daily routine of any school.

Mr. Chairman, I strongly urge a positive report on S. 2356 by this Committee . . .

INDEXING TAX TABLES

The CHAIRMAN Senator Hansen.

Senator HANSEN. Senator Buckley, if I understand you, considering the ravages of inflation, is it not true that absent indexing the burden of a greater bite being taken from an American's paycheck is more severely applied to persons in low income brackets than in high incomes? I have studied your schedule here. It looks like a person with an income of $5,000 in 1975, if he were to be kept even in terms of actual purchasing power by 1985 would need to receive $10,000. Yet his income according to present schedules would take 2 percent of the $5.000 but 10 percent of the $10,000; whereas, if you are up in the $100,000 bracket you would pay an income tax in 1975 of 24 percent. That would be increased to 54 percent, not nearly 5 times as much, only about 25 percent more instead of 500 percent more for that sort of income. Do I interpret your schedule correctly.

Senator BUCKLEY. That is correct. So long as we have the graduation we now have in out tax scedule, that will be the effect. The so-called bonus is paid by those people least able to afford it.

Senator HANSEN. So your bill would adjust this concept through indexing.

I understand the Canadians have had some experience with indexing. How does it work there?

Senator BUCKLEY. From every report, very successfully. I believe the Canadians adopted their system of indexing 2 years ago. It has resulted in a cost to their treasury—this sort of invisible bonus—but it is a way of dealing with their people fairly; and it means they don't ahve to go back to the drawing board every few years to undo the inequities that have crept in. I believe the Canadians are very satisfied with the way the system is working.

Senator HANSEN. I kwow you and I have similar reactions to the Government narrowing the differences between what the Government spends, on the one hand, and what it receives in taxes on the other. I am still hopeful that we will be able to ultimately prevail in bringing about some balance in that regard.

In the meantime, do you think this idea of indexing really deserves a more extensive and indepth hearing than it has so far received?

Senator BUCKLEY. I think it does, Senator Hansen. I think people who follow these matters closely now understand why we ought to adopt it. I think it needs a better understanding and a better institutional understanding. Also, it has many other features than the ones I have touched on.

For example, in capital gains, my bill would ultimately adjust the basis of your tax assets. I will give one specific example where the present system creates a hardship on the elderly. It is a very common situation for an elderly couple, whose children are gone and who own a house they may have bought 10 or 20 years ago at $20,000 to find that now their home has a new market value of $40,000. That increase do ensot reflect any gain, but just the effects of inflation. Yet they sell that house, in order to move to something more compact, they must pay a capital gains tax on the fictitious increase on its value.

Senator HANSEN. So the net effect of what you are saying is you could have purchased the property say 20 years ago, and you could sell it today for twice as much, and assuming, which I think is born out in fact, that double the dollars today will not purchase more than half that amount would have 20 years ago. If they take what they could realize on their sale today, given the effects of inflation on prices and when they get through paying the capital gains tax, they cannot make another purchase that would give them the same amount of home or whatever they wanted to buy that was represented by the purchasing power that went into their earlier purchase. Is that the point you are making?

Senator BUCKLEY. Yes. Or to put it another way, inflation changes their tax from a capital gains tax into a capital levy. There is nothing in our tax laws that permits this, yet this is what happens.

Senator HANSEN. There seems to me to be some real merit in this indexing idea. I must say it is not a panacea. It is going to cover everything because there are too many instances where I gather no adjustment will be made. I don't know about a person who has a savings account or has made investments in other areas and would hope to be able to live from the income of those investments or savings at an earlier time, but I must say that I think it certainly deserves a real examination, a greater examination than I believe we have been able to give it so far. I thank you very much for your contribution.

Senator BUCKLEY. Thank you, Senator.

RESTRICTIONS ON ABSENT PARENT DATA

The CHAIRMAN. Senator, I am particularly interested in a matter you have not testified to but it relates to one of your legislative achievements. I am afraid it might be used contrary to the way you think it ought to be used.

We have received information on this committee that there are complaints being made by State welfare agencies and from child support enforcement offices that they can no longer obtain needed information from school records, particularly as to the home address of a student and data on the absent parent of a student, that would aid in determining the eligibility of the family for AFDC or would aid in the location of the absent parent, and in obtaining parental support for the child, without written consent of the parents or students. We have this situation where people come in and apply to be paid welfare. One of the first questions that should be asked is, where is the father? Can he contribute to the support of the child?

Before we passed the new child support law, pe le would say, we are sorry but we are not required to tell you that. Likewise, we had to fight the Internal Revenue Service to tell us where that man is. He may be making $25,000 a year. IRS would rather have the Government pay $3,000 a year to support that family than to make poppa pay.

It would be interesting to research this question of the right of privacy on social security numbers. As I understand it, that was asked for by labor because they had difficulty getting their goon squads reinforced. After they blew up a man's plant, if the employer suspected that was the gang that blew up the other guy's plant, he is a little reluctant to hire them. They need to get new identities and get rid of their old social security number. It was decided these people should be able to lose themselves in society and get a new social security number. That is all right with me, but when they start blowing up this Government, that is different.

I think we ought to be privileged to know if a person wants to go on welfare what his social security number is, or if he deserts his children and leaves them for the State to support, be it Louisiana or New York, we should know where that man is if the Government has that information.

Was that your intention with regard to Public Law 93-513 as amended by 93-568, section 2 to keep us from finding those runaway fathers?

Senator BUCKLEY. That was not my intention or necessarily the intention of the law. HEW has been slow in coming up with regulations to crank in the factor of commonsense.

Second, it is clear in the law that any right to privacy can be waived. It seems to me all you have to do is say no waiver, no welfare.

The CHAIRMAN. Of course, in some cases, a mother does not know the father's social security number. When we try to act on behalf of the mother, we need to know what that social security number is, because the way those computers are set up over at the Internal Revenue Service, they do not go by names.

When I was in the Navy, I found there were 20 Russell Longs in the Navy as officers. I did not think my name was all that common—at least my first name.

We need the social security number in order to locate these deserting parents in a Nation of 230 million people.

Let me read you this regulation pertaining to that:

> Educational institutions shall not permit access to or the release of education records or personally identifiable information contained therein other than directory information of students without the written consent of their parents or the written consent of an eligible student, to any party other than the following:
>
> State and local officials or authorities to which such information is specifically required to be reported are disclosed pursuant to State Statute adopted prior to November 19, 1974. Nothing in this paragraph shall prevent a State from further limiting the number or type of State or local officials who will continue to have access thereunder.

We are seeking to find the whereabouts of these men who are costing us a billion dollars by refusing to pay something for the benefit of their own children. It just seems to me that we should not pass a law to prevent our locating them, and people should not draft regulations that interfere with this purpose. If we cannot do any better, we should amend this tax bill to say that with regard to a State trying to collect its income tax, if they need to know the social security number, they ought to be permitted to get it so they can get what they need to know to collect a tax.

Then, with regard to runaway parents, we ought to be able to get the social security number for the benefit of any State agency so it can do its duty under the law.

Senator BUCKLEY. I would be very happy to work with you to see if we can get that cleared up.

The CHAIRMAN. Thank you very much.

Senator Curtis, do you have any questions?

TAX DEDUCTIONS FOR EDUCATION

Senator CURTIS. With reference to your deduction for tuition paid, as I understand it, that would relate to grade school, high school as well as college level?

Senator BUCKLEY. That is right.

Senator CURTIS. Have you or anyone else made a computation as to the cost to the taxpayers if all of the church and private schools were to close and the load would have to be assumed by the public schools?

Senator BUCKLEY. I know of no such study, although I have not researched it but surely that cost would exceed many times the cost of our proposal.

Senator CURTIS. In the State of Nebraska, I think that in higher education, probably the church colleges are carrying a 25 percent to 35 percent load. It was closer to 40. The church colleges have not gone backward but there have been a number of community colleges created and supported by taxes. I think we find in most states that if the financial stability of the private and church colleges is not maintained so that they can contribute in a first rate maner the quality of instruction we would find a terrific additional load placed upon the taxpayers.

Senator BUCKLEY. Without any question, this is one of the real fears in the New York City area, for example, where a significant proportion of the school children attend parochial, Catholic and Jewish schools. The lower and middle income families are finding it harder and harder to meet the tuition charges. There is real danger the system will collapse, which would throw an enormous burden on the community at large.

Senator CURTIS. How does your proposal work? Would it be just a deduction? Are there any limits on it?

Senator BUCKLEY. Up to $1,000 per tuition.

Senator CURTIS. And it would be a deduction?

Senator BUCKLEY. It would be a deduction, not a credit. I think the Supreme Court may rule that credits, insofar as religious instructions are benefited, are out of bounds; but the deductions, as I understand case law, would not be considered out of bounds. This is a general application.

Senator CURTIS. On all of your subjects you have made a fine statement. I shall not burden the record further at this time but we appreciate it.

The CHAIRMAN. Thank you.

Senator Stone.

STATEMENT OF HON. RICHARD STONE, A U.S. SENATOR FROM THE STATE OF FLORIDA

Senator STONE. Thank you, Mr. Chairman, and Senator Bumpers.

I appreciate the opportunity to appear this morning to discuss three proposals with the Finance Committee.

DEFICIENCIES IN TAX RETURNS PREPARED BY IRS

First, Senate bill 1652, a bill which I introduced together with Senator McClure—and we now have some 14 other cosponsors, including Senators Scott, Humphrey, Thurmond, Fannin, Tunney, Hansen, Haskell and Buckley—would relieve a taxpayer of interest penalties where the Internal Revenue Service helped him fill out his form and where the error, later to be penalized, was not caused by the taxpayer's omission of information or misinformation to the IRS when they were helping him prepare the taxpayer's return. Believe it or not, quite a few do get penalized when it was not their fault.

I think this bill could well have been passed by a voice vote other than for the constitutional restraint to wait until a House-originated bill appears on the Senate side. So, I do hope that this bill can be incorporated in whatever tax reform measure this committee does report out. I really think it would meet universal acceptance and cause no revenue loss.

ESTATE TAX AND FARMS

The second matter on which I want to urge consideration has to do with the various proposals you are considering for the reform of the estate tax law with regard to family farms. I have introduced my own bill, S. 2267, and I have also joined in cosponsoring S. 80, introduced by Senator Mathias. As the committee knows, several other proposals, including one by the administration, have been suggested. These would in various ways defer or limit the Federal estate tax liability so as to prevent destruction of the family farm due to the inability of heirs, or the estate, more properly, to meet the estate tax liability.

Many family farms as in Florida are located in an urban sprawl area which greatly increases the value of farmland if it were sold for development. Under existing Federal law, these estate taxes are determined by the fair-market value of the property rather than by the value of the land for farming property. It is imperative that the present law be changed if we are going to preserve both green belts and food producers as a way of life for people who operate family farms in such areas.

I have to point out that the President's proposal as he has explained it seems inadequate to me. It merely provides for a 5-year moratorium and permits the estate tax liability to be paid over a subsequent 20-year period without any provision for a different kind of valuation of the estate. Without a real reduction in valuation from the fair-market value level, family farm estates located in developing urban-suburban areas will continue to face impossible estate tax burdens.

My bill would provide a credit in the amount of the difference between the tax imposed on estate based on fair-market value and the tax which would have been imposed on the estate had the property been valued as farm property. Family farms devoted to substantial farming for a period of 5 years before the death of the decedent would qualify for this tax credit. Upon election of the credit, a lien equal to the amount of credit would be imposed upon the land, accruing interest at the rate of 4 percent per year and would remain in effect as long as the property is used for family farming. There would be no payment of the lien on the property until the end of the year in which the property is substantially convetred to a use inconsistent with farm property. According to an estimate by the Economic Division of the Library of Congress, my proposal would, in its present form, cost the Federal Treasury only an estimated $20 million a year, far lower than the administration and other proposals estimated to lost as much as $1 billion or more a year and maybe as much as $2 billion a year. This is only $20 million a year and yet it would do the job.

At the suggestion of Mr. Edward McGinty, an attorney from Tampa, Fla., who presented testimony on this matter before the House Ways and Means Committee on March 17, I am also submitting several amendments to my bill which would make it more effective in serving the policy for which it is designed and for further restricting any revenue losses. That has to do with requiring the property affected to have either been inherited or used as farm property for 60 months before the date of the death of the decedent. That takes care of going out to seek a tax shelter. It would take care of a recapture provision over 20 years further restricting the revenue losses. I am submitting these details along with my statement.

TAX TREATMENT OF SPORT FRANCHISES

One final matter I would like to present to the committee is of particular importance to the State of Florida because of the new sports franchise awarded the Tampa Bay Buccaneers football team.

H.R. 10612 and the House Ways and Means Committee report filed with it make clear that three proposed changes in the tax treatment of professional sports would apply only to franchises sold or exchanged after December 31, 1975, except as to the limitation on artificial losses, the effective date for which is November 4, 1975.

A review of the financial and legal transactions involved in the sale of the Tampa franchise would indicate it was awarded in December of 1974, with a substantial payment of about $4 million, prior to the effective date of the proposed tax change referred to. However, because of some circumstances beyond the control of the new franchise owners, the actual selection of players has not yet been made. This raises a concern at least on the part of the franchise owners that the Buccaneers may, indeed, be subjected to those proposed changes in the tax laws affecting professional sports. I don't believe that is a reasonable interpretation of the financial transactions between the National Football League and the Tampa Bay Buccaneer owners but, nevertheless, I do urge the committee to review H.R. 10612 and amend it so as to make it absolutely clear to avoid the confusion that otherwise might be raised by super diligent IRS afterwards.

That is my presentation, Mr. Chairman.

Senator TALMADGE. Senator Hansen.

ESTATE TAX AND FARMS

Senator HANSEN. Thank you, Senator Stone, for the thoughtful consideration. You have given some very real and vexing problems.

I want to be certain I understand how you propose to have the credit apply on farm sales. As I understand, if a family farm has been substantially devoted to farming for a period of 5 years prior to the death of the decedent, that farm would qualify for this estate tax credit which is the difference between the value of the property based upon its agricultural earning power——

Senator STONE. And if it were subdivided.

Senator HANSEN [continuing]. And the fair-market value if it were subdivided.

That credit would become a lien upon the property, and it would draw interest at the rate of 4 percent a year, but there would be no requirement that any payment be made upon the lien so long as the property was continued to be used for farming. Is that the way it works?

Senator STONE. That is right. In other words, it does no good if the valuation placed on family farmland is that which it would be were it sold as opposed to continuing to be used for farming. Yet, to totally forgive the difference in value between farmland and selling it off for what is would bring would be unfair to other real estate owners who do not have such a provision.

What we are trying to do is defer the cash requirement imposed on heirs at the time a decedent dies and take the deferral and accrued interest on it at 4 percent so there is no revenue loss to the people of the country.

Senator HANSEN. If I could interrupt you there, neither the amount of the lien or the 4 percent would be payable. Would that interest compound?

Senator STONE. No.

Senator HANSEN. It would be just a straight 4 percent, and if you had it for 10 years later and then sold it, you would get the 4 percent for 10 years?

Senator STONE. That is right. We are not trying to make money on it. We are trying not to lose money.

Senator TALMADGE. Suppose it were sold to another farmer who continued to use the land for agricultural purposes?

Senator STONE. The payment would trigger when the land ceases to be used for farming. You don't want to get into a technical hassle whether this was a first cousin or second cousin opearting it. If it is used for farming for that period, the period of deferral, then you simply accrue interest on it and you continue to farm. When and if the operators in their individual choice decide, well, we can't make it anymore, or farming is not viable anymore, or we are geting old and we want to retire, and they sell and it ceases to be used as farming, then the new purchaser in effect would be putting that into the value of his purchase.

Senator HANSEN. If I could follow up on a question that arises in my mind prompted by the one Senator Talmadge posed to you, supposing I inherit a farm and I keep it and elect to take this option, the tax credit with the lien on it, and I own the farm for 10 years and I sell it to Senator Talmadge—and he may not have even inquired of me as to what tax——

Senator STONE. If there is a lien on it, it is filled in the county records. When you search title, you are going to find the lien.

Just to clarify, the IRS is barred from obtaining payment of this particular deferred credit until the close, and I am quoting the bill, "the close of the calendar year in which the property is substantially converted to a use inconsistent with its usage as farm property."

I mean the purpose of all this is to keep these parcels growing food instead of by reason of the cash requirement to pay an estate tax to convert it into, in effect, urban developed land.

My approach does not create $1 billion or more revenue loss. It creates a very minor revenue loss—only $20 million according to the Congressional Service, and yet it does the job because it neither compounds a burden of financial obligation by the deferral, because we are talking about simple interest, nor does it forgive any part of the value from ultimate taxation which would be discriminatory toward nonfarm real estate owners. But it does not require a cash payment during this period after the decedent has died. It allows you to keep on using it for farming as long as you do.

I have a 20-year recapture proposal which I think would make this even more palatable. It is properly drafted with the help of tax counsel, but everything designed in this approach is designed to do the job for family farm's heirs and family farm operators thereafter without creating a discriminatory relationship with other real estate owners or with other estates.

I really think if we want to serve the purpose of keeping green belts around suburban and urban areas, of keeping the family farm operating, of inducing people when their head of family has passed away to continue to operate as farmers without a major loss, this approach is the way to do it.

The President's approach causes great revenue loss and does not really do the job.

Senator HANSEN. May I ask one further question, Mr. Chairman.

Suppose I inherit a farm and I continue using it as a farm for 10 years, and I elect to take this option and then I sell it to a neighbor of mine who is a farmer, and the value of the real estate has gone up but, as far as I know, it is his intention to continue using it as a farm.

Senator STONE. Senator, the valuation is imposed as of the date of death of the decedent, and it is imposed on a fair-market value basis. We are not going to stop that. The same thing will happen as happens now.

Now then, there is a second valuation that is made by the IRS, though. That valuation is valuing the property strictly in farm use. That is a much lower amount than what you could get if you were selling it particularly in areas near metropolitan areas, but it is true all over.

That portion of the difference between farm-use valuation and highest and best sale/use valuation, for example, becomes the credit which is a deferred tax liability instead of one which you must pay now. It is deferred with simple 4 percent interest requirement for as long as you use the property or the property is used for farming, or a use consistent with farming.

That is the way it would operate, with a minor revenue loss. If you sold to your neighbor, he would continue to operate with the same two valuations and the same estate tax obligations, the first part of which would have been paid by the original estate and the second part of which goes with the land. Somebody has to pay that who sits on that land, but you don't have to raise the cash until you sell.

So, it is part of your understanding of the sale. It works out much easier that way. It does not make you mortgage the farm. It does not make you raise cash. It does not make you sell. In effect, it acts as a tax inducement to continue with farming and with a minor revenue loss which we are all after.

We are not here to create the kind of shelters or loopholes to cause everyone else to feel they are being discriminated against financially. This tax will be paid with interest, but at the right time and it will not itself require a liquidation of the family farm. That is what we were all reaching for when Senator Allen, on the floor, came in with an amendment, but which the revenue loss was so ferocious on, I was sitting in the chair at the time. When I heard his amendment on the amendment and heard the revenue loss reported by the committee, I sent a note, "Please take me off the amendment." While we want to do this job, we don't want to make everyone else in the country say we are just simply subsidizing them. This is not so. This is a deferral rather than a cancellation, and it is a practical kind of deferral with interest.

ESTATE TAX

Senator CURTIS. Senator, we appreciate very much your recognition of the need for estate tax revision.

I think we might have the record show that the President made a subsequent statement in which he said he favored the raising of the exemption from $60,000 to $150,000. The day before yesterday when the Secretary of the Treasury was here, he presented the same thing.

It seems to me that while I am all for relief of estate tax to farmers, the situation goes much broader than that. The Federal estate tax was enacted several decades ago intended to reach the wealthy. Because of inflation, it has become a major problem in just about every household. It is not limited to farmers. It is not unusual, I would guess, in your State to have a home valued at $75,000 or $80,000; is that right?

Senator STONE. That is right.

Senator CURTIS. Take an individual, a widow, who is living in a home with her children that is valued at $80,000. Suppose she has $20,000 personal property. That does not take much. Suppose she has a very modest insurance estate of only $30,000 and that is very modest. If she is a widow, there would be no one to get the marital deduction. They throw in the life insurance and everything else. The estate would be valued at $130,000. With a $60,000 exemption, they would be taxed on $70,000 or, according to my rapid calculation, over $12,000.

Now, here is a place where we do want to lose revenue. It is a tax that was imposed to reach large estates that are passing. Right now, it has reached a great many of the people. For estate tax purposes, they include a lot of things that are not ordinarily income. The beneficiary of a life insurance policy gets it without income tax, but if they are up in a high estate tax bracket—and it does not take such a big estate long to reach the 30 percent bracket—I hope these hearings will develop the facts so that farmers, townspeople, small businessmen, everybody can be taken care of. We will be in a sad way in this country if the greater portion of the people are lobbying for rent subsidies and more public housing, but as long as we have an estate tax like this, there is not much of an inducement for anybody to own property.

Senator STONE. Senator, I agree that the provision of the estate tax is in order and way overdue. I encourage the committee to do the best it can after it makes whatever decision it chooses to make about the revenue level. I would urge, though, in addition to any general revision, that you do keep in mind the social and economic desirability of eliminating the cash requirements to eliminate family farms imposed by the current approach of the estate tax.

Senator CURTIS. The bill I have introduced, and I have quite a list of cosponsors, is the bill proposed by the American Farm Bureau. In addition to raising the exemption to $200,000, it has a provision that would increase the marital deduction. At the present time, the marital deduction is 50 percent of the gross estate. This would be $100,000 plus 50 percent.

Senator STONE. Senator, I support the American Farm Bureau's approach and yours, but the question is, can you pass it?

Senator CURTIS. I think so. I believe in the justice and fairness of the people if they have the facts. I think that as long as we keep the present estate tax, we are driving a car 40 years old, and that is not the efficient way to do things. There are a lot of people who have perhaps not given this any thought, and they will wake up with a shock some day, or their survivors will. It is a confiscation of people's property. It is not based on their ability to pay. It is a tax that is intended for the transfer of large estates, and inflation has changed that definition so much.

This American Farm Bureau bill also does something that your bill does but it does it in a different way. It injects as determining the fair value for tax purposes, using as part of your yardstick, the earning power of the land. It makes it known at that time, and the relief is immediate.

I believe there are enough people concerned about estate tax so that we can get a substantial bill.

I also agree with the President. We ought to do the right thing even if we have to phase it in over a few years. It is an unjust tax, and if we have to take care of it, we could reach our goal in some steps. It would be kind of hard on those families where there is a death in between, but they will still be better off than they are right now.

Senator STONE. Thank you so much.

Senator TALMADGE. Thank you, Senator Stone, so much for your ideas. Your views will be given due consideration by the committee. I want to thank you for your novel suggestion on taxing agricultural property for estate purposes. I think it is a very interesting idea.

Senator STONE. Thank you so much.

Senator FANNIN. I regret that I did not hear your testimony. I am intrigued by the suggestion you have made and what I have heard, and I will certainly go into it very thoroughly. I may want to discuss it with the Senator because it seems to me it is a very excellent contribution. It is just exactly what we are trying to do.

Senator STONE. I thank you very much, and I thank Senator Bumpers for letting me go ahead of him.

[The prepared statement of Senator Stone and the material referred to in his statement follows Oral testimony continues on p. 341.]

STATEMENT BY SENATOR RICHARD (DICK) STONE

Mr. Chairman, I appreciate the opportunity to appear before the Senate Finance Committee in connection with the Committee's consideration of various proposals for federal tax reform. I share the view of many of our citizens that tax reform should be given the highest possible priority by this Congress. I need not detail for this Committee the widely-held view that our present tax system is unfair, irrational, and counterproductive of many of our stated economic and social policies. I salute you, Mr. Chairman, and members of the Finance Committee, for your continuing efforts to bring about meaningful tax reform and intend to support the Committee's work in any way I can.

There are three particular matters which I want to underline for the Committee at this time. While none of the three is of universal significance to taxpayers, each in its own way represents an opportunity for the Congress to reassure the public as to the equity of our tax system.

First, I want to urge the Committee's consideration of S. 1652, a bill which protects the taxpayer from liability for interest payments on income tax deficiencies where the taxpayer's return has been prepared by the Internal Revenue Service. Senator McClure, of Idaho, joined with me in introducing this bill, pending before your Committee, on May 6, 1975. Thirteen other Senators have joined in cosponsoring S. 1652, at this time.

Presently, taxpayers are held liable for mistakes made by taxpayer service representatives of the Internal Revenue Service in preparing taxpayer returns. My bill would relieve the taxpayer of interst liability for unpaid taxes only to the extent that the taxpayer's return is actually prepared by an Internal Revenue Service representative and the taxpayer does not fail to provide information concerning his tax situation to Internal Revenue employees in the preparation of the tax return. This bill would not relieve the taxpayer of his obligation to pay any additional taxes he might owe to the federal government.

S. 1652 is not intended to discourage the Internal Revenue Service from continuing to provide its most helpful assistance to millions of taxpayers. Rather, it is to ensure that taxpayers who in good faith rely upon the technical advice given by the Internal Revenue Service taxpayer service are not penalized for mistakes made by Internal Revenue Service agents.

Mr. Chairman, the need for this legislation has been illustrated by a number of press reports, some of which were reviewed last year by the House Committee on Ways and Means, indicating that mistakes have been made and can be expected to be made in the future in the preparation of income tax returns by IRS employees. I would urge the Committee to take favorable action on this bill.

The second matter I want to urge Committee consideration of are the various proposals for reform of the estate tax law with respect to family farms. I have introduced my own proposal, S. 2267, and have joined in cosponsoring S. 80, introduced by Senator Mathias. As the Committee knows, several other proposals, including one by the Administration, have been suggested. These bills would in various ways defer or limit the federal estate tax liability so as to prevent destruction of the family farm due to the inability of heirs to meet present estate tax liability.

Many family farms are located in areas where urban sprawl has increased greatly the value of farmland. Under existing federal law the estate tax for these farms is determined by the fair market value of the property rather than by the value of the land as farming property. It is imperative that the present estate tax law be changed if our nation's family farms are to be preserved.

I am compelled to point out that the President's proposal, as I understand it, is inadequate. It merely provides for a five year moratorium and permits the estate tax liability to be paid over a subsequent twenty-year period without any provision for a different kind of valuation of the estate. Without a real reduction in valuation from the fair market value level, family farm estates located in developing urban-suburban areas will continue to face impossible estate tax burdens.

My particular bill would provide for a credit in the amount of the difference between the tax imposed upon the transfer of an estate based upon the fair market value of the property and the tax which would have been imposed upon the estate had the property been valued as farm property. Family farms which have been substantially devoted to farming for a period of five years prior to the death of the decedent would qualify for this estate tax credit. Upon election of the credit, a lien equal to the amount of credit would be imposed upon the land accruing interest at the rate of four percent per year, and would remain in effect as long as the property is used for family farming. There would be no payment of the lien on the property until the end of the year in which the property is substantially converted to a use inconsistent with farm property. According to an estimate by the Economic Division of the Library of Congress, my proposal would, in its present form, cost the federal treasury only an estimated $20 million.

At the suggestion of Mr. Edward McGinty, an attorney from Tampa, Florida, who presented testimony on this matter before the House Ways and Means Committee on March 17, I am submitting several amendments to my bill which would make it more effective in serving the policy for which it is designed. I am submitting the details of these proposed changes in my bill for the Committee's review. Briefly, the changes would set a time with a percentage phase-in for recapture of the credit, and add a requirement that to qualify for th credit the farm property must be acquired by inheritance, or have been owned by the decedent for the five years immediately preceding his death.

Mr. Chairman, in connection with these proposed changes in my bill, I wish to submit for the Committee's consideration a copy of Mr. McGinty's testimony presented to the Ways and Means Committee, and urge the Committee to review Mr. McGinty's very thoughtful suggestions with respect to estate tax reform.

Mr. Chairman, there is another matter of particular importance to Florida, which I should like to call to the Committee's attention. As passed by the House of Representatives, H.R. 10612 includes changes in the tax treatment of professional sports—specifically with respect to the basis limitation for player contracts, depreciation recapture, and limitations on artificial losses.

H.R. 10612 and the House Ways and Means Committee Report filed with it make clear that these three proposed changes in the tax treatment of professional sports would apply only to franchises sold or exchanged after December 31, 1975, except as to the limitation on artificial losses, the effective date for which is November 4, 1975.

As you perhaps know, Mr. Chairman, a new National Football League franchise appears to indicate that the franchise was awarded in December of 1974, with a substantial payment of four million dollars, prior to the effective date of the proposed tax changes referred to above. However, because of several circumstances beyond the control of the Tampa Buccaneers' owners, the actual selection of players has not as yet been made. This has raised an understandable concern on the part of the owners of the franchise that the Tampa Buccaneers may indeed be subjected to the proposed changes in the tax laws affecting professional sports. Although I cannot believe that a reasonable interpretation of the financial transactions between the National Football League and the Tampa Buccaneers' owners would result in the application of the proposed tax changes to the Tampa Bay franchise, I do urge the Committee to review H.R. 10612 and amend the bill so as to eliminate any possible confusion in this respect.

There are several ways in which the Finance Committee could resolve this situation:

(1) Consistent with the intention of H.R. 10612, the Committee Report could specifically and expressly indicate that these changes in the tox law shall not apply to the Tampa franchise and the Seattle franchise which, I understand, is in a similar situation.

(2) The effective date of these provisions could be established at a time subsequent to the actual selection of players by these franchises which, I understand, is to take place this spring.

(3) The following addition could be made to subsection (d)(3) of proposed section 1056 of the Internal Revenue Code:

"(3) The amendments made by sub-section (c) shall apply to franchises to conduct sports enterprises sold or exchanged after December 31, 1975, in taxable years ending after such date. *In no event shall such provisions be applicable to any player contract acquired as a result of the transfer or issuing of a new franchise prior to the effective date of this provision.*" (Addition in italic.)

Proposed Amendments to S. 2267

(1) Recapture of Credit

Upon revocation of an election made under this section with respect to any interest in qualified real property or upon the disposition of any interest in qualified real property with respect to which an election under this section has been made, the credit allowed by this section shall be decreased by 100%, minus

10% for each twelve month period that such interest in qualified real property was held after the date that such interest in qualified real property was held for 60 months from the date of the death of the decedent, of the amount of the credit attributable to the interest in qualified real property with respect to which the election has been revoked or with respect to which a disposition has occurred.

(2) QUALIFIED PROPERTY

In addition to other requisites set forth in S. 2267, the property ". . . either has been inherited by the decedent or owned by the decedent for the 60 months preceeding the date of the death of the decedent."

LAW OFFICES,
CULVERHOUSE, TOMLINSON, MILLS, DECARION & ANDERSON,
Jacksonville, Fla., March 11, 1976.

Re Proposed tax reform bill of 1975 and its impact on the Tampa Bay Buccaneers.

Hon. RICHARD STONE,
Senator, U.S. Senate,
Russell Senate Office Building, Washington, D.C.

DEAR SENATOR: I am sure you are familiar with my efforts to establish a new National Football League franchise for the Tampa Bay area. Briefly, I was awarded the franchise in December of 1974 for the sum of Sixteen Million Dollars, plus interest. The National Football League viewed a number of potential sites and based on their experience in other areas throughout the country, selected Tampa and Seattle for the first two expansion cities because of the potential of these areas.

The NFL's experience, along with the work we have done, shows the significant economic impact that our franchise will have on the Tampa Bay area. We anticipate that local and out of town fans will spend an aggregate of not less than Ten Million Dollars in connection with out seven regular season and three pre-sceason home games. Studies indicate that as this income is spent and respent in the community the gross incomes to businesses and citizens in the Tampa Bay area should approach 3.3 times the initial amount or about Thirty-three Million Dollars per year. An impact study was done for the Atlanta area with respect to the Falcons 1972 season and reported on in the Washington Post on April 21, 1973. It confirms the estimates we have made for the Tampa area. A copy of this article is enclosed. Relating the conclusions reached in the article to our situation in Tampa, recognizing that Atlanta has only a 55,000 seat stadium where we will have a 72,000 seat stadium and giving consideration to the amount of inflation since 1972, it is obvious that the economic impact that we will have in the Tam apBay area is very substantial. We have been advised that probably no other single industrial or commercial development in the Tampa area in recent years compares to what our impact will be.

In addition to the indirect impact described above, our organization itself will spend at least Seven Million Dollars a year in direct expenditures for payroll and other operating expenses. Our stadium rental payments to the Tampa Sports Authority will permit them to amortize and retire the bonds sold to build and expand Tampa Stadium.

All of the above is important because of the effect that the proposed Tax Reform Bill (H.R. #10612) now before the Senate Finance Committee will have on our operation. The overall impact of the proposed tax legislation is that it seems discriminatory against the establishment and transfer of professional sports franchises. We do not argue with the concept that generally speaking the depreciation recapture provisions should be as equally applicable to player contracts as they are presently to other assets used in a trade or business where depreciation is permitted. However, the proposed legislation goes far beyond the import of depreciation recapture.

In particular we are concerned about the proposed new Internal Revenue Code section 1056 which (beginning on page 74 of the Tax Reform Act of 1975) deals with a "basis limitation for player contracts transferred in connection with the sale of a franchise." Under the new legislation if a franchise to conduct any sports enterprises is sold or exchanged, and if in connection with such sale or exchange there is a transfer of a player contract, the basis of such contract to the transferee shall not exceed the sum of: (1) the adjusted basis of such contract in the hands of the transferor immediately before the transfer, plus (2) the gain (if any) recognized by the transferor on the transfer of such contract.

The above referenced new Internal Revenue Code provision would be effective for all taxable years beginning after December 31, 1975. However, the proposed Bill is not clear as to whether it would apply to our situation in which we had a binding contract (by reason of a signed letter of intent) and actually paid the sum of Four Million Dollars in December, 1974 and Two Million Dollars in December, 1975, but will not make actual selection of players from other NFL teams via the "expansion draft" until later this month or early April. To adopt legislation which could be potentially retroactive in effect would constitute a denial of our constitutional rights including the right to equal protection of the law and due process of law. Beyond its legal implication it would be grossly unfair and do great injury to the development of our new franchise, if not kill it altogether.

To rectify the above problem we urge that an addition to sub-section (d)(3) of the proposed Internal Revenue Code section 1056, (found on page 77 of the proposed Act) be made so as to read substantially as follows:

"(3) The amendments made by sub-section (c) shall apply to franchises to conduct sports enterprises sold or exchanged after December 31, 1975, in taxable years ending after such date. *In no event shall such provisions be applicable to any player contract acquired as a result of the transfer or issuing of a new franchise prior to the effective date of this provision.*" (Addition in italic.)

There are other provisions in the proposed Tax Reform Bill of 1975 which apply to professional sports franchises. They deal with "depreciation recapture" (section 209 of the Act) and "limitations on artificial losses" or tax shelters (section 468 of the Act.)

The depreciation recapture proposals, on their face, seem consistent with existing related provisions that apply to other businesses and industries. They do however overlook the fact that since player contracts are "intangible" assets, they cannot be written off by use of accelerated methods of depreciation and do not qualify for the investment tax credit. Consequently the alleged tax advantage to owning a sports franchise which the proposals are intended to cure are not really present. The same view pertains to the "limitations" on artificial losses" as it would apply to professional sports franchises. Unlike many of the other tax shelters considered by the House Ways and Means Committee, and reflected in the limitation on artificial loss provisions, the ownership of professional sports teams does not offer "fast depreciation" because as indicated player contracts are "intangible" assets and cannot be written off except over the useful life of the players on a straight line basis. Consequently, there is no true artificial loss created. In addition, the immediate write-offs allowable in the case of intangible drilling costs—also the subject of the proposed Bill—are not extended to professional sports nor are any deductions allowed in excess of cost as in the case of depletion. For these reasons the provisions of the proposed law as they would apply to professional sports franchises are discriminatory when viewed in light of other tax benefits available in those industries which are the primary target of the limitation on artificial losses in the Tax Reform Bill of 1975.

Likewise, the provisions of the Tax Reform Bill of 1975 dealing with the depreciation recapture and limitations on artificial losses should be amended to make it absolutely clear that they are not applicable to player contracts and losses arising in franchises acquired or issued prior to the effective date of the new law. Particularly is this true in the situation of the Tampa Bay Buccaneers where a binding letter of intent was signed and a payment of some Four Million Dollars was paid prior to December 31, 1975.

We would appreciate your consideration of our position in this matter and hope that you will feel it apropriate to take a firm view with regard to the form of the proposed tax legislation as it now stands and will apply to the Tampa Bay Buccaneers.

With warmest personal regards,

Sincerely yours,

HUGH F. CULVERHOUSE.

Enclosure.

[From the Washington Post, Apr. 21, 1973]

FALCONS: COMMUNITY SPIRIT, COMMUNITY DOLLARS

(By Dave Brady)

A study of the economic impact of the Falcons on Atlanta is a useful frame of reference in estimating what the Redskins mean to Washington or what the loss of the Senators baseball team might have cost the community.

The survey was conducted by William A. Schaffer, associate professor of economics at Georgia Tech, and Lawrence S. Davidson, who is completing a master of science degree there. Schaffer previously did studies on the impact of baseball on Atlanta and on Montreal; his football study has been published by the Falcons.

The authors determined that local and out-of-town fans spent an aggregate of $7,547,000 in connection with seven regular-season and two exhibition home games in 1972.

"As this income is spent and respent," the study notes, "the gross incomes accruing to businesses and citizens in metropolitan Atlanta should approach 3.3 times this amount, or $24,905.100."

Only 71 per cent of the paying customers lived in the metropolitan area as attendance rose to an all-time high of 449,000 in 1972.

The hometown-and-suburban fans traveled an average of 15 miles to the stadium, 85 per cent using their automobiles for a major part of the journey, while 31 per cent used shuttle buses to and from the stadium.

More than half of the 129,000 out-of-town fans came from other cities in Georgia, while most of the remainder came from North Carolina, South Carolina, Alabama and Tennessee, in that order.

They traveled an average distance of 150 miles and 88 per cent came by automobile, 37 per cent stayed overnight, 75 per cent ate in the city and 70 per cent bought gasoline there, leaving more than $4 million. They spent $3 million at the stadium.

Atlantans spent $3 million of $3.4 million at the stadium. They bought meals worth $156,000, while the rest went for gasoline and other transportation.

The out-of-towners spent $1.5 million on food and entertainment, $673,000 on lodging, $323,000 on shopping, $249,000 for gasoline and the rest for transportation around town.

Other football clubs spent an estimated $43,000 in Atlanta.

The sampling of 683 fans was limited to the last four home games of the season, against opponents of widely varying popularity New Orleans, Denver, Houston and Kansas City.

All four games were sellouts and tickets were priced at $3, $6, $7.50 and $12.50.

The stadium conveniently divides into four equar areas with the same percentages of seats by price and position—upper and lower levels, club section, field and ground seats Each interviewer was assigned specific aisles and was asked to question the adult fan nearest the aisle in selected rows.

While attendance reached a record 449,266, actual ticket sales were 501,316. Attendance at the November game with Denver dipped to 82 per cent of ticket sales in "moderately bad weather" after the Falcons' record became 5–5 because of a loss the previous week.

Attendance picked up to 88 per cent in good weather for the game with Houston in December after a victory over Denver revived hopes for a division title. But the long-awaited finale with Kansas City was a flop attraction that drew only 68 per cent of capacity because, besides being played in frigid weather, the division title had been won the preceding day by San Francisco.

The seven-year history of the Falcons shows that the number of no-shows of ticket holders has always been sizable. The fewest were in 1971 when 93.1 per cent used their tickets. This lends substance to the contention by the National Football League that the lifting of televsion blackouts for sold-out games could affect concessions and parking revenue.

According to the concessionaire, the typical fan spends 97 cents. Parking costs $1.

The Falcons paid more than $300,000 in stadium rental for fiscal 1971–72. They receive an estimated $3.766.000 from ticket sales.

The club is a private corporation and thus no public reports of finances are required, but the survey authors "conservatively assume" that expenditures approximate the estimated ticket revenue.

"Team expenses—including salaries of players and coaches and expenditures for equipment, supplies, medical services, scouting, travel, training camp, etc.—exceed $3 million," the survey says.

"The noneconomic impact on Atlanta" was measured also, by the authors, who point out that as a result of a well-oiled public relations program, when the Falcons played the Rams at home on Oct. 1, "three Atlanta area newspapers devoted more than 1,260 column inches, 105 feet" to the game that week.

STATEMENT OF A. EDWARD MCGINTY, TAMPA, FLA., ON PROPOSED LEGISLATION TO PREVENT THE FEDERAL ESTATE TAX FROM COMPELLING THE DESTRUCTION OF AGRICULTURAL AND OPEN SPACE LANDS

The purpose of my testimony is to discuss the major reasons why certain proposed legislation should be enacted to effect changes to the estate tax provisions of the Internal Revenue Code of 1954 to provide for a method of valuation, for estate tax purposes, of farm land and other agricultural lands and open spaces which would be lower than "fair market value" as presently required. In recent years, much has been said and written about the continuing decline in acreage devoted to the production of food and to continued existence as open-space or greenbelt. The preservation of such productive agricultural lands and open spaces has been much touted as a national goal to which the efforts of various federal and state agencies, as well as a number of non-governmental organizations, are devoted. I do not have the statistics presently available to me to document the extent of this problem. However, I am sure that the Department of Agriculture and other concerned federal agencies can provide some data in this regard. As a lawyer in Tampa, Florida, practicing in the fields of tax and estate law, and having represented clients in the real estate development and agricultural fields, I do know that agricultural and open space land is indeed being converted to more intensive uses.

THE URGENT NEED FOR FEDERAL ESTATE TAX RELIEF FOR AGRICULTURAL AND OPEN SPACE LANDS

One of the factors contributing, unwittingly, I believe, to the continuing conversion of agricultural and open space lands to more intensive uses is the federal estate tax. Why? While the federal estate tax rate structure (which is a progressive rate, rising from 3% to 77% as the value of the estate increases) and the "fair market value" system of valuation for federal estate tax purposes are generally fair and desirable, complex tax and regulatory laws can produce unfair and undesirable results as applied to specific types of situations when changing circumstances have precipitated unforseeable results. Just such a situation has occurred with respect to a large amount of the nation's agricultural lands and open spaces. Much of this land is located near cities and towns, resorts, major government and industrial installations or simply in a beautiful area with a good climate, such as my home state of Florida. Consequently, such land has become presently or potentially susceptable to more intensive uses, such as commercial, industrial or residential, which yield a much greater return on invested capital. There is a fixed supply of land, and as more and more of it is developed, there is less of it available for present and future development. For these reasons, such land is aggressively sought by those persons and companies who make their living developing and using developed land. The developers and speculators bid up the "fair market value" of the land. "Fair market value" means the dollar amount that a willing buyer will pay to a willing seller for the asset (See news articles by David A. Andelman in the New York Times of May 14, 1972, by Gail Bronson in the Wall Street Journal of May 15, 1974, by Michael Burns in the Baltimore Sun of May 19, 1974, by Isaac Rebert in the Baltimore Sun of February 19, 1974 and by Steven Norwitz in the Baltimore News American, all of which were made a part of the Congressional Record, 94th Congress, January 15, 1975, Volume 121, No. 2 and which are attached to this statement for convenience of reference). A two tier valuation is thus created for the same parcel of land, a low-tier value for agricultural and open space uses and a high-tier value for the more intensive uses of our industrialized society. This two-tier valuation problem literally forces the family of a deceased farmer to sell the farm to a developer, speculator or other intensive land user. Let me give you an example:

Assume a farmer owns an 800 acre farm which earns him about $30,000 per year, averaging the good and bad years. At strictly farm prices, his farm may be worth, say $300 per acre or $240,000.

In addition to this asset, he has a home on the farm worth $35,000, $50,000 in farm machinery, $6,000 worth of cars and trucks, $15,000 in savings, $5,000 in miscellaneous personal assets and a $50,000 life insurance policy with $5,000 cash surrender value. If we assume that he has no debts, our farmer has a gross estate value of $406,000. Upon his death, his estate tax picture will work out about as follows:

Gross estate	$406,000
Administrative expenses	−5,000
Leaving (adjusted gross estate)	401,000
Maximum marital deduction (assuming he is survived by his wife)	−200,500
Leaving	200,500
Estate tax exemption	−60,000
Taxable estate	140,500
Federal estate tax	32,850

The deceased farmer's family can afford to pay estate taxes of $32,850 and continue to own and operate the farm. Now, let's assume that the farmer's 800 acre farm is situated so as to be well-suited for a major community development. The fair market value of such land may well be in the neighborhood of $3,000 per acre or $2,400,000 for the 800 acres. He now has a gross estate value for federal estate tax purposes of $2,516,000.

Gross estate	$2,516,000
Administrative expenses	−5,000
Leaving (adjusted gross estate)	2,511,000
Maximum marital deduction (assuming he is survived by his wife)	−1,255,500
Leaving	1,255,500
Estate tax exemption	−60,000
Taxable estate	1,195,500
Federal estate tax	403,750

The deceased farmer's family cannot pay $400,000 in estate taxes except by selling the farm to a developer or speculator.

This example is typical of the classic farm family problem of low liquidity and high land values with concommitantly high estate taxes. How many times can this scenario be repeated before our agricultural production is inadequate to provide enough food for domestic production and to require us to import food to survive, as we now import oil to survive? What are the economic, political, ecological and social implications if the continuing loss of agricultural and open space lands is not halted?

It has been said that our farmers are wealthy. But the sad fact of the matter in most cases, as in the example I have used, is that the farmer is only wealthy if he sells the land to a more intensive user. Do we want him to sell his land to more intensive users? We are forcing him to do so now through the estate tax.

The purpose of the proposed legislation, as illustrated by the various bills that have been filed to effect a lower a valution than "fair market value" for agricultural and open space lands, is to change the estate tax law to make it posible for the survivors of deceased agricultural and open space land owners to hold onto the land and continue to use it for the production of food, other agricultural commodities and greenbelt purposes.

Why is such a state tax relief necessary only for farmers and ranchers and open space land owners? Would not such estate tax relief discriminate against heirs of other property, such as a family business? The answer is that the problem is unique to the owners of farm and ranch land and open space land. The "fair market value" of a going business, is generally determined by capitalizing the earnings of the business. This is because the buyer of a going business is interested in how much he can earn from the business rather than how much he can make by terminating the business and selling off the assets or converting the business to a different or more intensive use. When *estate* taxes are based upon values determined by capitalization of earnings, the resulting taxes will be an amount which can be amortized from the earnings of the business, so it will not be necessary to sell the business to pay the estate taxes. The proposed legislation seeks to apply to the owners of farm, ranch and open space lands, a valuation determined by capitalization of earnings or some other equitable method of determining value on the basis of the continuing use of such property for farming, ranching or open spaces.

TECHNICAL ASPECTS OF THE PROPOSED LEGISLATION

I do not have the time in this statement to go into all of the technical aspects of the proposed legislation. But I do want to make some comments concerning certain technical aspects of legislation addressed to the resolution of the estate tax problem of agricultural and open space land.

Estate Tax Credit or Alternative Method of Valuation?

There are two methods to effectuate a change to the Internal Revenue Code of 1954 (hereinafter the "Code") to provide an alternative method of valuing agricultural and open space lands for federal estate tax purposes. Most of the bills that have been filed would create a new subsection to Section 2031 of the Code providing an election for estates with qualifying property to value the land at its value according to its qualifying use. At least one bill, Senator Stone's bill, S. 2267, would create a new section of the Code, Section 2017, which would provide an elective estate tax credit for estates with qualifying property equal to the difference between the estate tax on the fair market value of qualifying property and the estate tax on the value of such land according to its qualifying use (See also the attached proposed bill which we have prepared). Either method produces the exact same formula for determining the value for federal estate tax purposes so that the amount of estate taxes probably would be the same under either method.

We prefer the latter method, the tax credit method, however, for technical reasons. It is important that the fair the fair market value be finally determined at the time the estate tax return is accepted because the amount of deferred estate taxes subject to future payment under the recapture provisions is determined by the fair market value at the time of the decedent's death or on the alternate valuation date. The amount of estate taxes due should not be affected by appreciation or depreciation in the value of qualifying property subsequent to the estate tax value determination date. In the event of the inability of an estate and the Internal Revenue Service to settle any differences of opinion concerning the fair market value of qualifying property subject to the election, it would be necessary for a court to decide the matter. In the case of the first method of effectuating this change, the addition of a new subsection to Section 2031 of the Code, we are concerned with the federal courts may determine that the question does not present a justiciable controversy at the time the return is accepted because the question of fair market value would not affect the amount of estate taxes payable at that time but would only affect a contingent future controversy in the event of recapture, an event that may never occur. See *Golden* v. *Zwickler*, 394 U.S. 103 (1969); *Toilet Goods Ass'n* v. *Gardner*, 397 U.S. 136 (1967). Under the second method, however, in which the adjusted valuation is determined through the device of an estate tax credit equal to the difference between the estate tax on the fair market value and the estate tax on the qualifying use value, a justiciable controversy exists because it is necessary to determine both the fair market value and the qualifying use value in order to determine the amount of estate taxes to be returned at the time of filing the estate tax return itself.

What Kind of Interest in Qualified Real Property Will Qualify for the Election?

None of the bills that we have read define the kinds of interests in qualified real property that will qualify for the favorable qualifying use values. For example, it is not clear under these bills that the corporate shares of stock in an incorporated family farm would qualify, or that a partnership interest in a family farm or a beneficial interest in a living trust would qualify. Since the family corporation, family partnership and family trust are methods that have been used for many years for family ownership of farms and ranches, it should be clearly provided that such interests in qualified real property will qualify for the election. We have prepared a proposed bill with a provision that satisfactorily resolves this matter, and we recommend that the provision be included in the Committee bill (see attached proposed bill).

How Is the Value of Land to Be Determined According to Its Qualifying Use?

Senator McGovern's bill, S. 2875, is the only bill which provides a specific valuation formula for determining the qualifying use value. We have used this formula to compute acreage values in several hypothetical cases with results very close to current estimated agricultural values. We find Senator McGovern's valuation formula preferable to leaving the question of how the qualified use value should be determined to the Internal Revenue Service, the taxpayers and the courts. Accordingly, we recommend the valuation formula contained in S. 2875.

THE RECAPTURE PROVISIONS

At least two of the bills that have been filed, S. 2267 and S. 80, provide for perpetual recapture, S. 2267 with perpetual interest accruing and S. 80 with interest accruing only for the first 10 years. We are opposed to a provision for recapture in perpetuity. With recapture accruing in successive generations, the total amount of recapture, especially with continually accruing interest, could conceivably equal or even exceed the fair market value of the land after two or three generations.

Perpetual recapture would also largely destroy the ability of the farmer and rancher to finance the business by borrowing, which is essential to modern farm operation requiring large capital investment in machinery and buildings, as well as large periodic investments in fertilizer, seed, feed, et cetera. If the land will always be subject to a lien, in an increasing amount, which is prior in dignity to any lien a bank may place upon the land as security for loans it may make for farm improvements or for the purchase of farm equipment or supplies, most banks will refuse to make any loan. National Banks will not make second mortgage loans. Inability to properly finance farm operations will result in lower crop yields which means a smaller food supply for the nation and inadequate income for the farmer to sustain his farm business and family.

Perpetual recapture would certainly cause serious administrative problems for the Internal Revenue Service, as well as for the heir and his heirs. The books could never be closed.

Finally, the combination of successive generations and successive perpetual tax liens would play havoc with real estate titles.

The other bills we have studied all provide for a recapture period of five years, and we believe this to be a reasonable period of time.

How can we prevent abuse of the estate tax advantages of the proposed legislation by persons not interested in preservation of agricultural land and open spaces but who desire only to buy and hold such land temporarily as a shelter from estate taxes?

A law that would solve the estate tax problem of the farmer, rancher and owner of open space land without opening the door to extensive abuse by wealthy people seeking only a temporary depository to shelter substantial capital from the estate tax is the goal of many who understand the problem of high values, low liquidity and high estate taxes facing owners of agricultural land and open spaces. How is the goal to be achiever? What safeguards can be employed which would prevent abuse and, at the same time, eliminate the estate tax-compelled sale of farms, ranches and open spaces?

Experience as a tax adviser and estate planner has taught me that this is a relatively simple task. It is only necessary to discourage individuals who have no intrinsic interest in agricultural land and open spaces from purchasing such land to hold for the briefest possible time in order to shelter from full estate taxation the passage of substantial sums to their heirs. Such discouragement can be effectively achieved in several ways without damaging the relief provided to the legitimate farmer, rancher and open space landowner.

First, all of the bills I have studied provide that in order to qualify for the special valuation treatment, the land must have been devoted to one of the qualified uses for a period of five successive years prior to his death. Virtually no one can predict that he will live for at least five more years but not much longer. Thus, if the requirement were altered to provide that the decedent must have either inherited his interest in qualified real property or owned such interest for five years prior to his death, it would effectively frustrate the planning of an investment in qualified real property solely as an estate tax shelter. If an individual buys such property and dies within the five year period, the favorable valuation is unavailable, and he has destroyed the liquidity of his estate, creating very serious problems for his heirs. If he lives much longer than five years, he has tied up substantial capital in an illiquid, low yield investment during the non-earning years of life when he is likely to need, and want to enjoy, a good income from his investments.

Thus, the provision that the election can only be made with respect to an interest in qualified real property which has either been inherited by or owned by the decedent for the five years immediately preceding his death should be adequate to prevent abusive employment of the election. However, a further step can be taken which should fully foreclose the possibility of abusive employment of the election. This can be very simply accomplished by providing that the value under the election shall be the higher of either the value of such land according to its qualified use or the adjusted basis of such land in the hands of the decedent immediately prior to his death. An example of such a provision is contained in our attached proposed bill.

Such a provision would have the effect of making the valuation under the qualified us election little different than fair market value for short-time investors in such property who seek to gain an estate tax break and who believe they can accurately predict their death in five or six years. The combination of the two provisions described above should be sufficiently discouraging to foreclose abusive uses of the special valuation election without damaging the intended relief for legitimate agricultural and open space landowners. If, however, still more protection is desired, say, to insure that the special valuation election is not used solely to gain a tax break by heirs who have no intention of keeping the land, the recapture provisions could be gradually phased out over an extended period. For example, after the first five years, recapture could be reduced by 10% per year for the next succeeding 10 years (see attached proposed bill). We believe such terms would be effective because Americans just do not think in terms of time periods as long as 15 years in the future, especially in connection with money and investments. Fifteen years is longer than Americans are willing to hold a substantial, illiquid, low-yield investment, unless they are in fact dedicated to agriculture and open spaces.

Such a lengthy recapture provision would, however, be damaging to legitimate farming and ranching heirs in that their ability to finance farm operations would be impaired and may result in low crop yields. We believe, therefore, that the provision requiring the decedent to have either held his interest in the qualified real property for the five years immediately prior to his death or inherited it, plus the provision computing the value under the election as the higher of the qualified use value or the adjusted basis of the property in the hands of the decedent immediately prior to his death constitute adequate safeguards to prevent abusive use of the special valuation election.

CONCLUSION

This statement, together with other statements and data available to the Committee, conclusively demonstrates the urgent need for immediate passage of the remedial legislation to prevent the federal estate tax from compelling the destruction of agricultural and open space lands. Furthermore, this statement conclusively demonstrates that such legislation can be enacted without creating a loophole for abusive use of the law by briefly holding agricultural and open space lands in order to shelter from the full measure of the federal estate tax the passage of substantial funds from generation to generation.

Only Congress can prevent the federal estate tax from destroying these lands because Section 2031 of the Internal Revenue Code of 1954 requires that all property included in the gross estate be valued according to its full value at the time of the decedent's death. A spokesman for the Internal Revenue Service admitted that the IRS had been aware of the problem for several years, but pointed out that the tax law required the Service to assess the tax on the basis of the value for which the land could be sold rather than on the value according to its use (see article by David A. Andelman, New York Times, May 14, 1972, copy from Congressional Records, Vol. 121, No. 2, January 15, 1975 attached).

The Treasury itself has estimated that a change in the tax law to permit agricultural land and open spaces to be valued on the basis of current use rather than "fair market value" would result in a loss in tax revenues of only 20 million dollars per year (see 94th Congress, 2d Session, Committee on Ways and Means, U.S. House of Representatives, *Background Materials on Estate and Gift Taxation* 62 (March 8, 1976). Surely 20 million dollars per year is a small price to pay to preserve our agricultural lands and agricultural production capacity. In fact, when measured against the cost of other government aid to agriculture, 20 million dollars is a nominal sum indeed to protect this critical resource and industry.

The task remaining is for Congress in our Bicentennial Year to enact this law to put an immediate halt to the presently continuing destruction of our agricultural and open space lands by means of determining the federal estate taxes on such lands according to the value of such lands for commercial, industrial and residential uses.

COMMENT UPON CERTAIN OTHER PROPOSALS FOR CHANGES IN THE ESTATE AND GIFT TAX LAWS

I. INCOME TAXATION OF UNREALIZED GAIN ON APPRECIATED PROPERTY AT DEATH

I am opposed to the imposition of an income tax on the unrealized gain on appreciated property at death as an additional tax superimposed on the estate tax. I believe that most lawyers practicing in the estate planning and estate administration field are opposed to such a tax. The most serious problem in the administration of estates today is insufficient liquidity to pay the death costs, of which the federal estate tax is usually the largest and most troublesome. The federal estate tax is a steeply progressive tax, and inflation has pushed many estates into significant estate tax brackets. Only a decade ago, estate taxes would not have been a great burden for many of these estates. Inflation is, in effect, visiting upon our citizens an automatic annual increase in income and estate and gift taxes.

Let's look at a fairly typical example of a decedent who started his own business thirty years prior to his death. The fair market value of his incorporated business at the time of his death may be $400,000.00, but his adjusted basis, immediately prior to his death, for his stock in the business may be only $30,000.00 if he built up the business over the years from retained earnings. He will probably have a house worth about $65,000.00, but he may have paid only $30,000.00 for it. He may have other assets worth $50,000.00 for which he paid $25,000.00. For the sake of simplicity, if we assume he has no personal debt, the gross estate of this decedent is $515,000.00, and his adjusted basis for such property immediately prior to his death is $85,000.00. If his estate obtains the maximum marital deduction, it will pay estate taxes of about $68,000.00, a little more than the value of his home and amounting to about 33⅓% of his gross estate. $68,000.00 is a great burden on this estate, especially if there is also a state estate tax in excess of the federal estate tax credit, but one which can probably be financed out of the business over a period of years. But if we add a capital gains tax of 25% on the $430,000.00 in unrealized appreciation, then we add another $107,500.00 in federal taxes due at death, to make a grand total of $175,500.00, or 34% of the gross estate. Few such families could finance this kind of debt from the business, and, hence, would be required to sell the business to pay the taxes. Needless to say, the same scenario would hold true for farmers, ranchers and open space landowners.

The very concept of imposing an income tax on unrealized gain is foreign to our system of income taxation. It seems inequitable on its face. It imposes an income tax on an involuntary but inevitable event. Furthermore, determination of unrealized profit or loss will generally not be an exact computation of the profit or loss that would actually be realized on a sale. Finally, such a tax would reward the virtues of industry, thrift, wise risk taking, and sacrifice to help the younger generation by forcing the sale of such investments and taxing away a very large part of the proceeds.

In essence, imposing an income tax at death on unrealized gain is nothing more than a cheap trick to increase federal death taxes which, because of inflation, are presently too high. I am unimpressed with the two arguments advanced in favor of imposing such a tax: (1) that the present system locks people into their present investments until they die and (2) that the present system discriminates against those who sell during lifetime. In my experience the lock-in factor influences only the very elderly and the very infirm, and, in such cases, the lock-in period is relatively brief. Others will sell if they are of a mind so to do when the price is right. As for the supposed discrimination against those who sell, most lifetime sales are usually voluntary and made after weighing all the factors, including the income tax. Just about every aspect of tax law can be construed as discriminating against some person or class of persons who choose to do or not to do something or who cannot meet the requirements of some provision bestowing favorable treatment. But this does not mean that our entire body of tax law is unfair or a poor system for allocating the burden of supporting the government.

If both the proposed legislation to prevent the federal estate tax from compelling the destruction of agricultural and open space lands and legislation to impose an income tax at death on unrealized gain were passed, the net effect would be that families would still be forced to sell agricultural and open space lands to pay death taxes.

II. ELIMINATION OF THE STEP-UP IN BASIS AT DEATH

I am opposed to a carry-over basis for estate assets. It seems to me only plainly equitable to step-up to fair market value the basis of assets which have been subjected to taxation on fair market values at the steeply progressive estate tax rates. I see no merit to a carry-over of basis for asset qualifying for the marital deduction because it seems to me that the marital deduction was a consideration in establishing the present estate tax rates and estimating the actual impact thereof in most cases.

III. INCREASING THE ESTATE TAX EXEMPTION AND PROVIDING FOR A MINIMUM MARITAL DEDUCTION

I am in favor of increasing the estate tax exemption from $60,000.00 because I think an upward revision of this specific dollar amount exemption take into account the effects of inflation is long overdue. Such a provision would largely eliminate the estate tax in a large number of cases in which no estate tax should be applicable, such as the death of young men with young families and estates, including life insurance, of about $300,000.00 to $350,000.00. Inflation has put these estates into a position of owing substantial estate taxes, and I believe it is time to rectify this situation.

IV. INCREASING THE GIFT TAX ANNUAL EXCLUSION AND THE LIFETIME EXEMPTION AND INTEGRATION OF THE GIFT AND ESTATE TAXES.

The gift tax must be the most unintentionally violated of the federal tax laws. Most people are unaware that taking title to shares of stock in joint names with their spouse or children, or that giving their wife a new car or a diamond ring are taxable events. Moreover, such gifts by those who are ignorant of the laws generally go untaxed because the IRS does not discover that a gift tax return should have been filed. Thus, lack of knowledge on the part of the public at large and lack of adequate methods of enforcement discriminates against those few conscientious taxpayers who are knowledgeable and who file gift tax returns accordingly.

I don't have any answers to the problem, but I think that raising the annual exclusion will help eliminate many of the innocent violations. Increasing the annual exclusion and the lifetime exemption is appropriate in view of the extraordinary inflation since the present amounts were established.

Unless omething can be done to adequately enforce the gift tax law, integration of the gift and estate taxes would only compound the inequity of present conditions. I would proceed cautiously with any changes here, and I would not disturb arrangements made under existing laws. In any event, if the gift and estate taxes are ultimately integrated, the estate tax rates, which are too high now, should be revised downward to equal the present gift tax rates.

[From the New York Times, May 14, 1972]

ESTATE TAXES DRIVE FARMERS OFF LAND

(By David A. Andelman)

Thousands of American farmers are being driven off their lands—forced to sell their farms to real estate speculators, some of them say, because of the method used by the Internal Revenue Service to assess inheritance taxes.

Such taxes are assessed on what the land could be old for, rather than what it is worth as farmland. Thus, many people who have inherited farms have had to sell them to developers simply to pay the taxes.

As a result, the revenue service is being termed partly responsible for destroying a segment of American agriculture and, at the same time, accelerating the spread of the suburbs to the rural areas of the United States.

Over the last decade, the value of agricultural lands in wide sections of the nation within easy access to metropolitan areas has skyrocketed as land speculators have bought up every available piece of property. The value of this land for agriculture, however, has largely remained constant or has declined.

The Internal Revenue Service insists on assessing all agricultural land at the "price at which property would change hands between a willing buyer and a willing seller."

The result has been that farmers holding property whose value for development is five to 10 times its agricultural worth have been forced to sell their property to the waiting speculators simply to pay their inheritance taxes, which run as high as 25 per cent. Children who would have remained on the land are being forced off.

Most of this pressure has been focused on the spreading areas on the fringes of the suburbs where metropolitan America is pushing out to meet rural America—areas such as the farther reaches of Suffolk County, L.I.; suburban Phoenix, Ariz.; the extreme northwestern part of Cook County in Illinois, and the Sierra Foothills region of California.

"Once farmland is given to the speculators, that's the final step as far as agriculture is concerned," said James E. Cross, a farmer in semirural Cutchogue, L.I. "You're taking land that took 25,000 years to develop, an amazing land that is rich and fertile, and overnight you bring in bulldozers and sock houses on it. We all pay for it in the long run."

Another Cutchogue farmer, John Wickham, cited the situation of a neighbor with a 60-acre farm in one of the best potato-producing areas in the United States.

The neighbor, who had asked not to be identified by name, inherited the farm from his mother two years ago upon her death. The farm was worth about $800 an acre if used for agriculture. But the revenue service valued it at $3,500 an acre, which Mr. Wickham noted "is the fair development value," and the tax alone came to about $1,200 an acre.

CALLS SALE "FORCED"

"This means that this chap is a very good farmer," he added, "but he had to take out a tremendous mortgage to pay the inheritance taxes, a mortgage with 9 or 10 per cent interest, and he simply can't pay it off—not with today's price of potatoes. So he has to sell it. In actuality, they [the Federal Government] forced its sale, very simply."

In Barrington, Ind., Xaver Schmid, a 72-year-old farmer who is worried about the problem that will arise when he dies, cited the case of a 90-year-old neighbor who died and left a 500-acre farm to his wife.

"They haven't sold the farm yet," Mr. Schmid said, "as the estate is still in probate. But his wife is nearly 90, and when she dies taxes will be levied all over again and the sons will have to sell the farm for sure to pay taxes."

That the situation became most acute very recently is largely attributable to the newly developing pattern of change in suburban America.

GROWTH ON FAR FRINGE

The 1970 census revealed that the fastest growing segment of the United States was the suburbs and the fastest shrinking was the rural areas. But of even greater significance was the evidence that the fastest growing segment of the suburban population was in the so-called "exurban areas"—those counties on the far fringe of the suburbs, between suburbs and countryside.

It is here that the real estate speculators are most busily at work and where the pressures on the remaining farmers are the strongest.

There are no statistics to show how many farms are going to speculators. Many are quietly sold but continue to be farmed for several years, even decades, under "lease-back" arrangement, until the land becomes so valuable that the speculator finally moves in and puts a halt to the farming.

NEED FOR LEGISLATION SEEN

A spokesman for the Internal Revenue Service, Edward Work, said, "We've been aware of the problem really for several years and, of course, what it boils down to is that under the law we have no alternative but to set the tax on the value the land sells for rather than on the vaue the property would be used for.

"It would take legislation to change the practice."

The legislation on which the current revenue service practices are based dates to the Revenue Code of 1916, Section 203.1, of which says that property must be valued at its fair market value. A service spokesman said, "It has been applied consistently since that date."

There have been numerous attempts at reform. Representative Graham Purcell of Texas, sixth-ranking Democrat on the House Agriculture Committee, has introduced each year for the last four years a bill providing for a change of the valuation criteria.

At last count, there were six bills before the House Ways and Means Committee and one in the Senate, all waiting for action that their sponsors generally believe will probably never come.

"Each year they get buried in the hearings on general tax reform," Mr. Purcell said in a recent interview. "Ways and Means just happens to like the extra revenue the law pulls in the way it stands."

The extent of the problem and the concern it has aroused in agricultural America is indicated by the search for the methods to circumvent the revenue regulations.

In the Dade County area surrounding Miami, almost all farms have by now been incorporated. The corporate farmer is able each year to transfer a small amount of stock—up to $3,000 apiece is tax-exempt under gift tax statutes—to his children as gifts, easing the final impact of inheritance taxes when he dies.

A few states, including New Jersey, California and Maryland, have either set up or given serious consideration to establishing agricultural land use districts. They require farmland under regulation to remain in farming for a certain period of years, usually at least 10, or indefinitely. But in many areas, the revenue service has not chosen to recognize these districts for estate tax purposes.

ACCEPTED BY GOVERNMENT

In California, the Land Conservation Act of 1965 enables a farmer to contract with the county government not to put farmland up for sale for at least 10 years, enabling the state to asses the land at agricultural rates. And, state officials said, the Federal Government has accepted the state assessment for Federal purposes.

But a new and more recent law may change this. It provides that if not enough of the restricted land is sold in an area, the county assessor may use the income of the land as a means of determining its value for assessment purposes.

Joseph A. Janelli, governmental affairs specialist of the California Farm Bureau Federation, is concerned that "the I.R.S. just might say this new law is a temporary expedient and we do not have the right to do it this way."

ARRANGEMENTS ARE URGED

Mr. York, the revenue service spokesman, said "there is a possibility" that an agricultural land use district "could affect the valuation—in effect discounting the valuation in some sitations." But he said, even so, the value would never reach the agricultural value.

So, the California federation has begun to advise members to make their proper arrangements well in advance of death—giving land or corporate shares in land to their children over the years to take advantage of the gift tax exemption.

So, the California federation has begun to advise members to make their proper arrangements well in advance of death—giving land or corporate shares in land to their children over the years to take advantage of the gift tax exemption.

"All this is fine," said Mr. Wickham, the Long Island farmer. "But I can't do this. I need cash loans on my property each year in order to operate. If I go to a bank and say I've given shares to my children, that I don't have clear title, they'll throw me right out."

Dean F. Tuthill, a professor of agricultural economics at the University of Maryland, said that there were only a handful of states that had been able to figure out any method of easing the burden of estate taxes for their farmers.

COAST LAW CITED

Most special agricultural taxing districts set up to help farmers are applied only to local property taxes and not to federally administered estate taxes.

Professor Tuthill cited, a one attempt to ease Federal taxes, California's statute, which he said was a prototype for other methods of "preventing intensive development of farmland," including a bill in Maryland last year that would have allowed farmers to sel their deveopment rights to the local county, farming it themselves but paying considerably lower taxes.

Systems such as this or one newly instituted in Suffolk County, L.I.—where the county plans to purchase, at the start, some 3,000 acres of prime farmland at speculative prices from the farmers, then lease it back to the owners—are other solutions proposed by agricultural economists in place of changes in the revenue law.

"There are so few ways open to preserve this valuable resource," Mr. Wickham concluded. "If the I.R.S. continues to follow this policy, it will put all agricuture out of business on Long Island within a generation. And who knows what will hapen everywhere else in this country?"

[From the Wall Street Journal, May 15, 1974]

THE 251-YEAR-OLD MANSION PROVIDES FEELING OF "ROOTS" BUT DOMINATES THEIR LIVES

(By Gail Bronson)

SHIRLEY PLANTATION, Va.—To walk inside the venerable brick mansion here with its paneled rooms and its oil portraits of long-dead ancestors, is to enter into the measured pace of the 18th Century.

It is easy, in the shadowy half-light of a fading afternoon, to envision a style of life two centuries removed from the busy world outside—to imagine squires with powdered wigs gathered around the Chippendale dining table, drinking sherry from graceful crystal glasses. Thomas Jefferson dined at Shirley, Robert E. Lee's mother was born here.

But C. Hill Carter, the 20th Century owner of Shirley, is not a squire, and he doesn't have a powdered wig. He has a crew cut, and should you visit his 251-year-old mansion 25 miles east of Richmond in the Virginia tidewater country, you may find him in paint-spattered shoes and baggy overalls, touching up an outbuilding. He often does such work himself—to save money.

Nor do Mr. Carter, his wife, Helle (rhymes with Nellie), and their three children dine very often at that splendid tables of polished mahogany on the main floor. They usually eat at a picnic-type table in the basement, seated on folding chairs beneath the bare pipes that service their 1910 sink. They eat in the basement because they want to maintain the main floor in all its 18th Century elegance, full of valuable antique furniture and American art.

RUINOUS TAXES

That is the commitment that has shaped the lives of Hill and Helle Carter—a commitment to maintain and preserve an 18th Century mansion on a 20th Century income. More than that, they are committed, despite rising expenses and the threat of ruinous taxes to pass Shirley on to their children and their children's children. They intend to keep Shirley in the Carter family, where it has remained for nine generations.

"In our society nobody has any roots," Mr. Carter drawls. "Everybody's mobile. When people come here and tell me how lucky I am to own Shirley, I'm right proud. We're determined to stay and keep these things."

Plenty of folks come to see Shirley. To help offset expenses, Mr. Carter opened Shirley to tourists some years back, posting a billboard near Williamsburg and distributing brochures locally. Last year, more than 10,000 people visited the plantation, often getting a guided tour by Mr. Carter himself, who clearly relishes the opportunity to take time off from endless odd jobs around the plantation to recall his family history and the glories of the past.

The white porticoed mansion dates back to 1723, but Shirley Plantation itself is even older. It was founded in 1613, only six years after the colonists arrived at Jamestown. While the land belonged to tobacco farmer Edward Hill, the Shirley mansion wasn't built until his daughter Elizabeth married John Carter, the son of a giant in colonial Virginia, William Robert (King) Carter.

RANDOLPHS, LEES, AND BYRDS

Contemporaries called him King because he owned a huge chunk of what is now the state of Virginia. King Carter amassed his wealth by deeding defaulted land to himself as land agent for Lord Fairfax and England. He lived quite comfortably on another plantation, cultivating tobacco with the help of 1,000 slaves. Over the years, his descendants intermarried with such leading Virginia families as the Randolphs, Lees and Byrds.

By comparison, King Carter's ninth-generation descendant has come down in the world—although, on paper at least, Hill Carter is a wealthy man.

"I reckon I'm worth $1.5 million," he mutters bashfully. "But I still feel like I'm scrambling to pay the grocery bills." Despite his assets, Hill Carter barely nets $15,000 a year, mainly from his tourist trade and some land he rents to a gravel company. To convert his assets to spendable cash he'd have to do the one thing he is committed not to do: sell Shirley Plantation.

The problem of maintaining a large estate isn't unique to the Carters. Many families find the financial burden too much or the way of life unappealing; usually, they sell their property for development or for some sort of institutional or foundation use. In Britain, the National Trust accepts country estates from owners who provide endowments to maintain the property in perpetuity for public access. In return the family may live there rent-free. The National Trust for Historical Preservation in the United States accepts property gifts with endowments, and Colonial Williamsburg buys land for the tourist trade. But Hill Carter wouldn't consider passing Shirley out of strict family control.

As a result, Hill and Helle struggle hard to keep Shirley both livable for the family and attractive to tourist. For Hill, life is a

* * * * * * * *

walls that need spackling and plumbing that needs fixing; currently, he's trying to complete some formal gardens around the house and build a driveway to the main highway. Helle opened a gift shop last year in one of the outbuildings and also hopes to start a small restaurant operation in another building.

Shirley Plantation mirrors much of Southern history in its evolution from tobacco plantation to wheat farms to the homestead that Hill Carter inherited. "My grandfather was wounded at Chancelorsville and was forced to quit working around 1884," says Hill, "so my dad started farming when he was 16. He never got an education, and financial things weren't easy for him. He spent all his time farming just to feed his family through the Depression."

Hill inherited the estate in 1952 through an elaborate plan to keep Shirley in the family; soon, the farmland was leased to others, a gravel mining company had leased several hundred other acres, and the Carters were seeking to build up tourist traffic to the house itself. "When other people are out on Sunday drives, I'm showing people around the house," says Hill.

Still, life at Shirley has its compensations. Hill and Helle enjoy sitting out back watching the historic James River roll by; many evenings are spent entertaining friends in Shirley's stately and ornate dining and drawing rooms. Though the family usually eats in the basement, the children, Charles, 11, Randy, 10, and Harriet, 9, are allowed the run of the house and property. "I don't want to turn this place into just a museum," says Helle.

Whether Hill Carter will succeed in his ambition to keep Shirley intact for his children—and whether they will want to stay at Shirley—is open to question. Hill figures the inheritance tax alone on Shirley would be about $650,000 at present rates.

But Hill and Helle figure it's worth the effort. "If money was the only thing in the world, I'd leave," says Hill. "But it's not. Most of the important things in the world can't be bought and sold," Helle adds. "It's gratifying when people come and appreciate this as part of their heritage."

[From the Baltimore Sun, May 10, 1974]

Disappearing Farms

(By Michael K. Burns)

In the years of agriculture abundance, not so long ago, United States farm policy was aimed at moving land out of production. That policy did not seem to work so well then but its effects are being felt today when the nation is realizing it might be better off with more farms and farmers.

Rising prices at the supermarket reflect the world's demand for more food. And the environmental movement has inculcated a reverence for open space and a revulsion against the devastation of suburban sprawl. Expansion of the domestic farm system seems to answer these non-farmer needs of society.

Forces are at work to create a coalition between the farmer and the environmentalist to preserve farmland as a privately held public heritage. But the alliance is still in the formative stage. Farmers distrust the conservationist who would freeze the value of his land under land-use laws, and chafe at his efforts to restrict uses of chemical and pesticides. Conservationists and consumers are wary of the producers of ever-more-expensive food and the owners of large spreads of high-priced rural real estate.

Land speculators have perhaps been the key element in the forging of the common interest. Population pressures and the ever-growing highway system created new fortunes for property holders who stood in the path of progress. Farmers did not create the boom, but they were quick to appreciate its possibilities for a windfall. A glut of reckless, shotgun speculation in farms throughout the state followed. And those farmers who sold out made it even harder for their neighbors to resist.

Some 2.7 million acres in the state, or 40 per cent of the land, are in farm production. By one estimate, that amount will dwindle to 1 million acres by the year 2000. Recognizing this undesirable trend, the Maryland Senate last year ordered the Secretary of Agriculture, Y. D. Hance, to make a study of means to preserve farmland. Mr. Hance appointed an 18-member commission with Frank L. Bentz, Jr., University of Maryland vice president for agriculture affairs, as chairman.

The commission has set as a goal the preservation of 2.5 million acres of agricultural land. Members are uncertain how fast farmland will be eaten up in the future; one subcommittee suggests 35,000 acres a year, another 62,000 acres. But they seem to agree that speculation, or investment, is a greater factor than the immediate demand for housing or commercial development. "Agricultural and commercial forest land acreage will decrease more than three times as much as urban-related land commitments will increase" by 2000, the group said in an interim report. Some of that land will be granted a temporary reprieve, as speculators rent it to farmers, but its fate is sealed. This despite the fact that there will be 50 per cent more people living on an acre of Maryland in 26 years than there are today.

As a commission subcommittee noted, preserving agricultural land can only be based in part on the actual demands of future population growth. Unrelated economic factors influence a number of individual decisions to give up farming and to take advantage of the speculator's offer. Farm prices are expected to increase and provide a return of about 15 percent on capital (exclusive of land), the commission reported. But a shortage of labor, heavy indebtedness and taxes may encourage all but the dedicated to give up.

Farm prices have shot up all over the state with little relationship to productivity and food prices. Farms that sold for $200 an acre is Frederick county 15 years ago are now worth $30,000 an acre by the new shopping mall. Even residential lots, minus sewer and water, are selling at $4,500 an acre.

In Anne Arundel county, developers are paying $3,000 an acre for average farmland as they leapfrog over sewer-connection bans in Montgomery and Prince Georges counties.

Partially influenced by the expanding Black & Decker power-tool plant, land in the Hempstead area of Carroll county is selling for an unheard of $7,000 an acre. "A couple of years ago, $1,000 was high for land in this area," recalled Paul R. Albaugh, a dairy farmer. "Now, I don't know of any land sold that's going to other farmers . . . they can't afford it."

"I don't think you can talk to a farmer who hasn't lost ground over the last five year," said Carroll Leister, whose grandfather bought the land he farms today. The small parcels of land a farmer rents for $15 to $20 an acre are sold off each year as land values rise, he explains. "The by-pass is going through 25 acres of our land and that will bring more houses," Mr. Leister said. "I guess in five years after the road is built we'll be out of here."

Developers and farmers covet the same type of land, Mr. Leister added. "That's the thing that hurts: they're buying good flat, cleared land, not the woods or the hilly area," he said. According to the state, more than 20 per cent of Maryland's "prime" farmland has been lost to urban use.

The commission headed by Dr. Bentz is to make final recommendations on legislation to Mr. Hance next month. So far, the group has explored several possibilities which have been discussed at a series of hearings in the state. The revision of federal estate taxes and state inheritance tax is one promising idea. Senator Charles McC. Mathias Jr., (R., Md.) and Representative Goodloe E. Byron (R., 6th) have introduced bills to change the estate tax, so that heirs are taxed on the agricultural value of farmland instead of on "fair market value." The lower valuation would make it easier for heirs to pay the taxes without selling the farm; if they did or if they developed the land, they would be subject to a retroactive higher levy. The chairman of the Maryland Environmental Trust and the Maryland Historical Trust support the measure as a valuable open-space tool.

The loss of farmland due to the estate tax valuation has not been extensive. Many heirs are all too willing to sell and farmers do the same thing to create heir retirement annuity. But it does help to keep farms in the hands of those families who want to continue at it, and they are becoming more rare. Herbert and John Wisner of Mt. Zion worked their father's farm since they were children, but had to form a corporation to save the land with a mortgage when it was inherited as an estate. "They should have done something to help the farmer in a situation like this," Herbert Wisner said.

Other plans considered by the agricultural land preservation commission include variations on programs in New York and New Jersey, New York permits farmers to create agricultural districts with powers to prohibit certain local ordinances that interfere with farming, to bar the use of public funds for utilities installation and to receive favorable tax assessment treatment.

The New Jersey plan, which is only a proposal made to the governor, calls for each municipality to set aside a certain percentage of prime farmland for preservation. A state tax on real-estate transfers would pay farmers for the loss of their development right by having the land use frozen in preserves. Under the New Jersey plan, farmland owners could claim their development-right payment today, or wait on the change that their rights will appreciate in the future. Speculation could continue in these rights or easements and investors could become richer. But the public would not be the poorer.

Maryland was the first state to pass a preferential farm property tax assessment law, taxing farmland at a lower rate than residential or commercial property. Economics claim the law has helped to keep land in production, though the evidence is tenuous. There is a tax recapture provision penalty if the use is changed, but that is a weak restraint against development.

This year the legislature enacted a law permitting farmers to give the development rights to the state. In exchange for freezing the use of his land in farming, the owner would reduce his local property taxes and reduce the value of his estate for federal taxes upon his death. Without any purchase agreement, however, its chances of success are slim.

From this mix of interests, and of economic incentives, the attrition of farms and farmers may be stemmed. The benefits of open space will be shared by all. Phillip Alampi, New Jersey's agriculture secretary, recently explained how self-interest can work constructively in this field. "Farmers have a selfish interest in preserving open space," he said. "Without it, they will go out of business. Urban and suburban people have a selfish interest in preserving open space. Without it, they may exist, but they will not live."

[From the Baltimore Sun, Feb. 19, 1974]

Endangered Label on East Coast Farms

(By Isaac Rehert)

The East Coast farmer has been changing to a rare and endangered species just when a crowded congested society has come to need him most.

For decades, while built-up concrete areas have been growing around big cities like warts, farmers, caught in the crunch of fast-rising costs and shrinking profits, have been abandoning agriculture.

The old-timers are carrying on, expanding and consolidating their holding, but with the increased capitalization, it becomes almost impossible for a youngster to break in unless he inherit. And increased valuation of land for development purposes is a continuin temptation to the farmer simply to sell his holdings for the building of supermarkets and retire from the field.

As if crowding by urban areas, skyrocketing capitalization and the cost-price squeeze were not enough, certain government tax policies have also tended to pressure farmers into getting out; and now, land-use legislation, one version of which has already been introduced into the Maryland General Assembly, has farmers worried. They fear that by legislative fiat, their equity, their security, their retirement bank account that they keep deposited in land, may be wiped out.

The extinction of the East Coast farmer, like the extermination of other rare and endangered breeds, is more a problem for the public than it is for the breed. Quite aside from the prdouction of food (which for the first time in memory is becoming increasingly critical), quite apart from nostalgia for "old time rural values" and a way of life that keeps looking better the further we pass from it, farms—at least green open spaces—are essential to ecology, to keeping a balanced environment, to maintaining an ethetic harmony.

Whereas in other areas real estate taxes are based on the highest market value of land—which usually would be its speculative value for development—in Maryland, farm land is taxed as farm land—which means lower rates, commensurate with its lower earning ability when used for growing crops.

But the federal government has not seen fit to follow a similar practice. There are no federal real estate taxes, but there is a federal estate inheritance tax, and the Internal Revenue Service insists on assessing all agriculture land at the "price at which proerty would change hands between a willing buyer and a willing seller."

Any land within easy access to metropolitan areas can attract numerous willing buyers eager to acquire all they can for speculative purposes. The result has been that in some areas, land values have skyrocketed to five to ten times what they would be for agricultural land.

And so, when parents die and their children inherit the land, they find themselves billed for a federal inheritance tax—which may run as high as 25 per cent—that is so high they are forced to sell the land to speculators in order to pay it.

In one instance, land that was worth $800 an acre for agricultural purposes was valued by the IRS at $3,500 an acre, which was its "fair development value." The tax alone came to about $1,200 an acre, and the farmer had no choice but to sell it for development in order to pay. In fact, the federal tax laws had simply forced the farmer off the farm and the land out of farm production.

It is not merely IRS administrative policy but explicit legislation that says that property must be valued at its fair market value, and so it will take new legislation to make a change.

This year, Senator Charles McC. Mathias, Jr., (R., Md.) introduced a bill that would change the practice, bringing it into line with that used in Maryland and other states, so that the IRS, in considering the value of land for tax purposes, would use its value as an actual earning resource rather than its market value.

In a Senate statement. Mr. Mathias pointed out that without such legislation, everytime a farm passed to an heir, the heir would be paying most or all of the income he could earn from his farm land just to pay the taxes. The situation is impossible, and "the effect of this (IRS) policy is to force many farm families to sell their farms in order to pay the estate tax—regardless of their attachment to the land or to the occupation of farming. And the result of such forced sales is, in the end, a grave and immeasurable cost to the community."

His bill incudes safeguards that prevent land held by speculators from qualifying at the lower rate of tax, namely that the property must have been used as farm, wood or open scenic land for at least five years prior to and must continue to be used that way for five years after the estate tax return is filed.

One of the interesting developments in the farm land picture is that because of the world-wide food shortage and the energy and fertilizer shortages, farm commodities have been increasing in value so rapidly that with next year's harvest the value of farm land may nearly equal its value for development.

From the public's point of view, at least one aspect of the situation has become perfectly clear. Despite the name "agribusiness," farms are not merely business; they are a natural and esthetic resource of the entire community, and the East Coast farmer, who is their steward, as a rare and endangered species, needs some help to be saved.

[From the Baltimore News American]

FEDERAL TAX GRAB COUNTERED: STATE ACTS TO SAVE FARMS

(By Steven Norwitz)

In upper Harford County, John Brown (not his real name) tills a 650-acre farm he'd like to turn over to his children when he dies.

But farmer Brown estimates that when he passes on, his family will face a federal estate (inheritance) tax of $400,000.

As a result, the Brown family will be forced to do what the Johnson family did with their 100-acre farm in Havre de Grace a few years back—sell it to developers.

The federal estate inheritance tax, which often amounts to a third of the development value of a farmer's land, is one reason why Maryland loses an estimated 35,000 acres of farmland a year to development, according to the state Department of Agriculture.

In 1969, the latest year for which figures are available, 44 percent of Maryland's land areas, or about three million acres, was devoted to agricultural use.

It is projected that the amount of farmland in the state will drop to 2.4 million acres, or 38 percent of the state's land area, by 1986.

To help slow the trend, the Maryland legislature this year passed a bill designed to aid the farming family that wants to pass its farm down from one generation to the next.

For farmers who agree to permanently turn over the development rights of their land to the state, the bill provides that the farms would be assessed at their agricultural value, about $600 an acre, instead of potential development value, now ranging from $2,000 to $3,000 an acre.

The aim is to significantly cut the federal estate tax on the property, enabling the family to keep the land for its agricultural use.

"This would help people who have had farms that have been in the family for generations and want them to be kept in the family," says T. Allan Stradley, president of the Maryland Farm Bureau.

The state, meanwhile, would preserve some of its open spaces and maintain a $425 million a year industry.

While the bill is considered a good concept, its effective implementation hinges on two unknowns.

"First," says state Sen. James Clark, Jr., D-Howard, a co-sponsor of the bill, "we're not absolutely certain the IRS (Internal Revenue Service) will recognize this."

The federal government does its own assessing of property when calculating the estate inheritance tax.

"Second," Clark adds, "if you give up the development rights to your property and the property all around you is turned into subdivisions, the plan won't work."

If these roadblocks are worked out, however, Clark feels "there are a good many people who will go for it." Clark himself would be one of them.

The senator runs a 500-acre farm on Rt. 108 across the road from Columbia. "The estate tax on this would definitely cause us to lose the land," he says.

"But I wouldn't hesitate a minute (to give up the development rights to the property) if I was assured I wouldn't have development all around me. Agriculture is all we've ever done; that's all we want to do."

While many farmers will be leery of giving away the huge profit potential of their property. Sen. William S. James, D-Harford, co-sponsor of the bill and president of the Maryland Senate, says the bill is "just a start" in the state's effort to preserve its agricultural land.

Eventually, James notes, Maryland may adopt a plan similar to one in New Jersey which authorizes the state to purchase outright the development rights to a farmer's land.

"The New Jersey green acres program," James says, "has permanently preserved one million acres (of its 1.4 million acres of farmland) by this approach."

This summer a state Commission on the Preservation of Agricultural Land is to offer sweeping recommendations on steps the state should take to accomplish this purpose.

A BILL To amend the Internal Revenue Code of 1954 to provide for the deferral and transfer of liability for the payment of a part of the Federal estate tax on certain real property the fair market value of which exceeds the value of such property for continued use as agricultural land, undeveloped land, or historical sites

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part II of subchapter A of chapter 11 of the Internal Revenue Code of 1954 (relating to credits against estate tax) is amended by adding at the end thereof the following new section:

"(a) IN GENERAL.—If the executor of an estate so elects, the tax imposed by section 2001 shall be credited with the amount of the excess, if any, of the tax imposed by section 2001 over the amount of the tax which would be imposed by section 2001 if the value of any interest in qualified real property included in the gross estate is determined by the higher of either its value for the use under which it qualified in accordance with the provisions of subsection (b) of this section or its basis in the hands of the decedent (immediately prior to the death of the decedent).

"(b) QUALIFIED REAL PROPERTY.—For the purposes of this section, the term 'qualified real property' means real property substantially all of which is and, for the 60 months preceding the date of death of the decedent, has been devoted to—

"(1) farming (the production of agricultural commodities).

"(2) ranching (the raising of livestock),

"(3) woodland (including land used for the commercial production of trees and land publicly used for undeveloped scenic or outdoor recreational purposes),

"(4) being maintained substantially in its natural state (being developed for agricultural or other purposes),

"(5) maintenance of historic values and is listed in the National Register of Historic Places, either separately or as part of a district so listed.

Such real property shall include residential buildings and related improvements occupied on a regular basis by the owner or lessee of such property or by persons employed by such owner or lessee for the purpose of operating or maintaining the real property and improvements described in this subsection (b), and roads, buildings, and other structures and improvements functionally related to the uses listed in this subsection (b).

"(c) INTEREST IN QUALIFIED REAL PROPERTY.—For purposes of this section, the term 'interest in qualified real property' means—

"(1) beneficial interest in the fee ownership of such property as sole owner thereof or as a joint tenant with the right of survivorship, a tenant in common, or otherwise.

"(2) any interest in such property or in voting stock of a corporation described in paragraph (5) of this subsection, the value of which is includible in the gross estate of the decedent by reason of any one or more of sections 2033, 2035, 2036, 2037, 2038 or 2041 of this chapter.

"(3) beneficial interest in a land trust which holds the fee ownership of such property, if—

"(A) such trust had 10 or less beneficiaries and

"(B) such property comprised at least 80% of the value of all property owned by such land trust

"(4) an interest as a partner in a partnership which holds the fee ownership of such property, if—

"(A) such partnership had 10 or less partners and,

"(B) such property comprised at least 80% of the value of all property owned by such partnership.

"(5) voting stock in a corporation which beneficially owns the fee ownership of such property, if—

"(A) such corporation had 10 or less shareholders and

"(B) such property comprises at least 80% of the value of all property owned by such corporation.

For purposes of this paragraph, determinations shall be made as of the date of the death of the decedent.

"(d) BENEFICIARY.—For purposes of this section, the term 'beneficiary' means that person or those persons to whom any interest in qualified real property included in the gross estate of the decedent passes or has passed from the decedent.

"(e) TIME AND MANNER OF ELECTION.—The election provided for in this section shall be exercised by the executor on the return required by this chapter if filed within the time prescribed by law or before the expiration of any extension of time granted pursuant to law for the filing of the return, and shall contain the name, address and taxpayer identification number of the beneficiary or beneficiaries.

"(f) REVOCATION OF ELECTION.—The election made under this section shall be revoked with respect to the whole or any part of such qualified real property which is—

"(1) converted to a use other than one or more of the qualified uses described in subsection (b) of this section; or

"(2) removed from the National Register of Historic Places or maintenance of the historic values is discontinued if such property qualified for the election only pursuant to subsection (b)(5) of this section; or

"(3) sold or otherwise transferred.

"(g) RECAPTURE OF CREDIT.—Upon revocation of an election made under this section with respect to any interest in ualified real property or upon the disposition of any interest in qualified real property with respect to which an election under this section has been made, the credit allowed by this section shall be decreased by 100%, minus 10%, for each twelve month period that such interest in qualified real property was held after the date that such interest in qualified real property was held for 60 months from the date of the death of the decedent, of the amount of the credit attributable to the interest in qualified real property with respect to which the election has been revoked or with respect to which a disposition has occurred.

"(h) LIABILITY FOR PAYMENT.—If the amount of any credit claimed under this section is recaptured pursuant to the provisions of subsection (g) of this section, the executor, if such recapture occurs during the administration of the estate and prior to distributionof the interest to which such recapture is attributable, or the beneficiary or beneficiaries of the interest to which such recapture is attributable, if such recapture occurs subsequent to the distribution of such interest, shall give notice to the Secretary or his delegate of the event causing recapture of any part or all of such credit pursuant to the provisions of subsection (g) of this section, such notice to be given at such time and in such manner as may be required by regulations prescribed by the Secretary, and the Secretary or his delegate shall (the provisions of section 6501 notwithstanding) redetermine the amount of the tax under this chapter and the amount, if any, of the tax due on such redetermination, plus any interest due thereon, shall be paid by the executor or the beneficiary or beneficiaries, as the case may be, upon notice and demand or upon the expiration of any extension of time granted pursuant to law for the payment thereof.

"(i) CROSS REFERENCES.—

"For lien against property where credit is claimed under this section, see section 6324(a)(4).

"For interest payable on amount of any credit allowed under this section which is recaptured under subsection (g) of this section, see section 6601(j).".

(b) Section 6324(a) of such Code (relating to liens for estate tax) is amended by adding at the end thereof the following paragraph:

"(4) UPON SECTION 2017 PROPERTY.

"(A) Lien imposed.—If the executor of an estate elects to claim the credit against the estate tax allowed by section 2017, the amount of such credit shall be a lien for a period of 15 years (unless sooner released as provided in subparagraph (B)) from the date of death of the decedent upon the property (as defined in section 2017 (b)) with respect to which the credit was claimed. If the credit relates to more than one parcel of section 2017 property, a lien is imposed under this paragraph on each parcel of such property in an amount which bears the same ratio to the total amount of the credit allowed under section 2017 as the value of that parcel of such property (for purposes of chapter 11) bears to the value of all the property to which the credit relates.

"(B) RELEASE OF LIEN.—The lien imposed by subparagraph (A) on parcel of section 2017 property shall be released by the payment to the Secretary or his delegates of the amount of the credit subject to recapture from time to time under the provisions of subsection (g) of section 2017 plus any interest due thereon.

"(C) CROSS REFERENCES.—

"For interest payable on amount of any credit allowed under section 2017 plus any interest due thereon. 6601(j)."

(c) Section 6601 of such Code (relating to interest on underpayment, nonpayment, or extensions of time for payment, of tax) is amended by redesignating subsection (j) as (k), and by inserting after subsection (1) the following new subsection:

"(j) INTEREST ON RECAPTURE OF CREDIT ON SECTION 2017 PROPERTY.—If the executor of an estate elects to claim the credit against the estate tax allowed by section 2017, interest shall be paid at the rate of 4 percent per annum on the amount of any credit recapture dunder subsection (g) of section 2017, computed from the date of the death of the decedent to the date of the event causing the recapture. The interest shall run from the date prescribed by section 6151(a) for the payment of the tax imposed by chapter 11 on the transfer of the estate, without regard to any extension of time for such payment under section 6161(a)(2), 6163, or 6166. The interest shall be paid by the person or persons paying the amount of the credit recaptured under subsection (g) of section 2017 at the time such amount is paid."

(d) The table of sections for part II of subchapter A of chapter 11 of such Code is amended by adding at the end thereof the following new item:

"Sec. 2017 Credit for part of value of certain real property."

SEC. 2. The amendments made by this Act apply to the estates of decedents dying after the date of enactment of this Act.

Senator TALMADGE. Our next witness is Senator Dale Bumpers of Arkansas.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator BUMPERS. I want to thank you for allowing me the opportunity to appear before this committee. I might say as a prefatory thing I agree with the concept of estate tax exemption for family farms which has been just discussed by my colleague, Senator Stone. I am a cosponsor of S. 277 which deals with the problem in a slightly different manner. I think the concept has grown sufficiently so that certainly some form of it will be adopted before the end of the year.

IRC COMPLEXITY

Mr. Chairman, before addressing some of the specific issues which this bill H.R. 10612 offers, I would like to offer a general comment. The title of the bill, The Tax Reform Act of 1975, is unfortunately a misnomer. Although the bill would result in increasing Federal revenues for calendar year 1976 by about $1.3 billion, and although certain so-called loopholes would be closed or narrowed by some of the bill's provisions, it is by no means a "reform" measure. It simply adds to the already almost incomprehensible complexity of the Internal Revenue Code.

A glance at any section of the bill will reveal that it is honeycombed with special exceptions, carefully tailored effective dates, and special-interest rules. As a matter of fact, each section of the bill seems to have been prepared with particular individual or corporate taxpayers in mind. The Internal Revenue Code, instead of being a simple and reasonably straightforward device for raising revenues to support the operations of the Federal Government, has instead become a mass of unintelligible rules, many of which are designed to encourage or discourage certain conduct that either does or does not appear to have social value. The taxing statute, in other words, has become a vehicle for almost everything except taxation, and if I could leave one point with the Committee in my testimony today, it would be that H.R. 10612 should be scrapped. It would be better for the Committee to start anew from the ground up and produce a true reform measure, beginning the difficult and painful process of streamlining the Internal Revenue Code so that it is fair and understandable.

I don't say that is likely because I recognize what I say here is immensely much more complicated than the average layman could even begin to comprehend.

It is easier to talk about this task than to accomplish it, of course, but we have to start somewhere, and today is as good a time as any.

TAX TREATMENT OF FARMING OPERATIONS

I would like to comment on just a few of the provisions I consider to be seriously flawed in H.R. 10612. I am concerned, first of all, about the provisions of the bill on limitation of artificial losses, known in taxing jargon as LAL. In the case of farm operations, for example, section 101 defines "artificial losses" to include prepaid feed, seed, and fertilizer expenses, accelerated depreciation of livestock, and expenses incurred for crtain crops. Artificial losses include expenses incurred for crops, animals, or trees before the period of production. But the bill continues then to except from this new provision livestock other than poultry.

I fully understand and sympathize with the general purpose of these proposals. They discourage persons with high non-farm income from using farms as tax shelters. Real economic losses from farms, for example, current expenses of production, could still be deducted against any kind of income, farm or non-farm. But by omitting poultry from the exception for livestock, the bill discriminates against an important agricultural interest of Arkansas, which, incidentally, Mr. Chairman, is a $600 million industry.

I can see no economic or tax-policy reason for distinguishing poultry from livestock with respect to the deductibility of artificial losses. If the loophole is going to be closed, it ought to be completely closed, and if it is going to be left open, it should be left open for all crops and agricultural pursuits without unreasonable distinction. As a matter of fact, this group of provisions is an excellent example of what is wrong with the Internal Revenue Code. The statute has become a lacy filigree of special-interest exceptions and carefully tailored grandfathering dates. For example, the LAL provisions do not apply to that portion of a grove, orchard, or vineyard planted before September 11, 1975.

I heard Senator Stone testify a moment ago about what the Tampa Bay Football Franchise means and how he seeks to grandfather it in. While I understand it, the Code is literally laced with those sorts of exceptions.

Therefore, I suggest that the new section 468(c)(1)(B)(iii) be amended by adding rice and soybeans to the favored group of crops, and that new section 468(c)(1)(B)(iv) be amended by striking out the words "other than poultry."

Mr. Chairman, Section 204 of the bill, which would add a new Section 447 to the Code, contains similarly objectionable special rules. In general, the new section would prohibit farming corporations from using the cash basis of accounting. Their taxable income would have to be computed on the accrual method. In passing, I might say that I see little justification for such a special rule as to farming corporations. The Commissioner of Internal Revenue already has the authority under existing law to disallow the use of any basis of accounting that he finds does not clearly reflect income, and I do not understand why this authority is not sufficient to cure any distortion of income that mnay now be taking place in the tax returns of farming corporations of other taxpayers. After all, an expense paid and deducted in one year will normally be compensated for by income earned the next year.

By way of digression again, I might point out that 80 percent of the farmers in Arkansas use the cash basis and I would assume that is probably true nationwide.

Beyond that, the proposed new section 447 is not a simple prohibition of the use of the cash basis for all farming corporations. If it were that straightforward, it would perhaps be defensible. The proposal, however, in a manner typical of the approach of this bill to taxation, contains a number of exceptions. A corporation, for example, could continue to use the cash basis, if it wishes, if two-thirds of its stock is owned by members of the same family. There then follows, in proposed new section 447(a), an extensive definition of the term "family," and, in proposed new section 447(d), special rules under which two families, for tax purposes, can be treated as one.

And why, one may ask, would Congress want to specify instances in which two families are considered as one, any more than we might want to include in the Tax Code a series of special circumstances in which the moon shall become the sun or vice versa. The answer, I suspect, is that some small group of taxpayers wanted to preserve its own option to use the cash basis and has done so not by a frontal attack upon the principle of proposed new section 447 itself, but by securing adoption of a carefully structured special-interest exception.

The trouble, Mr. Chairman, is that all of these exceptions, even if justifiable in the case of the individual taxpayers whom they benefit, cut two ways. That is, farming corporations which do not, for one reason or another, fall within the precise terms of the exceptions, may be placed at a distinct disadvantage with respect to other farming corporations with whom they compete and which do fall within the exceptions.

The proper solution, it seems to me, is that all of section 204 be stricken. In this way, the problem of structuring special exemptions for certain taxpayers can be avoided altogether, and farming corporations, in common with other business corporations, could continue to use whatever basis of accounting clearly reflects their income.

Section 206 of the bill would make non-business interest, as a general rule, deductible only up to $12,000 a year. I generally support this approach. It would preserve the interest deduction for the vast majority of home purchasers, while disallowing it only for taxpayers who really do not need special treatment. I would suggest, however, that the committee consider an amendment to disallow any interest deduction on residences other than the taxpayer's principal residence,

TAX TREATMENT OF REAL ESTATE

I am disturbed by certain aspects of the development of vacation and second homes. Some of the effects of this development are sufficiently troubling to justify, in my view, a removal of the subsidy represented by the interest deduction. Since second-home buyers are generally more affluent than the first-home or single-home buyer, they often compete for the limited amount of mortgage money that is available in a given area. Most second homes are constructed in remote or rural areas. The environmental impact of second-home developments in such areas can be extremely adverse. In many places inadequate sewage, roads, and other services have led to tremendous problems of pollution.

Mr. Chairman, I won't pursue that any further except to say I think it is unfair for the taxpayers of this country who simply cannot afford a second home to in effect subsidize the Federal Treasury for those who can.

Hard-pressed local governments are faced with the costs of rectifying these problems, and this extra burden of taxation is forcing low and modest-income people out of the areas where they have traditionally lived. Furthermore, vacation homes exacerbate the energy crisis. Many of these homes are electrically heated, even during the winter when they are not occupied. There is also the energy of extensive weekend travel to and from these vacation homes.

Mr. Chairman, I have no quarrel with any person who wishes to construct a second or vacation home, if he can afford it, but I do question the wisdom of forcing other taxpayers, in effect, to subsidize these second homes because of the deductibility of interest. As is well known, interest payments in the early years of a loan account for almost the entire monthly payments that a borrower makes, so the deduction for interest is extremely attractive for high-income taxpayers. Allowing this deduction for second homes clearly benefits people in the higher brackets at the expense of the general public, and I urge the committee to eliminate this deduction entirely.

DEDUCTIONS FOR CONVENTIONS OUTSIDE THE UNITED STATES

Mr. Chairman, section 602 of the bill, relating to deductions for the expense of attending business meetings outside the United States, is a step in the right direction, but in my opinion it does not go nearly far enough. Under section 602, for example, taxpayers would be allowed to deduct the cost of attending two foreign conventions per year, and their transportation expenses could be deducted only up to the cost of coach air fare. I frankly do not see why any deduction should be allowed for attending conventions, seminars, or conferences out of the country.

There is rarely a genuine business purpose for holding a business meeting abroad. Usually they are just excuses for wealthy professional people to take a deductible vacation. Again, persons should be perfectly free to travel without as well as within the United States, but I cannot understand why the general body of low and moderate income taxpayers should have to subsidize this travel for higher income persons who could afford to go on their own. I suggest, therefore, that section 602 be rewritten to prohibit this kind of deduction altogether.

In addition, for many of the same reasons, all deductions for air fare should be limited to the cost of coach tickets. S. 1698, which I am cosponsoring and which is now pending before this committee, would accomplish this result, and I urge that provisions of S. 1698 be attached by way of amendment to section 602 of H.R. 10612.

TAXATION OF FOREIGN INCOME

Section 1035 of the bill relates to the tax treatment of foreign taxes on oil and gas extraction income, and this would be an appropriate opportunity, it seems to me, to raise again the whole question of abuse of the foreign tax credit. I have no quarrel with the general proposition, long recognized in the law, that income should not be subject to double taxation. There should be a credit allowed, in other words, for amounts paid to foreign governments that are truly income or excess-profits taxes, and this is in fact what the statute now says and has said for a long time. Rulings of the Internal Revenue Service, however, are permitting the crediting of certain payments to foreign governments that are in fact royalties, not taxes. These payments are measured not by the net income or profit from foreign operations, but by the artificial posted price for oil, reduced by a few relatively insignificant deductions.

I suggest, therefore, that existing law on the creditability of foreign income taxes be clarified to provide that payments that are actually royalties or gross income taxes not be eligible for the credit.

This simple change, which is in full accord with the spirit of the statute as it presently exists, would produce several hundreds of millions of dollars of revenue each year and would greatly increase the respect of the ordinary taxpayer for the equity and fairness of the law. It would also remove a serious disincentive for domestic exploration and production of energy resources. At the present time, because of the structure of the tax laws, it makes much more economic sense for an oil company to explore in foreign lands than here in the United States. Changing the rules for the foreign tax credit in this way would simply continue the work that we began last year in the Tax Reduction Act, Public Law 94–12, by eliminating the foreign percentage depletion allowance.

CAPITAL GAINS TAX

Finally, Mr. Chairman, I would like to comment on Section 1403 of the bill. This section would gradually increase the holding period required for a capital gain or loss to be long term from 6 months to 1 year. The large difference in rates between ordinary income and long term capital gain, of course, makes the holding period extremely important. For some reason, however, section 1403(d) provides that the six-month holding period shall be retained in the case of futures transactions in any commodity subject to the rules of a Board of Trade or Commodity Exchange. Speculation in futures, Mr. Chairman, is entirely lawful and, according to some, serves useful economic purposes. I cannot understand, however, why this kind of investment should be favored by retention of the 6-month holding period, when all other kinds of assets are going to lose that privilege. I suggest, therefore, that section 1403(d) be stricken from the bill.

Mr. Chairman, I appreciate very much the indulgence of the committee in allowing me to share some of my impressions with regard to tax policy in general and H.R. 10612 in particular. I would appreciate very much whatever consideration the committee can give to the changes in the bill I have suggested. Thank you for hearing me out.

CAPITAL FORMATION

Senator FANNIN. Thank you very much for being with us this morning. You have some excellent suggestions. I do feel that perhaps some of your suggestions might interfere with the capital formation that we have tried to produce in this country. This is one of the greatest problems we have in America today. Forecasters say that in the next decade we would need as much as $4 trillion or more for the development of all industry, and $1 trillion for the development of the energy industry alone.

Do you feel that you can support programs or would you support programs that would assist in developing in capital formation that would help take care of this need?

Senator BUMPERS. Senator Fannin, as you perhaps recall, I was one of the people who voted for and supported the concept of a $6 billion loan guarantee fund in the ERDA authorization bill which was stricken.

Senator FANNIN. I remember that so I am familiar with it.

Senator BUMPERS. I felt there were enough safeguards in that loan guarantee program which would preclude the major companies from participating in it but it would be a great incentive for the smaller companies. I have some reservations but I think I would support a similar bill again. When the Internal Revenue Code allows a royalty to be treated as taxes, creditable against taxes owed in this country, it creates a disincentive to the development of energy here in this country. I think there is an incentive to go abroad because of this tax credit.

Senator FANNIN. I have a few different views as to what we can do in that regard. I am desirous of getting all the development in this country that is possible and we will work toward that end.

TAX TREATMENT OF FARMING OPERATIONS

We are talking about what can be done on LAL. I share your concern. For example the LAL provisions do not apply to a portion of a grove or vineyard planted prior to September 1975. I know in your statement you had a great development in your State.

In the State of Arizona we have had the problems of over-production of cotton and trying to convert into other crops or other endeavors in the agricultural community. They have been very successful in getting orchards underway. Without these provisions I doubt that we would have those programs going forward.

Do you have similar programs in Arkansas?

Senator BUMPERS. We don't have the same problem there, Senator Fannin. I recognize for example an orange grove requires something like 5 years. It requires very tedious care.

Senator HANSEN. It takes longer than that in Wyoming, Senator.

Senatom BUMPERS. I am talking about Arizona. It takes longer in Arkansas.

Senator FANNIN. We have 6,000 acres of pecans we would not have if we did not have this provision. I do feel we have been able to convert from crops resulting in over production into crops where there is a need. I don't think we could do that unless we did have this provision.

Senator BUMPERS. As this bill was originally reported to the House, before a floor amendment was adopted at the last minute, certain items of LAL were limited to certain named crops, but not including rice and soybeans. At the end of a year, farmers will fill the barn up with feeds. You are looking at a man who is guilty of it. Everybody does it because it makes good tax sense. Provisions favoring livestock other than poultry are still in there.

For Senator Talmadge to say his poultry farmers and for me to say my poultry farmers, if you are raising cattle you get the artificial losses and you can deduct them but if you are in the poultry business which has also been considered a livestock business in my State you can't have it, is a patent absurdity. Either count them all or don't count any of them.

Senator FANNIN. I certainly agree, Senator, I think it is very unfair.

We realize our agricultural industry is the greatest in the World. We export more than the others combined, so I think we must have been doing things fairly well or we would not be in the position we are in today.

Don't you feel that many of these provisions allowing for deductions in certain years really balance out in the long run?

Senator BUMPERS. I certainly feel that way.

Senator FANNIN. When you are talking about a special privilege this year you are going to pay for it next year. In other words, you can't carry it over 2 years, so I think many times we look at some of these proposals, and we think this or that should be corrected, but I don't think we go far enough into the projections and determine what the end results are. I have been very concerned about interfering with some of the successful programs that have been in operation for quite some years.

TAX TREATMENT OF OIL AND GAS

Now, when we talk about incentives and capital formation, we also get into areas where there has been a great deal of criticism, particularly as it relates to the oil industry. At the same time much of the capital that has been made available to the small, independent operator has come from this source. I feel that if we start limiting it and design it so that it can only be deductible up to a certain amount, we are going to eliminate a great opportunity for these independent companies to raise money.

TAX TREATMENT OF REAL ESTATE

Senator BUMPERS. I am talking about nonbusiness interest. My criticism is aimed primarily at the second home. There are several reasons for my position. If a man is paying $12,000 a year on a home, he is fairly wealthy and I have no objection to that, but the United States Treasury and the middle-income people who pay most of the taxes into the Federal Treasury are subsidizing that second home.

Also, he usually builds it in an area where he creates pollution and sewage problems. It creates demand for an area where money is usually limited and it excludes people who don't have a first home yet.

Senator FANNIN. Many people who are retiring do have a second home, and I think it is a necessity perhaps that they are getting along in years, whether they can't stand the cold or the winters in some of the areas so they come out to Arizona where it is nice and warm and they have a second home. I don't think we should penalize them in having the same privileges as anybody else. I think it would be a barrier to them being able to do what I think they are entitled to do.

Senator TALMADGE. Your time has expired, Senator Fannin. Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman.

Senator Bumpers, I am sorry I was called out temporarily and did not get to hear your oral presentation.

Do I understand that you recommended the imposition of a $12,000 interest payment total limit total on the amount that could be deducted under this LAL?

Senator BUMPERS. Section 206 of this bill, Senator Hansen does this. It makes nonbusiness interest deductible only to the extent of $12,000 a year. I a saying that I support that provision.

Senator HANSEN. I did not know just what the effect of it would be.

Senator BUMPERS. My suggestion was that I support the limitation of $12,000, but I would suggest that the committee add an additonal provision that no interest be allowed on a second residence regardless of the $12,000 limitation.

Senator HANSEN. I think a member of my staff indicated you made some reference to that and it would be that part that I would want to inquire further of you as to your thinking.

As is not untypical, many of the older residents in my home State of Wyoming for reasons oftentimes partly health find it necessary to have a second home. I don't know how much restricted your philosophy would be in permitting them to continue making payments on a residence for reasons of health. A lot of them have to get out of the cold in the wintertime. I happen to be an asthmatic. I know when it gets real cold people with my particular problem oftentimes have a very severe breathing difficulty.

Senator BUMPERS. Senator Hansen, my statement and personal information on that point are that in regard to second homes, in the 17-State Southeast region in the United States, Arkansas is just behind Florida in growth.

Secondly, our growth is in retirees who are moving from Chicago, St. Louis, that area into my area. These are middle-class, middle-income people who are not moving there into a second home. They are moving there, period, for their retirement years.

There are some second homes but we have tremendous development companies in our State, just as there are in Arizona and Florida, where these retirees are moving in. I am not suggesting the middle-income person drawing a small retirement—I don't believe many of these people can or do maintain second homes. The only people I know who have vacation homes, and that is what I am thinking about, are the wealthier people of this country. I feel to allow an interest deduction on that second vacation home is a penalty against the very people we are talking about who have worked for wages all their lives and have in effect subsidized the deduction those other people get on these vacation homes.

Certainly, I would not want to be accused overtly or covertly to indulge in penalizing people who have to move into warmer climates in the winter months.

If the committee sought to make an exception for people who had to do it for health reasons then perhaps you could write such language in. We have so much exception language written in already I am always reluctant to put any more in.

In my personal experience I have not known anyone to maintain a second home who did not have a significant income. They are usually pretty well fixed.

Senator TALMADGE. With the exception of the Members of Congress.

Senator BUMPERS. I anticipated that question, Senator Talmadge. You know your home here would actually be considered an ordinary business expense because you are here under mandate of your people. I trust you are, and I hope we all are, but that would continue to be a reasonable expense. Members of Congress already get a $3,000 exemption for living in Washington.

Senator HANSEN. My wife thinks it is more than reasonable. At times it is an unreasonable expense.

TAX TREATMENT OF FARMING OPERATIONS

Senator TALMADGE. Thank you very much for your suggestions. With many of the points you make, I concur. We must do something about the so-called artificial accounting losses. In some areas I think this goes much too far.

For instance, the needs for future timber production in the country are tremendous. We have gone even to the extent of passing the Forest Incentive Act to produce more timber. We are trying to mandate the U.S. Forest Service to plant more trees than it did on its own. Yet, under this LAL as I understand it, it takes 52 years life cycle for a tree in Georgia and I presume about the same in Arkansas. You could not deduct the costs of keeping fire out of the timber resources. On things like that, I am sure you would concur.

Senator BUMPERS. I certainly would, and I would say if there is a legitimate area for artificial losses, it is certainly in the timber industry and in the citrus industry.

Senator TALMADGE. The citrus industry now has special capitalization rules under a special law passed when Senator Holland was here in the Senate. That law was agreed to with the idea that a lot of people, speculative in nature, would plant more groves and take their tax deductions. You pointed out the differentials in some of these costs.

I would concur that similar crops should be treated similarly under the tax laws. I don't know why they put that provision on poultry in there.

I guess it is because the life cycle of a broiler is 12 weeks and I guess they feel there would be no opportunity to create a loss. Actually it is a real loss, not an artificial loss.

The Senator pointed out the foreign tax credits. In the Tax Act of 1974, we put some severe limitations on tax credits for the oil and gas industry and I think we accomplished most of the thrust of the Senator's remarks.

Thank you very much.

TAX TREATMENT OF REAL ESTATE

Senator HANSEN. If I could make one final observation, Mr. Chairman, I want to say I don't know all that much about this second-home business, but I do know firsthand a number of people from Wyoming, when I speak about a second home, their second home is a permanent trailer installation. It is not maybe the kind of home you might be thinking of. I would have to say I can give you the names of a lot of people who are not in a very high income bracket, a number of whom are still actively engaged in pursuing an occupation in the summertime in Wyoming. It is purely a matter of health for a number of them.

Senator BUMPERS. Some of those people would be allowed medical deductions if they could get a doctor's certificate; it would be deductible as a medical expense.

TAX TREATMENT OF FAMILY CORPORATIONS

One other thing I was not asked any questions on and perhaps it escaped you or maybe I did not emphasize it enough in my testimony, but I feel very strongly about this definition of the family corporation. I definitely think the committee ought to look into that. I think to say that in certain instances two families can be treated as one, or if one family owns more than two-thirds of the stock, it is a family corporation, is unreasonable. Some of the biggest farms in the United States are owned by one-family corporate farms. So I hope you will consider that.

Thank you again.

Senator TALMADGE. Thank you very much. We appreciate your contribution.

Our next witness is Mr. Peter L. Faber, New York State Bar Association.

STATEMENT OF PETER L. FABER, CHAIRMAN, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. FABER. Mr. Chairman, I appear here on behalf of the tax section of the New York State Bar Association and not the association as a whole.

My name is Peter L. Faber, and I am a partner in the law firm of Harter, Secrest & Emery in Rochester, N.Y. I am the chairman of the tax section of the New York State Bar Association and appear before you today on behalf of the section. The section has over 1,900 members, all of whom are lawyers with a special interest in taxation. Our members include practicing lawyers, teachers, corporate counsel, and employees of Government agencies including the Internal Revenue Service.

IRA COMPLEXITY

The fact that so many people make their living explaining the tax laws to private citizens and businesses is itself a sad commentary on the complexity with which our tax system is afflicted. It is that complexity, and the extent to which it may be aggravated by proposed tax legislation, that I would like to discuss today. Committees of the section are reviewing the various provisions of H.R. 10612, referred to in this statement as the tax reform bill, and will submit detailed written comments during the next month.

It is appropriate to deal with the subject of complexity at this time of year, when millions of taxpayers throughout the country are struggling with the 15,000 words of Internal Revenue Service instructions to form 1040. Despite valiant efforts by the Service to simplify both the forms and the instructions, it is clear that they are just too much for the great majority of taxpayers.

Almost 4 years ago, the section's Committee on Tax Policy prepared "A Report on Complexity and the Income Tax" which called attention to the problem, analyzed its causes, and recommended solutions [27 Tax Law Review 325 (Spring 1972)]. The committee did not attempt to blame the situation on any one source, finding that Congress, the courts, administrative agencies, and, in fact, the tax bar, all had a measure of responsibility. Unfortunately, although the report was widely praised, it was just as widely ignored. The last few years have seen the enactment of several pieces of tax legislation that have substantially aggravated the problem.

Now, Mr. Chairman, what are the effects of complexity?

One result that is hard to quantify is the lack of confidence in the fairness of the tax system that it fosters among individuals. People are suspicious of that which they do not understand. In a tax system which depends as heavily as ours on the honesty of taxpayers who compute their own tax liability, the creation of such suspicion can have unfortunate results.

The complexity of tax laws applicable to business makes it impossible for the small businessman lacking access to sophisticated tax advisors to predict the tax consequences of a transaction with any degree of assurance. Most small businessmen are represented by lawyers and accountants in general who do not have the time or familiarity with the tax system to master all its nooks and crannies. Moreover, even the small businessmen who do have sophisticated advisors often cannot afford to pay them for the time necessary to do an adequate research job.

The complexity of the tax laws akes it harder for the Internal Revenue Service to perform its functions. Laws that are unduly complicated cannot be applied by revenue agents on audit and cannot be explained to taxpayers by the Service's taxpayer assistance staff. A recent survey showed that advice given to taxpayers by the taxpayer assistance personnel of the Service was wrong 25 percent of the time. When one considers that questions addressed to the taxpayer assistance staff are likely to be basic ones, the result of the survey becomes truly frightening.

By diluting the effectiveness of the Internal Revenue Service's audit procedures, complexity in the tax law encourages taxpayers to take positions with little or no basis, hoping that they will not be audited or that, if they are, the revenue agents will not pick up the point.

Complicated tax laws that are hard to understand and comply with can have consequences going far beyond the immediate impact on tax determination and collection. For over 30 years, the Federal income tax laws have provided direct incentives to employers to establish retirement plans for their employees, thus encouraging private business to assume a social role that otherwise would be performed by the Government. The Employee Retirement Income Security Act of 1974 [ERISA], although enacted by Congress with the best of intentions in order to strengthen the private pension system, has proved to be so hard to understand and administer that many people feel it has had just the opposite result. It has been stated that the number of plan terminations since ERISA's enactment has been substantially greater than expected. I can testify from personal experience that many of these terminations have been a direct result of the law's complexity and incomprehensibility, not of added costs posed by expanded coverage, vesting, and funding requirements.

Is this much complexity really necessary?

It has been argued that the complexity of our tax laws results from the complexity of our society and is necessary if equity is to be done. A simplified tax structure would inevitably have the effect of applying the same rules to taxpayers in different positions who, arguably, should receive different tax treatment. The question that must be asked in each instance is whether the added equity resulting from different tax rules is really important and, if it is, whether it is worth the additional layers of complexity that result. In many cases, the balancing of interests will lead to a conclusion that the added equity is in fact worth the additional complexity. All I ask of you today is that this balancing of interests occur. All too often, it does not, and the complexity side of the equation is totally ignored.

It has been suggested that simplicity in tax statutes simply leads to complexity in administrative regulations and court decisions. Section 482 of the Internal Revenue Code, giving the Commissioner of Internal Revenue the power to allocate tax attributes among controlled taxpayers in order to reflect fairly the income earned by each, is an example of a statutory provision of less than 100 words that has been expanded into several thousand words of regulations. While this may be true in some cases, the problem is that a complicated statute does not provide any guidance as to its basic meaning. A lawyer in general practice reading Section 482 will understand the basic principles involved and will realize that the Commissioner has the power to readjust income where related parties do not deal with each other at arm's length. Can a lawyer in general practice whose client asks for advice about depreciation recapture get the same general message from the statute? I doubt it.

It is not a defense that complexity in the tax law applies primarily to wealthy taxpayers who can afford to pay sophisticated advisors to interpret the laws for them. In fact, some of the most complicated provisons—for example, IRC Section 341 dealing with collapsible corporations, apply primarily to small businesses and individuals. Even the rich cannot always cope with complexity. All too often, a wealthy taxpayer's hgh-paid advisors come to him and report that their hours of diligent research have failed to produce a clear answer to his problem. If, as is often the case, pressures of time, and the Freedom of Information Act, make seeking a private ruling impractical, the wealthy taxpayer may be in exactly the same position with respect to a proposed transaction as his less affluent brother, except that he has paid his lawyers several thousand dollars to find this out. The rich may not enter the Kingdom of Heaven, but surely they are entitled to some certainty in their lives.

With this as background, let me discuss some provisions of the Tax Reform bill and their effect on the complexity of the tax laws.

Let me begin on a positive note by applauding the expansion of the use of tax tables embodied in Tax Reform bill Section 501(a). This will help many individual taxpayers to accurately compute their tax liability.

One unfortunate tendency in the bill is the excessive length of many of its provisions. It may well be laudatory to expand the retirement income credit and provide a childcare credit, but couldn't these be done in less than 1,000 words? Most of us, I am sure, endorse the idea embodied in Tax Reform bill Section 1502 of allowing an individual covered by a qualified retirement plan to deduct contributions to an individual retirement account, but must the provisions which enable him to do this really be as long as the Constitution of the United States?

In addition to the sheer volume of statutory language, the bill reflects a recent tendency of Congress to clutter up the Code and tax forms with additional deductions and credits that serve no purpose other than to confuse people. A case in point is the credit for home garden tools that would be added by Tax Reform bill Section 1801. Does onyone seriously believe that the addition to the code of such a credit—the maximum tax savings in any one year would be $7—will result n the creation of one single home garden that otherwise would not exist? I think it can be sad with confidence that the only results of this provision will be to cost the Federal Government some money, some of whch will undoubtedly go to owners of flower gardens who don't read the instructions carefully, and confuse a few more hapless taxpayers.

One perversity that recurs in the draftsmen of Internal Revenue Code provisions is their fondness for cross-references. The limitation on artificial loss provisions—bill Subsection 101 and 102—read like a parody of this tendency. It may be instructive to trace the steps that would be necessary to research a problem arising under this part of the bill.

On pages 7 through 15 of my written testimony, I have sketched the steps necessary for a general practice lawyer to answer a very simple question if his client asks it: What is the effect of LAL on me if I invest in real estate? Let me state in order to do this research, a very simple job, the lawyer would have to go through numerous separate steps involving review of 26 separate Code revisions and having done that he would not have a clear answer for his client.

[The pages referred to follow:]

Let us assume that we are in the office of a lawyer in general practice who receives a telephone call from a client asking what the new rules are respecting the extent to which losses from a proposed investment in rental real estate can be used to offset his other income. The lawyer, being conscientious and disdainful of secondary sources, tells his client that we will look the answer up and call him right back.

Knowing that the principal component of the tax losses will be depreciation deductions, he turns first to § 167 and is somewhat put out to find that there is no reference whatsoever to any limitation on the use of depreciation deductions to shelter other income. He then thumbs through the index of his copy of the Internal Revenue Code and comes across a reference to "limitation on artificial losses" in subpart D of Part II of chapter 1 of the Code. The titles of the sections under that subpart seem vaguely related to depreciation deductions and, taking a chance, he turns to § 466, which he is delighted to find is indeed the applicable provision. Section 466(a)(1) seems to have the answer, providing: "Except as otherwise provided in this subpart, in the case of any taxpayer subject to this subpart, accelerated deductions which are attributable to a class of LAL property and which (but for this section) would be allowable for the taxable year shall not be allowed for such year to the extent that such deductions exceed the net related income for such year from such class of property." A few of the terms used in this sentence are not entirely clear but our lawyer friend is confident that explanations will be offered. Before moving on, however, he notes a reference in § 466(a)(3) to an exception "for certain accrual taxpayers engaged in farming." He knows that his client has a few farm properties and decides he had better check this out. The exception refers to "property described in section 467(a)(3) if the taxpayer "uses an accrual method of accounting with respect to such property and capitalizes preproductive period expenses described in section 468(c)(1)." He dutifully turns to § 467(a)(3) which describes the property in uestion as being property used in farming or property "described in section 1221(1) and held in connection with the trade or business of farming." He turnsto § 1221(1) which seems simple enough and he concludes that this particular provision may apply. Turning back to § 468(c)(1)," he wonders why the language from § 1221(1) couldn't have been put directly into § 467(a)(3).

Section 468(1)(1) indicates that the expenses in question are those used with respect to a "class of property described in section 467(a)(3)." He turns back to that section, remembers he has just looked at it, and returns to § 468(c)(1) which, mercifully, seems clearly not to apply.

Concluding that the exception for farming operations in § 466(a)(3) does not affect his client, the lawyer turns back to § 466(a)(1).

The provision applies only to taxpayers "subject to this subpart" and fortunately those taxpayers are described immediately below in § 466(a)(2). Subparagraph (a) clearly seems to apply to his client, who is an individual. Noting the cross references to §§ 1371(b) and 447(a) in the case of corporate taxpayers, the lawyer congratulates himself on his foresight in talking his client out of forming a personal holding company for his investments the year before.

The next expression used is "accelerated deductions" and, turning ahead in the Code, he finds a definition in § 468(a). Although the definition seems simple enough, he notes that it applies only to "a class of property described in section 467(a)(1)" so he turns back to that provision. Property in that section is described as property which is "or will be" property "described in section 1221(1)" or property held for rental. Fortunately, he remembers from an earlier stage in his research what § 1221(1) is all about. Unfortunately, the definition goes on to say that § 467(a)(1) property does not include "any section 1245 property (as defined in section 1245(a)(3)) which is leased or held for leasing." Turning wearily ahead to § 1245(a)(3), he finds that it applies generally to property which is or has been "of a character subject to the allowance for depreciation provided in section 167 (or subject to the allowance of amortization provided in section 185)." Fortunately, he remembers that the property is in fact depreciable and that § 167 is the section authorizing the depreciation deduction, so he need not turn to that provision. Since his client has indicated that the proposed investment is in real estate, he concludes that subsections (A), (B), and (C) do not apply. Subsection (D) looks disturbing, however, because it applies to real property "which has an adpusted basis in which there are reflected adjustments for amortization under section 169, 185, or 188." Turning to these sections, he finds that they deal with the amortization of pollution control facilities, railroad grading and tunnel bores, and expenditures for on-the-job training and child care facilities. Common sense tells him that none of these sections apply to his client's situation and, without reading them carefully, he turns back to the definition of "accelerated deduction" in § 468(a)(1). The definition of "accelerated depreciation" in § 468(a)(2) refers to deductions "allowable under this chapter" and he checks the table of contents of the Code to make sure that the coverage of the word "chapter" is sufficiently broad. Then, he notices a few pages ahead that § 470 seems to have definitions of terms used in subpart D and, sure enough, he sees definitions for "construct" and "construction period." He reviews these to make sure how they apply to his client's situation.

Feeling confident that he has established the meaning of the expression "accelerated deductions", he turns back to § 466(a)(1) and sees that it applies only to deductions attributable to a "class of LAL property." This strikes him as an expression that could not possibly have a useful meaning outside the Internal Revenue Code and he turns the page, hoping to find a definition. He almost does. Although there is no definition of "class of LAL property," § 467(a) defines L"AL property" and the word "class" as applied to different types of LAL property is explained in subsections (b)–(g). With some trepidation, he decides to apply logic and common sense and concludes that, for purposes of his client's problem, the definition of "classes of LAL real property" in § 467(b) is the one he must deal with.

Turning back to § 466(a)(1), our attorney finds that his client's accelerated deductions will not be allowed to the extent that they exceed the "net related income" for the year from the class of property. This, too, looks like an expression that must be defined somewhere, and he turns ahead to § 468, which includes the phrase in its title. Sure enough, it is defined in § 468(g). He shakes his head, wondering why Congress could not have put all these definitions in one place instead of spreading them throughout subpart D. He decides that, like Li'l Abner, he loves and respects the U.S. Congress and if they did it this way they must have had a reason.

The basic definition in § 468(g)(1) seems simple enough, but unfortunately subsection (2) is entitled "special rules" and our friend knows that this means trouble. He is right. The special rules indicate that net operating loss deductions under section 172 shall not be taken into account. This is a phrase that he has not run across in his practice and he turns to the section to see what it means. It seems to be concerned primarily with active businesses and, after looking at it carefully for a while, he decides that it does not apply to his client's case. Another special rule relates to capital gain deductions under § 1202 and capital loss carry-backs or carryovers under § 1212. Knowing that his client has from time to time bought and sold real estate, he checks these out as well. Section 1202 seems familiar and he does not dwell on it. Section 1212, unfortunately refers to § 172 again. Not wanting to reenter that particular thicket, he decides to take his chances that this provision does not apply.

Our attorney has now concluded that the deferral of accelerated deductions will indeed be a problem from his client. The next step is to find out exactly how it will work and whether he will ever get some tax benefit from them. Unfortunately, it is late in the day and all hopes of getting in a set of tennis before dinner have vanished. He calls his client and tells him that the research is taking more time than he had hoped and that he will call him tomorrow. He then goes home and has two martinis with his wife before dinner.

The next day, suitably refreshed, he arrives at the office a bit early and gets back to § 466. He finds, in subsection (b), that the deferred deductions are placed in a "deferred deduction account." Subsection (c) indicates that these deferred deductions will be allowed in later years if the income from the same class of property exceed the accelerated deductions attributable to the class of property for the later year. It seems simple enough.

A thought then strikes him. He knows that depreciation deductions reduce the basis of property for purposes of determining gain on later sales. He wonders whether the basis will not be reduced if deductions are not allowed under § 466. Knowing that the basis adjustment provisions appear in § 1016 of the Code, he turns to that section and finds that it reads the same way it always did. This seems to indicate that there is no basis reduction since the deferred deductions are neither allowed nor allowable. Turning back to subpart D, however, he finds in § 470(d)(1) that a deduction not allowed under § 466(a) will bet reated as "allowed" for purposes of § 1016.

Our lawyer notices that § 469 deals with the consequences of "dispositions" of property. Section 469(a) indicates that, if any LAL disposition class is sold during the year, any amount remaining in the deferred deduction account is deductible in that year. This seems to say that all of the client's investment real estate must be sold in order to get this deduction. Reading on, however, he finds in § 469(b)(2) that in the case of property described in § 467(a)(1) this rule applies where any item of property is transferred. Turning back to § 467(a)(1), he finds that he has already reviewed this definition and, looking at his research notes from the day before, he satisfies himself that it does in fact apply. It occurs to him that it might not be illogical (although it certainly would be confusing) to provide that the deduction under § 469(a) might be limited by the property's depreciation recapture potential (or the depreciation recapture potential the property would have had if accelerated deductions had been claimed). He can find no reference to this in § 1250 and decides that he may or may not mention it to his client, depending on how confused the client seems to be when he tells him everything else.

Finally, he remembers that accelerated depreciation is subject to the minimum tax on tax preferences and decides that he had better review the application of the minimum tax in years in which amounts are placed in the deferred deduction account and the year in which the property is sold. He finds in § 57(e) that an amount placed in a deferred deduction account under § 466(b) is not a tax preference. The law does not indicate, however, whether the deduction resulting under § 469(a) when he sells the property is a tax preference item in the year of sale.

Having (he hopes) completed his research, he calls up his client and tells him that he is not absolutely sure that he thinks there may be a problem. He discusses some of the principles involved, including additional record keeping expenses, at which point his client cuts in with an exasperated tone and says "look, I don't care about all these fancy rules, should I buy that property or shouldn't I?" At this, the lawyer shouts into the telephone "how should I know, ask your Congressman!" and hangs up in disgust.

This scenario points out some of the complexities of the drafting of the LAL provisions. I might add that the LAL concept is inherently complex. The Tax Section will submit a detailed report on LAL in the next few weeks.

Mr. FABER. Let me close with some thoughts for those of you who will be drafting and voting on tax reform legislation during this session of Congress and those to follow.

In drafting, consider who will be reading and interpreting tax statutes. Will the average attorney in general practice who is conscientious and doesn't want to rely on secondary sources be able to advise his client? Will the Internal Revenue Service be able to design a 1040 form that accommodates new deductions and credits clearly, and will it be able to explain them to taxpayers? It is not sufficient to make a policy decision, instruct the drafting personnel of the appropriate committees to prepare legislation, and vote for it without reading carefully the draftsmen's work product.

This is what happened with ERISA. The Pension Reform bill passed by the Senate by a vote of 93–0 obviously had not been read in its entirety by anyone. The draftsmen had to work under time pressure and last-minute floor amendments did not integrate with the rest of the statute. Policy aside, and without regard to complexity, it was internally inconsistent.

Remember that you are the generalists. You represent the people who will have to live with the new tax legislation.

Don't try to solve every conceivable problem and treat specifically every possible factual variation. Instead, enact generalized statutes that clearly indicates their purpose.

A further element of complexity arises from the uncertainty as to what the tax laws will contain. This results from what I can only describe as a continual tampering with the tax laws. Just about every year since the Tax Reform Act of 1969, new proposals to curb so called tax shelters have been seriously advanced in Congress. Since these proposals typically have a retroactive effect, the complexity and uncertainty already written into the tax laws are compounded by apprehensions as to what complexities and uncertainties may be added retroactively. Sensible planning is impossible in this kind of atmosphere. If you conclude that reform is needed in a particular area of the tax law, by all means do something about it (hopefully in a simple manner). Once you do, forget about it for a few years. This will give the taxpayers and the Internal Revenue Service a chance to live with the legislation for a while and will not force the to conduct their affairs in an atmosphere of continual change.

We in the Tax Section are mindful of the pushes and pulls of the legislative process. Many people will appear before you in these hearings asking you for special rules and exceptions for one group or another. Many groups will have special problems and appeals for special treatment will should attractive to you. We urge you to think hard about whether the alleged equity resulting from each new exception is really worth the added complexity and confusion.

Finally, let me make a plea for the clarity of literary style. Tax lawyers are not noted for their conciseness of expression, but to some extent our literary style is tarnished by that of the materials we are forced to read every day. The Internal Revenue Code already contains a single sentence that is almost twice as long as Lincoln's Gettysburg Address.[1] The Tax Reform bill proposes to give us several more of similar length. Complex concepts are troublesome enough, but when they are expressed in complex language the felony is compounded.

I realize that general testimony of the type I have just presented may not appear as directly pertinent to the work before you as the more detailed and specific comments that will be submitted later by

[1] IRC § 341(e)(1).

other committees of the Tax Section and by other speakers at these hearings. I submit to you, however, that this message is, in the long run, more important than whether a category of deduction is limited by or freed from the LAL provisions. I hope that this issue of complexity will be given more attention than it has in the past. I sincerely believe that the viability of our income tax laws depends upon recognition of the adverse effects complexity has on our self-assessment system.

Senator TALMADGE. Thank you very much for your contribution.

I have read most of your statement while you were reading and I concur thoroughly that trying to file a tax return is a mystic maze these days. While I have been on this committee for 18 years, I don't feel I am enough of a tax authority to file my own return. What in your judgment can we do to simplify it?

Mr. FABER. That is a good question. A committee of our section will be submitting a detailed report on the 1040 form.

Senator TALMADGE. I would hope you would submit it in third grade language on one page.

Senator FANNIN. We have received a great deal of information there.

Senator TALMADGE. I did take that rapid reading course that Evelyn Wood had and I got nothing whatever out of it the first time. I repeated the course and I got up to fantastic levels at one point, but I found that to retain those skills you had to practice it everyday. When I quit practicing, I lapsed back into my old habits. I still think I read a good deal faster than I did before I took the course.

Senator FANNIN. I have in mind the award you received. I don't know whether she paid a royalty on you or not.

Senator TALMADGE. As a matter of fact, I did not authorize the publication and I had to ask them to quit using my name in their advertisements.

Senator FANNIN. Mr. Faber, you have presented an excellent statement and you are to be commended for the work you have done in preparing this fine paper.

IRS ERRORS IN TAX RETURN PREPARATION

You were here I think when Senator Stone testified. He talked about S. 1652, a bill which protects the taxpayer from liability on interest payments on income tax deficiencies where the tax return has been prepared by the Internal Revenue Service.

I note you say taxpayer assistance personnel were wrong 25 percent of the time. If this is true, what would happen if the Senator's stipulation was included in legislation? Would the Internal Revenue Service stop so readily giving this assistance?

Mr. FABER. Senator, I am responding now as an individual and not for the section. I have not reviewed that particular proposal. I would be somewhat concerned that that might happen and it might have an inhibiting effect on the giving of advice.

I can see problems of proof that would be raised. I would assume, if this were to be done, you might have to have written advice rather than oral advice by Internal Revenue personnel. I can see administrative problems. I am sure Commissioner Alexander and his people would want to comment on it, too.

Senator FANNIN. As I understand it, you have made a clear case that the tax provisions are so complex that taxpayers in many instances, must hire lawyers and accountants to prepare their returns. Even when they hire an accountant, many times they have to hire a lawyer, too, or get someone who is both a lawyer and accountant. Is this of great concern to you also?

Mr. FABER. Yes. I think suggestions have been made for major tax reforms that would eliminate the great bulk of deductions. In fact, Charles Walker of the Treasury Department has suggested this.

ERISA

Senator FANNIN. I think most Members of Congress have been concerned as to what happens to the employee as a result of the Employment Retirement Income Security Act of 1974. There have been many statements made about the disincentive that has come about. You had brought out one that I had not heard brought out to the extent that you have done so.

Do you feel that this is one of the fears the employers have in adopting a new program as well as the continuance of programs they now have in effect?

Mr. FABER. We represent some 150 pension-sharing and profit plans in the office and we are in the process of amending all of them. The amendments will be much more expensive to our clients because of the complexity of the statute. I have had occasion to sit down with small businessmen with 5 or 10 employees to explain the new language we have put together for their plans that are absolutely required by ERISA. We have no choice in doing this. On a couple of occasions I have gotten the reaction "I can't understand this. What is it all about? I can't understand it. I am afraid of it."

We have had people when confronted with the kinds of things they needed in their plan because of ERISA say "I don't want any part of it. It is too confusing."

Senator FANNIN. Many had great hopes this would encourage well enough the new retirement income security programs, but if it has resulted in the opposite effect, I know you have made some recomendations here, but what do you think is going to happen now if we do not take some action?

Mr. FABER. Senator, I think the great majority of existing plans will simply be amended and not terminated. There will be many that will be terminated and there will be many that will be continued on. I would urge simplifying and eliminating many of the provisions in ERISA which in my personal view don't really provide a very important function but which do add to the cost of compliance with the law and which have created a good deal of confusion.

One I might mention is the joint and survivor annuity proviso which is very confusing and could have been done in a much simpler manner and there are many others.

Senator FANNIN. Should we give these people a moratorium so they can take the necessary action? What could be done to alleviate this dropout problem we have especially among the small businesses? We have certain requirements of the small businesses in relation to their programs. Would you recommend that we have a period in which they could properly organize their programs?

Mr. FABER. Senator, one possibility would be to simply delay the effective date. I think unfortunately what is happening is that, since the major provisions of ERISA requiring actual plan amendments take effect with a majority of preexisting plans as of the first taxable year beginning in 1976, most plans are already being revised. Certainly drafts are being produced. I know we have been cranking them out continuously. If anything like a moratorium is to be done it should be done immediately. I am speaking now as an individual and not for our organization, but I think one approach would be to postpone the effective date of these provisions for a year or so to give the Congress an adequate time to consider their ramifications.

I have included a footnote to one of the earlier versions of ERISA which was passed very quickly without adequate consideration. I think a moratorium might be suggested.

Senator HANSEN. I had a lot of questions, but I think Senator Talmadge stole my thunder in his question. I have no other questions.

Senator TALMADGE. Thank you very much.

Our next witness is Joan Bannon, Council on National Priorities and Resources.

STATEMENT OF JOAN BANNON, COUNCIL ON NATIONAL PRIORITIES AND RESOURCES

Miss BANNON. Mr. Chairman, the Council on National Priorities and Resources is committed to promoting the use of national resources to meet human needs. We believe that tax expenditures are frequently as important as direct program expenditures in the Federal budget and must be taken into account in discussing national priorities. Although the organizations comprising the Council have in the past given their primary attention to spending programs, their concern with overall priorities is inevitably leading them into involvement with the modification of tax laws. The statement presented today represents to the best of my knowledge, the first time a coalition of broad-based organization has endorsed a specific agenda for comprehensive tax reform.

TAX REFORM

Fundamental reform of our system of taxation is long overdue. Never before has the loophole-ridden tax system seemed so unjust. Massive tax avoidance by wealthy individuals and corporations is quickly eroding not only the tax base but the confidence of taxpaying citizens in the fairness and integrity of their Government. According to a study by the Treasury Department, nearly one-fourth of all tax subsidies in fiscal year 1974 went to the wealthiest 1.2 percent of taxpayers. The 160,000 richest taxpayers in this country, 0.2 percent of all taxpayers, saved a total of $7.3 billion in taxes in fiscal year 1974, due simply to tax loopholes and subsidies. And 14.6 percent of all taxpayers—those with incomes over $20,000—received 53 percent of the benefits from tax breaks.

According to the most recent figures available, in 1973 more than 500 individuals with incomes over $100,000 paid no Federal income taxes whatever.

The reason for the inequity becomes obvious as soon as one looks at the list of tax credits, deferrals, exemptions and deductions available to the American taxpayer when filling out his tax form. Although available in theory to everyone, in practice only a small number of tax breaks are truly available to those earning moderate incomes of $15,000 or less. Favorable treatment of capital gains, the exemptions of income from tax-exempt bonds, excess depreciation deductions and any other tax benefits provide preponderent benefits to the top 1 or 2 percent of the income scale.

Corporations benefit from even more tax breaks and giveaways than wealthy individuals, and, as a result, corporations are paying a shrinking share of the total burden of taxes. According to a study by Otto Eckstein, "Profits and Profit Taxes Revised, 1974" the average effective Federal tax rate on corporate profits dropped from 43.3 percent in 1971 to 34.0 percent in the first quarter of 1974—a rate which probably dropped still further in 1975, due to the increase in the investment tax credit and in the corporate surtax exemption.

Given the dramatic and well-known inequities of the tax structure, it is no wonder the American people are beginning to lose faith and confidence in the American political system.

It has been 7 years since enactment of the Tax Reform Act of 1969 that any major change has been made in the tax structure. Yet, in the economic crisis gripping this country during the last 2 years, unique and critical demands have begun to make themselves felt on the Nation's budget. For revenues to meet these increased demands, they must continue to grow, but this unnecessary growth will be severely curtailed unless and until gross tax injustices are eliminated and the wealthy are required to pay their fair share of taxes.

Tax expenditures are not only often inequitable, they are uncontrollable as well.

It is noteworthy that since 1968, the tax expenditure budget has been growing just as fast or faster than the national debt, GNP, budget outlays, or total revenues. In 1968, tax expenditures resulted in a revenue loss of $44.14 billion; in 1977 the value of tax expenditures will have risen by an astronomical rate of 140 percent to $105.9 billion. Moreover, the Congressional Budget Office in its 5-year projections predicts the tax expenditure budget will rise to approximately $150 billion by 1981.

Obviously, tax expenditures have become an increasingly important part of the Federal budget. Yet, pointing to the way in which tax expenditures have grown, the inequities they produce, and the manner in which they have quietly eroded the tax base, is not to say that all tax expenditures are inherently bad. There are many tax provisions designed to help taxpayers meet certain basic needs, such as emergency medical care and housing, or to induce economic activity considered by everyone to be vital to the Nation.

It is those subsidies that serve no public purpose at all which should be eliminated. What are needed are reasonable criteria against which expenditures may be ranked and judged. We must look at each subsidy in terms of the legitimacy of its goals, and whether it is meeting those goals, in terms of whom it benefits and to what extent, and who would be hurt by the subsidy's elimination. And, of course, with those subsidies that benefit wealthy individuals and corporations almost exclusively, we must ask the difficult questions of whether any national goal at all is served by continuing the subsidy, whether windfall profits are being earned at the Govermnent's expense, thus ultimately at taxpayers' expense, and to what extent the equity and progressivity of the whole tax system is undermined by continuing the subsidy.

Certainly, at a minimum, those subsidies that concentrate benefits in the higher income brackets must be examined with great care: they are, by their very nature, suspect. If the Federal Government is going to spend money to support or reward certain activities, it does not make sense to do so under a system which provides the highest benefits to those with the highest incomes.

It is ironic that at the same time the President proposes to cut Federal spending, he does not propose a reduction in, much less the elimination of, a single tax expenditure with the exception of the earned income provision. Moreover, the tax proposals of the President would disproportionately reward high-income corporations and individuals: The earned income credit would be discontinued, payroll taxes would rise significantly and additional stock ownership, estate tax and accelerated depreciation incentives woud be instituted. The Council on National Priorities and Resources believes that the President's tax proposals are without merit and would be positively harmful to poor and middle-income workers.

A general principle in reforming the tax code should be to eliminate those deductions, credits and deferrals that are available only to the wealthy and hence distort the progressivity of the tax structure, and those that do not serve any legitimate Government objective. By repealing those loopholes, tax rates on all citizens could be dramatically reduced, and important Government services could be more adequately funded.

It is also important to evaluate tax expenditures against their possible alternatives--specifically as opposed to direct Govermnent expenditure programs. There are a variety of ways to provide Government financial assistance—direct grants, loans, interest subsidies, guarantees of loan repayment or interest payments, insurance on investments, and tax incentives. Given a congressional decision to provide assistance to a particular group, Congress should decide how to furnish such assistance with more careful consideration than it has in the past, and not automatically enact a new tax expenditure. Tax incentives should be enacted only when they can be demonstrated to be the best and most efficient way of meeting a goal.

There are four major principles or criteria by which we believe every tax expenditure should be evaluated by the taxwriting committees of the Senate and House.

First: A tax expenditure must, at least minimally, achieve an objective that is considered nationally desirable, whether stimulating the economy or encouraging home ownership or some other purpose.

Second: It must achieve its objective efficiently that is, it must result in a greater dollar value to the individuals, corporations, or activities involved than is lost to the treasury through the tax expenditure, and it must be administratively simple to implement and enforce. DISC is an example of a tax expenditure that fails to fulfill both of these "efficiency" criteria.

Third: Its benefits must be distributed in an equitable and fair manner. Thus, tax expenditures must not benefit only the wealthy nor result in windfall profits nor needlessly benefit those who would carry on the subsidized activity without any tax incentive.

Fourth: The tax expenditure must not unduly complicate the tax code. The tax system is complex enough as it is, and to have a large number of tax incentives side by side with provisions making up the structure of the tax itself can only cause confusion. A tax system whose innumerable and often needless complexities require the interpretative abilities of thousands of accountants, lawyers, economists, and long hours of work by ordinary citizens is in dire need of simplification, so that it can be quickly understood by everyone.

Most Americans agree with the principle that a tax system should be equitable and should tax income and wealth in a progressive fashion, thereby serving to redistribute resources in our society. Stated simply, these notions require that persons in similar circumstances with similar incomes and assets should be taxed alike, and those who have more should pay more than those who have less. In addition, the tax system must implement a sound fiscal policy, since it is by means of altering revenue and expenditure levels, or by adjusting the monetary system, that the Governent can influence the Nation's economy. Perhaps most importantly, the tax system must raise revenues adequate to meet the Government's expenditure needs.

Today, it is primarily the equity and progressivity of the system that are in question. It is the second feature which insures an important and dynamic redistribution of wealth and resources in the society. Yet, the present tax system, rather than redistributing income to the majority of people at the lower end of the economic ladder, has become a contributor, through its many loopholes, to the maldistribution of wealth.

However, with respect to fiscal policy, too, there are problems caused by tax loopholes. The myriad of tax incentives and preferences in the system today greatly decrease the ability of the Governent to maintain control over the management of its priorities—control both over the types of programs it wishes to implement and over the amounts it wishes to spend. The careless enactment and continuation of tax expenditures runs counter to the whole thrust of recent concerns over the ordering of national priorities, and the wise allocation of our resources—resources which we have come to view as limited, and in need of careful management. Tax expenditures are typically outside of expenditure limits placed on the budget by Congress or the President.

The Council of National Priorities and Resources believes that Congress should regularly review and reenact tax expenditures in the same way as direct expenditures—so that each tax expenditure is up for renewal every year. Adopting an annual review and renew procedure would, at the very lease, ensure that tax expenditures receive the attention they warrant.

In view of the many problems with our tax code caused by the huge numbers of tax incentives, we set forth below some of the most flagrant loopholes and abuses of our present tax laws which should be quickly eliminated. Our list is by no means a comprehensive or exhaustive program for reform. Other tax expenditures not covered here also deserve review. But with the program we recommend, the Nation would begin to take bold strides in the direction of true equity and progressivity. Notably, the tax package we propose would give substantial tax relief to low and moderate income taxpayers by insuring that others pay their fair share and by refunding money through a tax credit mechanis.

Our proposals for tax justice and a more understandable tax code include: (1) Repeal of tax expenditures providing excessive profits to corporations and serving no national purpose, including the accelerated depreciation allowance, the investment tax credit, and percentage depletion for independent oil and gas companies and hard mineral producers; (2) Repeal of tax incentives that favor foreign over domestic investment, including deferral of income from foreign subsidiaries, domestic international sales corporations, DISC, and Western Hemisphere and less developed country corporations, as well as changeover from the foreign tax credit to a deduction; (3) Strengthening the minium tax concept, elimination of the maximum tax and the $100 dividend exclusion, full taxation of capital gains; (4) Refor of the individual income tax to replace present deductions and exeptions with tax credits, including a refundable credit; (5) Integration of the estate and gift taxes as well as the elimination of the generation-skipping trust and the 100 percent estate charitable deduction; (6) Analysis of the social security payroll tax to deterine how the burden of the tax in low income groups could best be alleviated; (7) Extension of the Tax Reduction Act of 1975.

Mr. Chairman, in an effort to conserve your time, I will not read the remainder of my statement, but I would ask that it be placed in the record.

Senator TALMADGE. Without objection, the balance of your written statement will be placed in the record.

Thank you very much. We thank you for your contribution and your recommendations will be given every consideration. Thank you very much.

[The balance of Miss Bannon's statement follows. Oral testimony resumes on p. 378.]

BALANCE OF STATEMENT OF MISS BANNON

The tax reforms suggested here illustrate the individual concerns of many of the constituent organizations participating in the Council on National Priorities and Resources. However, while the organizations share a basic concern that the nation's tax laws must be consistent with the objective of meeting human needs and support the thrust of the proposals presented here, they are not necessarily in a position to endorse or to be knowledgeable about all of the specific reforms presented.

Investment Tax Credit

The investment tax credit was first created as a general stimulative tool in 1962 to spur the economy during times of recession. The credit reduces taxes by a percentage of the taxpayers investment in machinery and equipment—currently, a 10% credit is allowed. Thus, if a business spends $10,000 on new equipment, it may deduct $1,000 from its tax bill. The tax incentive is meant to encourage plant modernization and expansion, in order to increase productivity and employment.

There is little question that the investment tax credit has been an aid in stimulating investment. The question, rather, is whether it has been directed at those areas of the economy and at those industries in greatest need. Many factors indicate that it has not been. Investment in machinery and equipment is not necessarily a top priority need during depressed economic periods. Efforts should be directed toward creating and stimulating employment and toward labor intensive industries: heavy investors in machinery are not necessarily large employers. In fact, plant expansion during high unemployment is often useless because businesses are already operating at less than full capacity and cannot hire enough workers to even utilize existing machinery. Increased investments in such a situation may help help alleviate future bottlenecks, but little is achieved in immediate relief to the unemployed. The employment argument is further weakened by the fact that increased productivity through modernized equipment is more likely to result in fewer workers employed than before.

There are naturally industries which can benefit from additional and modernized equipment and increase their employment level, but the investment credit is not limited to such areas. Direct subsidies to needy industries and geographical areas are a much more efficient and economical way of achieving the credit's purpose. Direct and selective assistance insures that the right businesses are being helped without a tax giveaway to undeserving industries.

The investment tax credit is a waste of taxpayers' money anytime the credit is used for normal replacement of machinery. Even plant expansion is generally a response to increased levels of demand, so that often the credit is simply a bonus to businesses who would be making the same investments without the credit.

The use of the investment tax credit as a counter-cyclical tool to spur investment has beenseriously questioned by many economists. The little data that exists indicates that the primary effect of the investment tax credit comes after a recession—in fact, in the middle of the recovery. By adding to the crest of economic expansion, the credit may actually be harmful.

The investment tax credit is also inequitable because of the types of businesses it *excludes*. It does not cover construction, which in many industries is an important part of expansion and modernization. Likewise, it does not help the depressed housing industry. But more importantly, the tax credit excludes many businesses simply because it is a stimulus conducted through the tax system. Many taxpayers cannot take advantage of the credit because they do not pay taxes: without a tax bill, one cannot receive a tax credit. This includes businesses which are just beginning or ones that are failing, who are not making enough money to incur a tax liability. These are the businesses which are most in need of aid, yet the credit bypasses them. Tax-exempt businesses and non-profit organizations, such as hospitals and government organizations do not receive any benefits from the investment tax credit either.

The investment tax credit will constitute a loss to the Treasury of $1.5 billion in 1977. Considering the many problems with the credit, this is an immense and unjustified waste of the American taxpayers' money—and it is the taxpayer who eventually pays for others' tax breaks. Congress should move to repeal this unfair tax expenditure and consider alternative ways of stimulating those portions of the economy most in need of assistance.

Asset Depreciation Range

The asset depreciation range tax allowance was originally designed as a companion tax expenditure to the investment tax credit. Directed exclusively at relieving taxes on business investments, it has even less merit than the investment credit. ADR sets useful lives for business assets as a guide for computing depreciation deductions. The guidelines originally established in 1962 were deliberately shorter than the actual lives of assets, as an investment incentive and to give businesses the benefit of the doubt in estimated lives. A "ratio reserve test" was set up to allow for shorter or longer lives for businesses whose asset retirement practices differed significantly from the guidelines.

In 1971 the ADR system underwent changes which completely removed its justification as an accounting device and made it simply a tax giveaway. Asset "lives" were reduced 20%, which leaves no correlation between the actual life of an asset and the life used in allowing depreciation deductions. The reserve ratio test was abolished, so that there is no allowance for individual business variations. The result is that companies spread deductions over a short period, which gives very substantial tax benefits during the depreciation range period. The defenders of ADR contend that it is merely a tax deferral—large deductions taken immediately mean no deductions in later years. But a tax deferral is not a mere technicality—it represents an interest-free loan to the taxpayer. The money saved is available for increased investment and profit. Furthermore, as businesses continue to acuire assets, the free loan is continually renewed. As Harvard tax expert Stanley Surrey explains it, "In a stable business, as each asset is replaced, the deferral of tax on that asset offsets increased taxes on other asset as their deferral is ended, so that the orginal deferral in effect is never made up. In a growing business, the additional assets contribute still more deferral." (Surrey, *Pathways to Tax Reform*, 1973)

Proponents of ADR who admit to the benefits of the deferral resort to other arguments in support of the tax break. One claim is that assets cost more to replace because of inflation, so businesses need a compensatory tax bonus. One wonders if these supporters are aware that everyone is affected by inflation, but not everyone receives a taxe break to make up for it. Another argument brings up the double taxation issue—the fact that corporate income is taxed first to the company and again to the shareholders when it is given out in dividends. This supposedly justifies an unrelated tax break. Defenders also claim that other countries have liberal tax laws for business investment so American companies deserve the same advantages. (Of course, other countries also have much more progressive and equitable taxes on individuals—yet we have not changed our laws to conform to theirs.) Not only do none of these defense have much logical support, ADR should not be used as a solution to these "problems". If a problem indeed exists, it should be handled directly rather than giving indiscriminate tax relief through ADR.

The other defense of ADR is the same as for the investment tax credit—it is needed as an incentive for modernization and expansion. This argument is subject to the same weaknesses described in connection with the credit, and certainly two methods shouldn't be used to achieve the same goal. Again, if industries are indeed in trouble, the most sensible solution is to utilize direct subsidies. Thus, the asset depreciation range should be returned to its functions as a realistic measure of asset lives. It is time to put a stop to such exhorbitant revenue waste.

Unfortunately, the Administration has decided not to include ADR in its list of tax expenditures, stating that it is a "reasonable" depreciation allowance and thus not a subsidy. We believe such a large tax break—which allows "asset lives" much shorter than industry averages—should be included in the tax expenditure budget. The present ADR loophole will be responsible for a loss to the Treasury of $1.8 billion in 1977.

PERCENTAGE DEPLETION

Despite the recent changes made in the oil depletion allowance as part of the Tax Reduction of 1975, the depletion allowance remains fully in effect for tens of thousands of oil, gas and mineral producers.

Percentage depletionallows the producer of oil, gas and other minerals to deduct 22% of the income derived from production in computing taxes. Just as unfairly, it allows landowners to deduct from U.S. taxes the same percentage from royalty income, those payments made to him by mineral companies in exchange for drilling.

Because the deduction is computed as a fixed percentage of sales, up to 50% of the net income from a property, those mineral producers with the greatest profit receive the greatest benefits from the subsidy; those on the verge of bankruptcy and with low profits—those most in need of government assistance—receive little or no benefit from the allowance.

The percentage depletion loophole is an expensive one, given the large amounts of money it channels to large oil firms. Percentage depletion deductions against domestic production allow oil companies to deduct, on the average, approximately 16 times the total dollar cost of the wells. The revenue loss to the Treasury totals $1.58 billion, even after the major reduction made by the Tax Reducation Act.

The present system of percentage depletion allowance has three major effects: 1) It lowers the price of oil and gas, thereby stimulating public demand; 2) It distorts the allocation of resources, resulting in overall economic inefficiency; and 3) According to a 1969 Treasury Department study, it provides higher profits and royalties to landowners, foreign states and oil companies. None of these results would seem to be in the public interest at a time when we are trying to restrict petroleum consumption, and when oil company profits are at unprecedented high levels. Moreover, a major justification of the percentage depletion allowance—that it provides the large quantities of the capital needed to discover and produce oil—would seem to be superfluous: companies with high profits and the potential of even higher profits already possess the requisite incentive for production. Domestic oil exploration and development is at record highs, due largely to the marketplace incentive of increased crude oil prices. Although percentage depletion was cut from 27.5% to 22% in 1971, drilling footage in 1974 totalled 158 million feet compared to an annual average of 149 million feet in 1967-69, and overall exploration and development expenditures were at an all time high.

Moreover, whatever justification there was for the percentage depletion allowance when originally enacted—that justification has been critically undermined by recent Congressional action repealing the allowance for "large" oil and gas producers while still leaving it intact for producers earning millions of dollars of profits each year. Independent oil producers as defined in the tax cut bill are not small. A firm that produces 2,000 barrels of oil per day, the cutoff size, will usually earn about 7.5 million dollars per year, a figure which places the firm in the top one percent of all U.S. firms. Moreover, today the independents are getting the highest prices, earning the highest profit margins and paying the least taxes of all oil firms. Their typical rate of return on equity capital is a whopping 25%. Because of the now selective nature of the oil depletion allowance, independent producers are not only making high windfall profits but stand to make still higher profits as large producers raise oil prices to compensate for the loss of percentage depletion.

There is no rational justification for granting percentage depletion to independent oil and gas producers (for up to 2,000 barrels per day of oil or 6,000,000 cubic feet of natural gas). The amount of tax-free income thus exempted comes to $1,606,000 per year.

The fundamental defects of percentage depletion become clear again when analyzing the tax loophole it provides to the producers of hard minerals—coal, metals, etc. Originally extended to coal and other minerals to make them more competitive with oil and gas, the percentage depletion was later liberalized still further to provide tax relief to producers of clam and oyster shells, sand and gravel, stone, etc. It is arguable that with oil and gas depletion eliminated, equity considerations demand the same sort of cutbacks in the allowance for hard minerals. Moreover, as with oil and gas depletion the percentage depletion system fails to provide encouragement or incentives to those producers most in need of help; the system discourages efforts to conserve scarce resources, as well as efforts to recover minerals from the sea or to recycle used materials.

DOMESTIC INTERNATIONAL SALES CORPORATIONS

The Domestic International Sales Corporation, commonly known as DISC, is a device for reducing the income taxes of firms that export U.S. products. Technically, the DISC program involves the "deferral" of taxes on one-half of a DISC's export profits—but in practice the deferral of taxes has amounted to complete forgiveness of tax liability. Because of the windfall benefits made available to corporations under this tax subsidy, many large U.S. firms have spun off special export subsidiaries in order to take advantage of the tax gimmick and substantially cut their tax bill.

When enacted in 1972, DISC's were intended to encourage the export of domestic products and, in that way, to remedy our adverse balance of payments problem. Thus, the DISC provision directly counteracts other tax incentives (e.g., the deferral of income from foreign subsidiaries) with the opposite—that of stimulating foreign investment. The elimination of the one would eliminate the excuse for the other.

Fortunately, when the DISC mechanism was created, an evaluation report was required by 1975. Both the Treasury and the Office of Management and Budget have concluded that the DISC tax expenditure should be eliminated. The revenue loss resulting from DISC has gotten totally out of hand. When enacted, the Treasury projected its cost to be $170 million in 1973; in fact, the cost in that year turned out to be $770 million. The Treasury Department estimates that DISC will cost taxpayers as much as $1.4 billion this year and $1.6 billion in 1977.

What's worse, these huge amounts of money do not even appear to be accomplishing any reasonable objective. From March 1972 to March 1973, the first full year for which data are available, the DISC program produced only about $400 million in additional dollars of foreign exchange—but at a program cost of $650 million. Paying $650 million to produce and export goods that earn foreign exchange of only $400 million hardly qualifies DISC as one of our efficiently run federal programs. In 1974, OMB estimates that the U.S. paid $2.6 billion to produce $1.6 billion in foreign exchange; yet, there is no proof that this $1.6 billion would not have been generated anyway. This contribution of DISC to increased export sales has not ever been convincingly demonstrated.

Not only the great cost but the inequity of DISC argue for its discontinuation. In 1972, over 80% of the 2,249 DISC's in operation were owned by corporations with assets over $100 million. Eight DISC's owned by very large companies earned 22% of all DISC profits in that year. Small business firms received almost no benefits from the DISC deferral.

Given recent changes in international economic relations—especially the adoption of a floating rate monetary system—the original justification for DISC has all but disappeared. Our balance of payments problem, largely the result of our over-valued U.S. dollars in the 1960's, has been alleviated, if not cured by the dollar devaluations of 1971 and 1973 and by the adoption of the floatingm oney standard, so that we are now able to maintain a balance of payments equilibrium without artificial subsidies like DISC.

The fact that DISC is seen by some foreign countries as discriminatory and hostile to international agreements on tariffs and trade (GATT), which outlaw export subsidies, adds further weight to the case for DISC's elimination. By artificially lowering the attractiveness of exports to large corporations, DISC has not only hurt the trade position of foreign countries, but has arguably hurt our domestic economy as well. DISC was partially responsible for spurring unwanted international sales of agricultural products in short supply —wheat, soybean, lumber, fertilizer and animal feed. Due to high foreign demand, corporations receiving DISC benefits ended up with high profits and high subsidies; consumers simply ended up with high prices.

There is no longer any compelling reason—if there ever was one—for the U.S. to continue to subsidize large and wealthy corporations in a wasteful and economically inefficient fashion. International and economic policy considerations add further arguments against continuation of DISC. We therefore support the immediate termination of this tax expenditure.

EARNINGS OF OVERSEAS SUBSIDIARIES

Foreign source income of domestic corporations is more likely to escape taxation due to inequitable tax treatment than nearly any other kind of income received by U.S. citizens or corporations. It is primarily due to favorable tax treatment of foreign incomes that oil companies in 1974 paid only 12% of their multi-billion dollar incomes on the average in taxes, and that domestic corporations with foreign incomes paid an effective U.S. tax rate in 1972 of only 5%. Moreover, the greater the income of a multi-national corporation, the more likely it was to benefit from the foreign subsidies in our tax laws, and the greater a tax break it received.

One of the major tax loopholes through which multinational corporations managed to evade paying more than minimal U.S. taxes was through operating in the form of foreign subsidiaries. Under U.S. law the income of foreign subsidiaries is not taxed until distributed or repatriated to the U.S. parent corporation as dividends. Thus, if these earnings are reinvested, or invested in third countries, a corporation can escape U.S. taxes on the income completely.

Recommendations that this tax expenditure be dropped from our tax laws have been made for some time. The Treasury advocated outright repeal in 1962. It makes sense to eliminate this foreign tax preference on the grounds that it serves no useful purpose to subsidize foreign investment over domestic investment while draining the nation of needed revenues.

By subsidizing the export of technology and productive facilities—which in turn makes necessary the importation of goods produced by these facilities—the preference needlessly exacerbates the nation's balance of payments deficit. Given the high unemployment rate here in th U.S., it is particularly crucial that we stop encouraging companies to expand overseas rather than at home where jobs are needed.

We believe that tax equity and basic notions of nationality and efficiency demand that earnings of overseas subsidiaries of domestic corporations should be taxed on a current basis.

FOREIGN TAX CREDIT

Another major tax expenditure benefiting wealth multinational corporations at the expense of the taxpaying and working public is the foreign tax credit. The tax credit, like other subsidies for foreign investment and income, contributes significantly to making corporate investment abroad more attractive than investment at home. By allowing a dollar-for-dollar credit for foreign taxes on acompany's U.S. income tax bill, we do more for a large multinational corporation than we do for the small businessman in this country. A U.S. business that pays state and local income taxes, property taxes, real property taxes, sales taxes, and value-added taxes, is allowed only a deduction for such taxes. Large multinational firms, on the other hand, are allowed a credit for foreign income taxes, a subsidy worth roughly twice as much.

The case has been persuasively made that the tax credit serves to export job opportunities needed domestically and contributes to our balance of payments problem. The real issue, though, is whether there is any important national objective served by foregoing revenue to foreign governments.

Discrimination in favor of foreign investment cannot be tolerated at a time when domestic unemployment is so high—and at a time when some feel the need for domestic capital investment is so great. The foreign incomes tax payments of U.S. corporations should be treated just like the taxes paid on domestic operations—as deductible costs of doing business.

FOREIGN TAX CREDIT OVERALL LIMITATIONS

One method of calculating the foreign tax credit, which adds to its injustice, is the overall limitation. Under the overall limitation method (as opposed to the per-country limitation), total earnings and losses from all foreign countries in which the company operates are aggregated, as are all foreign taxes. By lumping together all income and all taxes, a corporation can use credits from countries with high tax rates (such as Sweden or the Arab countries) to offset, this means that high tax countries, rather than the U.S., are collecting taxes on income earned in low-tax jurisdictions.

Certainly, we do not want companies to be required to pay full taxes to two or more different countries. et, it is senseless to encourage companies to arrange subsidiaries and branches in such way as to avoid all U.S. taxes. There is no national interest that dictates we give massive tax breaks to corporations simply because of the fortuitous circumstance that they do business in a certain set of countries. Nor is there any reason to give high tax countries those taxes we would otherwise have collected. Thus, at a minimum, if the foreign tax credit is *not* eliminated, the overall limitation method of calculating the foreign credit should be phased out.

TREATMENT OF ROYALTIES

Payments made by oil companies to OPEC nations should be classified as royalties and be treated as deductions on the companies' U.S. taxes. By claiming such fees as income taxes rather than royalties, multinational oil companies have been able to credit their U.S. tax bill for the amount paid, and thereby realize huge profits without having to pay correspondingly high taxes. In fact, this provision is one of the main reasons major oil companies with billion dollar incomes paid as little as 2 or 3 percent of their income in taxes.

Excess tax credits generated from oil production—even after offsets allowed under the overall limitation for low taxes paid to other countries—totaled almost a billion dollars in 1971 and undoubtedly much more in the last few years of immense oil industry and oil country profits. There is no good reason for the U.S. to continue to subsidize high profit companies in this manner at such exorbitant and wasteful cost to taxpayers.

OTHER TAX PREFERENCES FOR FOREIGN SOURCE INCOME

There are two other tax subsidies accorded foreign source income which ought to be eliminated: 1) The 14% reduction in the U.S. tax rate for Western Hemisphere Trade Corporations, and 2) The deduction for foreign income taxes which is allowed Less Developed Country Corporations.

Western Hemisphere Trade Corporations benefits were originally instituted in response to the immense tax burden imposed on a few corporations doing business in Latin America in World War II. The effect today, however, is to provide unwarranted and unneeded subsidies to U.S. firms exporting products to Latin America and to those engaged in natural resources activities in Latin America. In fact, of the $345 million cost of this subsidy in 1972, $196 million or 57% went to mineral industries—chiefly to the oil corporations.

Compounding the inherent inequities of the tax expenditure, a broad IRS interpretation has allowed corporations to obtain the Western Hemisphere benefits even on goods manufactured outside this hemisphere, simply by manipulating the title of goods sold.

The Western Hemisphere tax gimmick serves mainly to complicate existing corporate tax law without providing substantial benefits to the nation. It is only reasonable and internationally prudent that income from all foreign sources be taxed at the same rate, and that Latin American countries not be favored over other nations.

Similar reasons exist for repealing Less Developed Country Corporations' (LDCC) deductions. Presently, the earnings of LDCC subsidiaries, like those of other subsidiaries, can be deferred indefinitely. In addition, though, foreign taxes paid on the dividends of subsidiaries, when transmitted to the parent corporation, receive both a credit and a deduction on U.S. taxes.

It would seem much wiser to extend U.S. subsidies to those underdeveloped and Latin American countries we wish to assist in the form of direct loans, grants and technical assistance. Not only could such assistance be better targeted and more closely aligned with our international interest, but it would very likely be more effective in helping underdeveloped nations achieve well balanced growth.

MINIMUM TAX

The federal tax system is so riddled with tax exclusions, deductions, deferrals and preferential rates that some taxpayers manage to end up with little or no taxable income. The wealthy individual, with good accounting advice, can invest in bonds, business ventures, and in capital for the sole purpose of sheltering his income from taxation. Corporations can also take full advantage of tax preferences to the extent that their final tax bill is negligible. The "minimum tax", enacted in 1970, was a token effort by Congress to rectify the situation. It acknowledges that everyone should pay at least some tax, but the law is so weak that it is next to ineffectual.

The minimum tax is calculated by adding up certain areas of non-taxable income: the excluded part of capital gains income, accelerated depreciation on real estate in excess of straight-line depreciation, percentage depletion allowance, rapid amortization of certain investments, and excess reserves for bad debts. From this total is subtracted the taxpayers' regular tax plus $30,000. A 10% tax is imposed on the remaining amount.

It is obvious why the minimum tax has done little to alleviate tax injustice. (In 1971, after the tax was enacted, there were still nearly 500 individuals with income over $100,000 who paid no taxes whatsoever, including several millionaires.) The tax preferences covered by the minimum tax are by no means the only loopholes available; the tax should be extended to the many other kinds of excluded incomein the tax laws. Moreover, the subtraction of the regular tax paid from the total of the preference items greatly cripples the tax's impact. More reasonably, the minimum tax should be a supplemental tax to the regular tax, since the fact that someone is paying normal taxes should not shield him from taxation on otherwise excluded income.

The $30,000 floor in unreasonably high especially when the taxpayer's regular tax has already been subtracted. It is far too large an amount of money to escape taxation. The minimum tax is meant to affect taxpayers who derive a substantial amount of income from tax preference interests, but a person who has even $10,000 is excluded income is not exactly a member of the lower income classes. Imposing the minimum tax on all preference income above $10,000 at most would be more appropriate.

Another problem with the tax is that it is not progressive—the 10% applies whether the taxpayer is earning $30,000 or $300,000 in preference income. It has no relation to normally taxable income—in fact, because of the subtraction of the regular tax in computing the minimum tax, as taxable income rises, the amount of preference income subject to the minimum tax is decreased. This is completely contrary to the principle of progressive taxation, particularly when the normal rate for most of the taxpayers affected by the minimum tax is as high as 70%.

In a truly equitable tax system, there would be no need for a minimum tax. It is a shameful admission of the fact that our tax code invites widespread exploitation. Ideally, this should be recitified through the repeal of the unfair tax expenditures. But until that goal is reached, the minimum tax should be strengthened by lowering the floor, enlarging the list of preference items, making the tax progressive, and making it an addition to the regular tax. Several billion dollars in revenues would be generated through these changes, compared to the mere $182 million raised by the minimum tax in 1973.

MAXIMUM TAX

In 1969, Congress arrived at an interesting recognition of the problem of tax preferences. They saw that unearned income was benefiting from all kinds of tax breaks, so rather than attacking these tax breaks they decided earned income should have its share of relief too. The "maximum tax" was established, which places a 50% tax rate ceiling on earned income.

The House Ways and Means Committee explained that the maximum tax would "reduce the incentive for engaging in (tax avoidance) activities by reducing the high tax rates on earned income." It is an unreasonably optimistic view of human nature to presume that presenting someone with an easy method of tax reduction will lull him into ignoring the more complex ways of escaping taxes. The maximum tax is simply an extra bonus handed to the wealthy taxpayer, serving to further reduce his tax burden.

While at first glance it may seem reasonable that no one should have to pay more than a 50% marginal rate on earnings, closer analysis reveals that such concern is misplaced. Nearly anyone earning enough to worry about paying higher than a 50% rate also has income from unearned sources—income which is subject to little or no taxes. Thus, while an individual may indeed be paying 50% on a large salary, he may be paying no taxes on income excluded or reduced through tax expenditures. In this case the overall tax rate may actually be as little as 10 or 20%.

The maximum tax is not founded on any logical evaluation of the tax system. It singles out earned income for special tax treatment, but total income is the only valid base on which tax rates should be imposed. With all the special tax preferences available to the rich, it is an extremely rare taxpayer who pays more than a 50% overall rate. If serious tax refor is enacted so that unusually high overall rates become a problem, this can be rectified through a change in the basic rate structure. As of now, however, the maximum tax on earned income should be immediately repealed.

$100 DIVIDEND EXCLUSION

Current tax law permits a taxpayer's first $100 of dividends from corporate stock to be excluded from taxable income. While this is one tax expenditure theoretically available to lower income taxpayers as well as the wealth, most of the benefits are still realized by those in the upper income brackets. This is simply because most stock holders are in the higher income range. In FY 1974, 57.5% of the benefits went to 14.6% of the taxpayers—those with incomes over $20,000.

There is no reason for the government to favor this select economic activity over other. It should not be the government's role to encourage investment in stocks over, for example, investment in savings accounts. Repeal of this tax expenditure will save the Treasury $350 million.

MARITAL STATUS AND INCOME TAXATION

Despite the reforms made in 1969, the current tax rate scheduling procedures continue to discriminate against both single and married persons, particularly when both partners work. Certainly different people have differing living expenses and obligations, but individual responsibilities should be accounted for through the allowance of tax credits rather than through the use of different tax rates based on marital status. Congress must reevaluate the split-income concept implemented in 1948 and must respond to the need for a tax schedule with a single rate that will be applicable to each level of taxable income.

Joseph Pechman and Benjamin Okner estimated that income splitting (and the special rates for heads of households that are part of it) costs the Treasury over $32 billion per year (at 1976 levels). More significantly, 94% of these tax benefits go to taxpayers with incomes above $10,000 since low and moderate income taxpayers receive virtually no benefit from income splitting.

The 1969 Act reduced the penalty on single taxpayers who do not have the advantages of income-splitting by 20%, but the individual taxpayer (never married, widowed, divorced, or married but filing singly) still pays on a sliding scale up to 20% more than couples who can split their incomes.

Simply stated, there is no logical reason to continue the present system whereby a single person must pay more in taxes than a married couple with an identifiable amount of taxable income. The 16th amendment did not tax people. It taxed "income from whatever source derived." Clearly it does not imply that one shall be taxed according to marital status.

Although the income-splitting concept is defended as an aid to those with child rearing responsibilities, under present law single persons filing as heads of households are unfairly penalized. A single parent earning $8,000 pays $100 more in taxes than the married couple with one income. At an income of $16,000 this penalty rises to $280 (regardless of whether the couple has any dependents).

As a result of changes in federal tax law in 1969, married couples who both work often pay higher taxes than if both were single. Certainly this tax structure which, intentionally or not, favors those families with only one working partner must be adapted to the realities of today, when often both partners work either by choice or by necessity. While the need for extra funds is felt most heavily in the lower income brackets, the law bestows its greatest advantages on the middle and upper income groups. The advantage is given principally to one-income families and not to those in which the wife's income is a significant supplement.

Clearly, review of the tax structure is needed to ensure that tax rates do not penalize single individuals or handicap those families with two or more workers. Although the substitution of tax credits for present deductions and exemptions, as recommended in the next two sections, will alleviate most ineuities, alternations in the tax rates will probably also be needed.

ITEMIZED AND STANDARD DEDUCTIONS

The present system of deducting certain personal expenses from gross income, or alternatively using the standard deduction, is a regressive factor in our tax system. This occurs because of the way deductions are tied to the marginal rate structure. If an individual in a 70% tax bracket gives $100 to charity, $100 is excluded from the income on which he would normally be paying $70 in taxes. Therefore, his $100 contribution has actually cost him only $30. On the other hand, a taxpayer paying at a 14% rate saves only $14 by deducting the same $100 contribution. Why should identical contributions (or medical expenses or mortgage payments) be so much more advantageous to the wealthy taxpayer?

This ineuity can easily be changed by substituting a system of tax credits. The credit is computed as a percentage of the itemized expense, and then subtracted from the individual's tax bill. Using a 25% credit, a $100 charitable contribution would subtract $25 from the taxpayer's total taxes, regardless of his tax bracket. This means equal credit for equal expenses. High income taxpayers will still receive more credit than those with lower incomes, but only because their personal expenses are generally larger.

Taxpayers using the standard deduction rather than itemizing expenditures would instead receive 25% of the deduction as a credit. This gives some tax relief to lower income taxpayers, who most often use the standard deuction.

A 25% credit for both the standard deduction and itemized deductions would, according to recent figures generated by George Break and Joseph Pechman of the Brookings Institution, result in a revenue gain of $6 billion a year, and substantially benefit low and middle-income taxpayers.

REFUNDABLE TAX CREDIT

The $750 dollar personal exemption is another regressive tax provision. Again because of the marginal tax rate, a $750 exclusion is worth $252 to someone in the 70% bracket, but only $105 to a person in the 14% bracket, while to an individual so poor he pays no tax, it is worth nothing. The exemption should be converted to a credit, and it can at the same time be a major tool for tax relief and restoring progressivity to our tax system. As a refundable credit of $250, when the credit exceeds the tax liability, the difference would be paid *to* the taxpayer by the government.

Current measures for helping the poor in our society have proved to be inadequate and limited. There are still many families living well below the poverty level, because they are ineligible for government assistance or do not receive enough to meet their needs. This is particularly true with today's phenominally high unemployment rate. A refundable tax credit for each taxpayer and dependent would add considerably to the incomes of those with little or no money. Moreover, putting money in the hands of those less well off is an important counter-recessionary tool, because it goes right back into the economy through consumer purchases.

The $250 credit would provide relief to the middle income taxpayer also—in fact, taxpayers up to the $20,000 income bracket would benefit from the credit. Middle income wage earners now bear an unfairly heavy tax burden. They don't have money to take advantage of tax expenditures, and they suffer the most from the regressive social security tax. Tax relief for these individuals is long overdue.

The cost of the refundable tax credit would be large—the 1974 estimate was $13 billion—but the closing of major tax loopholes would more than compensate for this loss.

CAPITAL GAINS

Under the capital gains provisions of the tax code, only half of the gains on capital assets (real estate, stocks, and equipment) held more than six months are included in the income of an individual. The other half is deducted from income and thus never taxed.

Although special treatment of capital gains results in a huge loss of revenue annually, it is not included in OMB's tax expenditure analysis because of "practical problems" involved in identifying and taxing unrealized capital gains. Yet it is estimated that this 50% capital gains exclusion costs the Treasury about $7.4 billion per year—more than any other single tax expenditure.

What's worse, most of the benefits of the capital gains tax breaks go to the wealth. A full two-thirds of the benefits go to the 1.2% of taxpayers with incomes exceeding $50,000. This is because it is largely the wealthy who own stock; 78% of all Americans cannot afford to own stock, according to a 1971 University of Michigan survey. The last round of inflation may have cut down even further on the small group of wealthy taxpayers who stand to benefit from the capital gains exclusion.

Thus, it is not surprising that Treasury Department statistics indicate that taxpayers with incomes of $10–$15,000 received, on the average, $19.06 from the exclusion, those with incomes over $100,000, an average of $19,431 per taxpayer.

One argument typically made in favor of capital gains preferences is that it compensates the investor for inflationary—as opposed to real—increases in the value of an investment. It is noteworthy, however, that no other form of income receives such an adjustment. There is no logical reason to single out capital assets.

The inequity of the capital gains exclusion clearly argues for its repeal. There is no reason why income from assets should be favored over earned income. Capital gains should be subject to full taxation just like wages. In addition, appreciation of capital assets, should be taxed at death, with some exceptions and exclusions for surviving spouses, farms and family businesses.

POLITICAL ACTIVITIES OF FOUNDATIONS

Privately supported charitable and educational organizations are granted exemption from taxation principally under section 501(c)(3) of the Internal Revenue Code. In order to maintain this tax-exempt status organizations must comply with the requirement that "no substantial part" of their activities is devoted to influencing legislation or campaign activties. It has long been recognized that there is no specific test or other reasonable means of ascertaining the meaning of the word "substantial" as it is used in this section. Several attempts to clarify the situation in the past have proved unsuccessful. The 1969 act (26 USC4925) also imposed a 10% tax on each taxable expenditure of a foundation. Taxable expenditures under the act basically include money spent "on any attempt to influence legislation . . ." Together these limitations on influencing legislation are so broad, and so costly if violated, that these groups are discouraged from expanding their activities into areas touching upon public policy. In addition, the wording of section 4945 is so broad as to suggest that any attempt to affect the opinion of the public on any matter that might conceivably relate to legislation might incur penalties.

These strictures adversely affect the freedom of foundations and other groups to contribute to the general welfare. In the past, foundation-sponsored programs and activities have often led to a recognition that changes were needed in local or national conditions and that new legislation was required. It is clear that the legislative intent was to prevent foundations from engaging in partisan politics. In light of this purpose, modifications should be made so as to enable the language of the law to reflect more accurately the desires of Congress and leave room for legitimate functioning of foundations on behalf of the general welfare.

While charitable and educational organizations are limited by the "no substantial part . . ." requirement, business organizations, trade associations and unions have the right to engage in such activities without quantitative restriction. Congress must now reconsider the ABA recommendation that it pass legislation with respect to tax exempt organizations. Certainly if the goals of these organiztions are such that the Congress has found them to be worthy of tax-exempt status they arguably should be able to use their expertise to influence legislation in promotion of these established goals.

TAX STATUS OF FOUNDATIONS

As a result of the Tax Reform Act of 1969, foundations are faced with the threat of a diminishleng capacity to support those charities which are dependent upon them for their survival.

The 4% excise tax upon investment income of private foundations was originally intended to fund the administrative costs of IRS enforcement of provisions affecting the creation, operation, termination of foundations, as well as the flow of their monies under the 1969 act. In reality, the revenues produced by this tax have been much greater than the cost of administration of all tax exempt organizations. Unless this distortion is remedied, what was essentially an audit assessment will continue to be, in effect, an indirect tax upon private charity itself. This is contrary to a strong Congressional tradition of supporting private philanthropy. While same moy claim that 4%

is not an excessively high tax, it nevertheless establishes a poor precedent for the future. Regardless of whether the foundation can afford the tax, the larger question is whether the private sector can afford such a reduction in funding. The most effective means of dealing with this problem would be prompt establishment of a flexible rate system which would be adjusted from time to time todeal with changes in administrative costs. In the interest of the institutions and persons who are the potential beneficiaries of foundation activity, we urge that the level of the excise tax be adjusted to the real cost of administering the law.

The "payout" requirement for private foundations has also had a negative impact. The rate of growth of foundation assets is in fact dependent on their payout rates (grants as a percentage of assets) relative to the rate of return on their assets. The combination of rising costs of foundation-supported activities and the high payout requirements under the act would seem to imply a decline in the future role of foundations. Especially in view of the budgetary restraints on the expansion of governmental social programs, the needs for services which foundations meet are not likely to diminish, and there is urgent need for re-examination of required annual payout requirements and the disincentives to the establishment of new foundations.

Congress has properly mandated that foundations should use their resources for the full benefit of those they are designed to serve. While no foundation would argue with this principle, the law presents problems. Foundation services are highly labor-intensive and offer few opportunities for increased productivity. Therefore their costs of operation rise faster than inflation in other sectors of the enecomy. This factor coupled with the high payout requirement would appear to indicate the probability of a progressive decline in the real support power of existing foundation funds. Congress must act to lower minimum payout requirements and establish larger transition periods for meeting these requirements. Foundations have been diligent in their adherence to the requirement of the 1969 Act; and there is no reason to believe that lowering distribution reuirements would result in "hoarding" of funds by foundations. Foundations should not be forced to make greater payouts and settle for investment returns which a prudent investor would find unreasonable. To retain the present rule risks a possibly fatal impact on the future of such organizations.

ESTATE AND GIFT INTEGRATION

In principle, taxes on gifts and inheritances constitute a potential source of equity and progressivity in our system. Levied on wealth rather than on income, the estate and gift taxes fall primarily on the rich. Roughly, five percent of estates are subject to estate tax in any year. Two-tenths of one percent of all estates, those in the $500,000 and over bracket, paid 60% of the total estate tax bill in 1970, the most recent year for which data is available.

From the standpoint of fairness, the estate and gift taxes serve an important function—that of breaking up vast holdings of wealth and thereby ensuring that democracy is not jeopardized by the emergence of self-perpetuating concentrations of wealth. Especially in today's society, characterized by massive holdings of wealth by a few individuals, it is critical to deal with the problem of equitably distributing the nation's wealth.

Taxing the transfer of wealth at death has long been recognized both in the U.S. and abroad as a sound procedure. Because the estate tax is imposed at death, it is a relatively painless way of raising substantial government revenues. There is no one who feels sharply the impact of the tax, so that it has minimal effect, if any, on incentives and risk-taking. Moreover, it should not be forgotten that the income tax specifically exempts income received by gift or bequest, so that estate and gift taxes fill in a critical gap in the tax system. Moreover, the Treasury Department estimates that between 40% and 50% of the value of estates represents untaxed capital gains—real estate and other possessions that increased in value while the owner held them, a value which was never subject to income tax during the life of the owner. Given this relationship between estates and income taxation, the estate and gift taxes merely ensure that all wealth is taxed at least once in each generation.

Unfortunately, the revenue-raising and equity-producing potential of the estate tax has been seriously eroded by the separate rate schedules of the estate and gift taxes, by the generation-skipping trust, and by the deduction for charitable contributions.

The basic form of the estate and gift taxes has remained generally the same since 1942: separate estate and gift taxes, graduated upward as the value of the taxable estate increases, are imposed on wealth transferred at death. However, because of the separate exemption and rate structures, an individual who allocates a $1,000,000 estate equally between gifts and bequests pays estate taxes of $247,055, while if he passes on the estate entirely through bequest, he pays $75,000 more in taxes, a total of $325,700. Such reductions in tax liability are made possible through liberal exemptions (gift tax exemptions of $30,000 in lifetime gifts plus $3,000 per donee, estate tax exemptions of $60,000) and through generously low gift tax rates, which are 25% lower than the already low estate tax rates.

The value of the gift tax incentive rises dramatically with wealth, since not only are the wealthy better able to donate their money to others, but they are able to give more money to more people.

There is little or no value from the government's viewpoint in encouraging gifts over inheritances in this way. Whether an individual chooses to give property to his or her children before death should logically be a matter between the individual and his or her children. The nation is not particularly benefitted one way or another.

Given the inequities caused by imposing separate tax and rate schedules on gifts and bequests, and the tax complexities resulting from maintaining two separate taxes, it is our recommendation that the two taxes be combined. One tax rate should be imposed on all gifts made over the lifetime of the donor and on those gifts made before death, with total taxes at death correspondingly reduced.

GENERATION-SKIPPING TRUSTS

One major loophole in the present estate tax which significantly curbs the revenue-gathering capacity and detracts from the impartiality and equity of the tax is the generation-skipping trust. ~~By~~ establishing a trust meant for remote descendents, a wealthy individual can transfer money to his grandchildren while avoiding estate taxation. Yet, his immediate family can receive all of the income from the trust fund, along with a healthy share of the principal, and make many of the critical decisions, along with a healthy share of the principal, and make many of the critical decisions about the disposition and management of the property. In this way, the property—belonging for all intents and purposes to those who manage it and spend it—can escape taxes as many as three times simply because the property is not owned outright.

As a result of this abuse of the estate tax law, control of wealth and property can pass undisturbed from one generation to the next. Three out of every five millionaires transfer a portion of their property and wealth in trust, and half of this property and wealth escapes all estate and gift taxes until the death of the grandchildren or great grandchildren.

The device of the generation-skipping trust—so valuable to families of great wealth—is of limited value to those of moderate means. For a variety of economic reasons, those with small estates must leave their property to their immediate family, since those of moderate means cannot be sure that their wives and children will not need the money for medical or other emergencies. It is not until family wealth becomes to immense that no conceivable emergency could deplete the family's resources, that the generation-skipping trust becomes a valuable and invariably used tax shelter. Thus, while those with great wealth escape tax action, those with moderate holdings must pay estate taxes each generation.

To remedy the present inequity, the federal government should enact a surtax (in addition to the regular estate and gift taxes) on transfers of wealth that skip a generation. Such a surtax—if imposed at a rate equal to 60% of the donor's marginal estate or gift tax rate—would to some extent equalize the taxes paid by those who transfer money through use of the trust mechanism and those who are unable to resort to such mechanisms. The Treasury Studies proposal of 1969 recommended a 60% substitute tax or surtax on generation-skipping trusts in order to collect those taxes that would otherwise be foregone. We support such an approach to the problem posed by thte generation-skipping trust, since it would eliminate the most outrageous inequities of the existing loopholes.

THE ESTATE CHARITABLE DEDUCTION

Provisions in the present estate tax law which allow an estate to take an unlimited tax deduction for bequests made to qualified charities is one feature of the present estate tax framework drastically in need of correction. It is this loophole which allowed Alisa Mellon Bruce, with an estate valued at $580 million, to pay taxes less than 1% in federal estate tax when she died, simply because the bulk of her estate went to the Mellon Foundation, a tax-exempt charity. A similar unlimited charitable deduction is allowed under the gift tax.

The millionaires who take advantage of this deduction have for the most part retained control over their money even after giving it to charity. This is accomplished simply by transferring the non-voting stock of a family corporation to a private "family" foundation. By transferring only non-voting stock to the foundation, the family retains control over the business.

As desirable as voluntary giving to charitable organizations may be, there is little justification for allowing a 100% deduction in the case of a transfer to a private foundation. Recently there has been much criticism and questtioning in general of the government's proper role with respect to such charitable organizations, as well as extensive analysis of whether various tax incentives now on the books significantly stimulate voluntary giving in support of charitable causes.

In contrast to the overly generous estate tax giveaway, the income tax limits charitable deductions to 50% of income. It would be a relatively modest and sensible change with little impact except on those few millionaires with private foundations, to limit the estate and gift tax deduction of 50% of the value of the estate (or the value of life-time gifts), in keeping with the 50% limitation under the income tax.

SOCIAL SECURITY TAX

The current structure of the payroll tax is inconsistent with principles of tax equity and progressivity. Under present law, a 5.85% tax (11.7% including employer contribution) is imposed on all earnings, up to a maximum base of $15,300 ($16,500 in 1977). This setup presents a number of problems to low and middle-income workers.

For the low income worker, the social security tax becomes the highest tax he pays, higher than regular income tax. There are no provisions to exempt the poor from being taxed, such as the standard deduction and personal exemption in the income tax system. As a result, the payroll tax is the larger tax for more than half of all workers—those earning up to $15,000.

Any attempts to alleviate the tax burden of the income tax on those with low incomes are thwarted by the fact that the poor are still suffering an unduly heavy social security tax.

The social security tax unfairly assumes that equal income means equal ability to pay. The income tax system recognized that a taxpayer with dependents should not pay as much as the single taxpayer; equity distates that the payroll tax should take this into account also.

The middle income worker is treated unfairly too, since he is paying the same amount of tax as the wealthiest wage earner: $895 (5.85% of $15,300 is the maximum any individual is required to pay. At the same time, the middle income worker does not receive the same benefits in proportion to payments as does the low income worker.

The inequity of the social security tax deserves special consideration at this point in time, when the trust fund itself appears to be in trouble. For over a year now, from both in an dout of government, there has come a succession of increasingly bleak reports on the soundness of the social security trust fund. The system is now paying more in benefits than it is receiving in taxes—about $1.5 billion more in 1975 and a projected $4 billion more in 1976. If nothing is done soon to increase funding, trust fund reserves will be exhausted by the early 1980's.

Congress has a number of alternatives from which to choose in order to stabilize the trust fund and in order to make the social security tax more progressive. First the maximum earnings base subject to tax can be increased from its present level of $15,300 to $24,000. This increase of $9,000 in the wage base would return the program to its original intent—that all workers should have their full wages counted toward social security benefits and subject to the payroll tax. Today only about 85% of the workers covered by social security have their total earnings counted, while in 1938 the proportion was much higher—97%. Moreover, by raising the wage base, the contribution rate would not have to be increased and the security of the trust fund would be firmly established. Second, employer contributions to the social security system can be increased to comprise more than half of total costs. This is particularly justifiable in view of the fact that the employers' contribution is tax deductible as a business cost while the workers' contribution is part of taxable income. Third, and perhaps most important, the Congress could enact stand-by authority to use general revenues for the financing of social security whenever necessary. This could be done simply by restoring to the social security law the provision for general revenue financing that existed from 1944-1950.

It is also important to extend the 10% refundable tax credit enacted in 1975 to low-income individuals without children. Although the tax credit does not directly increase the progressivity of the Social Security tax, it does alleviate the burden of the tax on the poor.

In the long run, we may do best to follow the example of foreign social insurance systems and enact a combined retirement and health insurance structure financed partly by employer contributions, partly by employee contributions and partly by contributions from the government, out of general revenues, in recognition of the nation's stake in, and the critical importance of, a well-functioning social insurance system.

It is clear that the tax system is in need of major reform, and the Council has outlined a program which would be an important step in the direction of tax justice. Fiscal policy considerations also make it critically important that the Congress extend the Tax Reduction Act of 1975 through fiscal 1977.

The tax expenditure concerns of the Council on National Priorities and Resources are directly responsive to our concern for meeting the needs of our country. Comprehensive tax reform along the lines outlined here will go far toward meeting the needs of all Americans for adequate income by alleviating the heavy tax burden that now falls on low and middle-income workers. We pledge ourselves to continue working with you as you begin to remedy the defects of our tax system, and we welcome the continuation of the dialogue begun here today.

Senator TALMADGE. Our next witness is George S. Koch, Chairman of the Council of State Chambers of Commerce.

STATEMENT OF GEORGE S. KOCH, CHAIRMAN OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE; ACCOMPANIED BY EUGENE RINTA, EXECUTIVE COUNSEL

Mr. KOCH. Mr. Chairman, my name is George Koch, Finance Chairman of the Council of State Chambers of Commerce. I am accompanied by our Executive Counsel, Mr. Rinta.

Mr. Chairman and Members of the Finance Committee, we appreciate this opportunity to present our views on several tax issues on your agenda. We believe the items contained in our more detailed statement filed with your committee are among the most important tax issues which deserve your current consideration.

The issues we wish to emphasize today fall broadly into two categories. One is capital accumulation or formation. The other is taxation of foreign source income.

CAPITAL FORMATION

I want first to refer to capital accumulation.

No one can doubt that capital needs in the years ahead will be enormous. There may be differences in estimates of the amount of such capital needed, but the validity of any estimate of such future needs has to depend on the objectives to be attained through such accumulation. For example, we are convinced that the U.S. rate of capital accumulation is currently too low to promote satisfactory economic growth and will remain too low in the future under existing circumstances. This objective reflects the view of economists that increasing capital accumulation through investment now will create future increased consumption with its attendant advantages which would more than justify current sacrifies. These economic advantages have been articulated by the economists. Of course, a major one is the creation of permanent jobs.

Given net major advantages from increased current capital accumulation, we are satisfied that selective changes in our tax laws offer the most fertile field for encouraging such increases.

Our prepared statement discusses the changes we believe should be made through reduction of the unwise bias against capital which exists today in our tax structure.

The changes we urge are briefly as follows:

First: A capital cost recovery system should be adopted as an option to the present depreciation system for recovering the costs of capital assets. This optional system should permit recovery of the full costs of investments in machinery and equipment in five years and the costs of industrial buildings in ten years.

Second: The present temporary rate of 10 percent for the investment credit should be made permanent.

Third: Deduction of the entire cost of government-mandated pollution control facilities should be permitted over any period of years the taxpayer chooses.

Fourth: The double taxation of corporate income should be eliminated by permitting a deduction to the corporation for dividends paid to stockholders.

Fifth: Sharply increasing needs for savings and investment calls for a lessening instead of an increase in the tax burden on capital gains. Provisions of the House-approved tax reform bill relating to the minimum income tax would substantially increase the tax on many capital gains and should be rejected.

As noted in our prepared statement, in offering several proposals to improve capital accumulation, we recognize that enactment of these proposals with full, immediate effect may not be fiscally feasible. A significant start, however, in phasing-in these proposals should be undertaken. But whatever the estimated initial cost in revenue we submit that the return on that cost to the Nation would more than justify the effort to accommodate it.

We urge that a good start be made now.

TAXATION OF FOREIGN INCOME

I would like now to refer to proposed changes called for in some quarters, in the taxation of foreign source income.

This tax issue has two basic parts. One is known as deferral of U.S. income tax on income earned abroad. The other is the credit allowed for income taxes paid abroad. It might be said at the outset that these two items have remained unchanged in their basic form since the beginning of our income tax. The structure of these items has been incorporated in numerous tax treaties negotiated around the world. American enterprises have been developed worldwide in reliance on these long-standing provisions.

Recently, however, their use has somehow become an abuse of our tax law in the eyes of some. Why this is so is impossible to understand as a matter of good tax policy.

In the case of an established foreign corporation which is operating in a developed country it is most probable that its local income taxes are equal to the U.S. level of tax. Thus, any dividend from that company to a U.S. owner would incur no U.S. tax through the operation. But if it were in a country where a tax holiday was in effect or the level of income tax was below the U.S. level, then a U.S. tax would have to be paid equal to the difference in the tax levels. This would be true even though no dividend was paid by the foreign company if deferral were repealed. The result would be that the U.S. interest in that case would be non-competitive with interests from many other countries whose tax laws were not like ours.

Were deferral eliminated from our tax law it would seem most likely that the countries where the income was earned would find a way to raise their taxes on the U.S. interests so that there would be no U.S. tax anyway after credit. This obviously would not solve the noncompetition position of the U.S. interest unless such local increase were applied to all enterprises. Even so, there would be no revenue for the United States in any case from repeal of deferral.

Official estimates of the revenue to be derived by the United States from repeal of deferral are in the $300 million to $400 million range. But for reasons we gave in our statement, we believe that this initial revenue gain would, before many years, be turned into a permanent net revenue loss to the United States among other losses.

As for the foreign tax credit, the level of taxation all over the world simply precludes the ability to pay tax twice on the same income. Consequently, any repeal or important reduction of the credit allowance would render U.S. enterprise noncompetitive throughout the world.

We urge your committee and the Congress to reject proposals for repeal of deferral and reduction or repeal of the foreign tax credit as it is not in the United States interests.

I am pleased to point out that all of our 32-member State chamber organizations have endorsed the views presented in our statement.

Thank you, Mr. Chairman.

The CHAIRMAN. Are there any questions, gentlemen?

Senator Talmadge?

Senator TALMADGE. Thank you. You have made an outstanding appearance here in raising the point that raising adequate capital is a problem.

The only problem in Congress is getting the votes. You realize a lot of people in Congress have made a career out of demagoging the capitalistic system. That is what it amounts to.

Mr. KOCH. We heard a little bit of that this morning.
The CHAIRMAN. Senator Fannin.

CAPITAL COST RECOVERY

Senator FANNIN. I want to commend you for your statement and very valuable information. I know one of your great concerns is capital formation. The chamber and the organizations with which you are affiliated have made similar recommendations. The amount of capital that is going to be needed in the next decade is just beyond comprehension.

I am wondering in view of your summary, you say allow a deduction to the extent chosen by the individual taxpayer.

That includes a writeoff in the year it occurs?

Mr. KOCH. Yes, it could be.

Senator FANNIN. In other words, it gives him the ability to take the writeoff at the time when it would be most benefiical to them from the standpoint of accomplishing the objectives they have in increasing their plants' beneficial operations.

I agree with you wholeheartedly; this is a cost that must be absorbed from the standpoint of the capital investment. Isn't a matter of the initial problems, the increased costs of production as a result of pollution-free equipment?

Mr. KOCH. Yes; which are nonproductive assets.

Senator FANNIN. Those are written off in the year they occur.

Mr. KOCH. Yes.

Senator FANNIN. They just reduce the amount of income that accrues to the company in many instances because of the increased cost of production.

Mr. KOCH. It also serves to reduce the amount of capital availability.

Senator FANNIN. I realize that, especially in the utility industry it has been quite a burden for them. I know in the processing industry it has been a tremendous burden.

I very much appreciate your statement and I am certainly in agreement with your objectives.

Thank you, Mr. Chairman.

CORPORATE TAXATION

The CHAIRMAN. Mr. Koch, I am going to say something which I did not believe when I first came to Congress. It took me a long time to arrive at this conclusion, but I believe it is correct. It is something I heard Secretary Simon say on a Nation-wide TV program. I told a couple of people the exact same thing prior to hearing him say it; I like to think I said it before he did. He said that corporations don't pay taxes—people pay taxes. In other words, it would be just as though we levied a tax on your house. The house does not pay the tax, the man who lives there pays it. Many times we levy a tax aimed at one man but actually it is somebody else who has to pick up the tab.

For example. I have oftentimes felt that the social security tax is not a tax that the employee pays. I was discussing that with George Meany one time, when I was thinking about the proposal which eventually became the earned income credit for low income people. He did not see what I was driving at. He said "you know, really Senator, the employer pays the taxes, not the employees." He said that in the last analysis, that portion is taken out of the employee's paycheck and he never sees it, and we are kidding ourselves to say that the employee is being paid $1,000 a month if you are taking out 12 percent before he sees it and he is not taking it home and not spending it. The employer is the guy who is paying it. Isn't that right?

Mr. KOCH. I agree with you.

The CHAIRMAN. If you were a corporation, you could not stay in business unless you could make a profit over and above expenses. Otherwise, if you were just breaking even, you would get out of the business. A corporation is in business to make a profit. If it cannot make a profit, it goes out of business—sometimes a lot quicker than one would think. The sooner the owner realizes he cannot make make money, the sooner he gets out.

At the time we were working on the Tax Reform Act of 1969, the staff informed me that the taxes we levied on corporations for the most part were being levied on individuals because the corporations would and could pass that tax onto the public. They said that if you are talking about the final impact of the tax, somewhere between 50 and 75 percent would be on the individual rather than on the corporations. Since that time I have concluded that 100 percent of all corporate taxes must be passed onto the public. Otherwise, the corporations can't stay in business. Is that correct or not?

Mr. KOCH. Senator, I have had this view for years and I really believe that it is accurate.

One thing you can do, you can keep changing the rules so that it is difficult for the price structure to catch up with. Of course, competition gets into the act. I am not an expert in this field but I have thought about it a lot but I just agree with what you have said.

The CHAIRMAN. In some cases, by putting a tax on the corporation you are taxing the shareholders, but if you think you are taxing the corporation, that is short range thinking. Either the shareholder has to absorb that tax or the consumer will have to absorb it. In the long run, the corporation has to make a profit, and taxes are just like any other expense. He has to make a profit after all expenses, including taxes.

MINIMUM TAX

I have been thinking about sponsoring a minimum type income tax rather than the LAL proposal which the Treasury is recommending and which the House sent to us. It seems to me that if a man is doing a lot of drilling and he is in the oil business, or he goes into the real estate business and invests a lot of money to give people jobs—which is something we might want to encourage—or perhaps gives money to colleges and charities, no matter how many socially desirable things he does, we still ought to expect him to pay some minimal amount of taxes to the Government. It seems to me that on some basis we ought to say, let's just take a look at what the man made on the theory that he ought to pay some minimal amount of taxes. We should treat all the tax breaks the same whether he is getting his tax break because he is donating to a university or whether he is producing a lot of energy or in the process of paying for his own home or whatever that course of conduct may be.

Do you find some appeal to a minimal tax that people would pay regardless of how many socially desirable things they do?

Mr. KOCH. What we need is a minimal rather than additional tax. Your concept, the need for some minimal tax, I think, is sound purely from a matter of politics today. I just think the way people have been educated on this subject—and I really think they really have gotten only one side of the story—but, nevertheless, I think we have to have something in the law to that effect, yes.

The CHAIRMAN. When John Rockefeller came down to testify before the Ways and Means committee sometime back, he testified that although the kind of activity he is in consists entirely of educational, charitable and public interest type things, if you look at all the donations he makes to charity and that sort of thing, he really does not owe any income tax. But he pays some because he thinks the people should help support the Government.

I read a letter by Mr. Wriston in which he was suggesting you ought to repeal the whole tax law and start all over again where you pay a simple tax of no more than 30 and have practically no deductions. I don't think we are going to get from here to there immediately, although I think most business people think that would be a good idea. I know Secretary Simon made a speech about that. How do you feel about that type of approach?

Mr. RINTA. I think that would create considerable disincentives with respect to investments of various types, of the type you were talking about, Mr. Chairman, and others. Suppose, for example, you make long-term gains taxable at the full rate. If that level were set at 30 percent, it would be approximately what the capital rate is now. It is 25 percent. Of course, it can be less than 25 percent but for substantial capital gains, it runs in that area. But who is to say that the rate would remain at 30 percent.

The CHAIRMAN. That is one of the problems, of course. It seems to me you are touching something business people ought to be concerned about, because if we proposed that, I would be willing to bet you a dollar against a donut that somebody would be on the Senate floor seeking to raise the top rate to somewhere between 50 and 60 percent so that when they got through with it, it would not be the minimum you are talking about. You would have no deductions but they would slug you although you did all sorts of social desirable things. Perhaps 50 percent in many respects is counterproductive.

TAX SIMPLIFICATION

It seems to me though that we could go a long way in moving toward tax uniformity. I am not saying we should make everything uniform, but we should move along in that direction. We should start out by making the simple form more attractive to taxpayers and the long itemized form less desirable. We could shift about two-thirds of those people using the itemized deductions over to short forms, and then simplify the code. There are too many places where it says you get a deduction but you don't unless you do something else and except that and so on and so forth—so that by the time you get through, if you are like I am, you spend all night trying to read something and after you have been at it for 8 hours, you still don't know what the fool thing means. I think we could greatly simplify all of those things by providing a minimum tax and say no matter what, you still owe some minimal amount.

Mr. KOCH. The easiest simplification in the world would be to have a gross income tax but as you point out we would start out with a low rate structure to justify what we have done and the first thing you know you have the rate structure back up to where it is with no deductions.

The CHAIRMAN. You would find somebody coming in and saying that a poor man should not be paying anything so let's leave him out. They then would say, here is another man who has a lot of income and he can pay a great deal more than that, so let's raise his rate. I suspect by the time you got through you would wind up with most of the objections you find in the code now. I hope not, but I am afraid that is how it would work out.

I am confident if you try to do that, every problem that confronts us now we would still have to look at again. If you take everything in the tax code which stands for a taxpayer's question of what he does about one thing or another, I think you would have to look at every one of those things all over again to say how would you like to handle this. Do you see other ways to meet that problem?

Mr. RINTA. It is really the only way. When the minimum tax was originally proposed, groups like ours said instead of going into this let's look at all the preferences. Why do we have it and should we have it?

The CHAIRMAN. Where we do that, I think it is well, about once every Congress, for us to go back and review all those, taking a look and asking whether we want to continue doing business this way or not. Do you think it is still desirable to encourage somebody to give something to education, to the universities? I for one don't think we give them enough encouragement. I think we should make it more attractive for people to donate to universities. They are hard up for money. Instead of toughening things up we should give them a break they are not getting now.

Mr. KOCH. It is a very difficult problem. I would hate to have the task of having to take the code and simplify it to make it satisfactory to the country. I think it would be a prolonger hopeless task.

The CHAIRMAN. I wish sometime you would take a look at what the State of Louisiana has done with regard to its income tax. I don't think there is a simpler procedure in America. All you do is take your Federal income tax and answer about two questions. One, how much income did you report to the Federal Government? Two, how many deductions are you claiming? Then you just look at a chart. There is a bracket system so the chart shows if you are claiming two deductions and you made so much money, you owe so much. It tends to graduate in the upper brackets by thousands of dollars. If you are making $70,000 you pay the same thing as if you are making $70,999. That is a very low tax rate, the theory being you would not know in advance whether you are going to fall at the upper end or lower bracket. So we follow the same principal with regard to the sales tax.

Instead of carrying a bunch of tokens around in your pocket, you pay a penny or if it is less than ½-cent you don't pay any tax at all.

Just in terms of simplicity, it has so much to recommend it, and I would suggest you take a look at it. Every State would do well to follow that system.

Mr. KOCH. I am not familiar with your State's procedure there, but I know in New York some years ago they adopted a constitutional amendment which permitted them to incorporate the Federal income tax as their law. All you do is track the Federal. You take it off the Federal, compute a tax and send it in. If you look at it today, there has been some odds and ends added to it and you have to make this and that adjustment and you really have to stand on your head to make the return.

The CHAIRMAN. Louisiana conformed its law to the Federal law, making about 70 changes in the process. Then they put in a bracket system where you run your figure down a chart and where the two lines, cross, that is what you owe. A State poll was taken about 8 years ago and most of the people said they felt the State Revenue Department was doing a bad job. Recently in a poll most of the people said they were doing a good job. I think it was perhaps the way they changed the tax forms to make them simple.

In 3 minutes or less, you can fill out your Louisiana State tax return. If we could get the Federal tax law that simple, I think people would be very happy.

Mr. KOCH. If you will indulge me just a couple of minutes, I recall an anecdote. Several years ago I had occasion to go to England. We were examining the foreign tax credit system of the British tax law. The more I read the more confused I got in terms of knowing something about the foreign tax credit system. Finally I said to one of their experts 1 day "You know your law is a lot more complicated than ours." He scratched his head a moment and finally said "We have been at it longer than you have."

CAPITAL COST RECOVERY

Senator HARRY F. BYRD, JR. Let me ask you just a couple of brief questions. In regard to your capital cost recovery recommendations, your recommendations are based for the most part but not entirely on depreciation schedule. Do I read that correctly?

Mr. RINTA. The capital cost recovery is a proposal to get away from depreciation and useful life as such and set up a cost recovery under which the taxpayer would recover machinery and equipment over 5 years.

Senator HARRY F. BYRD, JR. It is essentially liberalized depreciation.

Mr. RINTA. In substance, yes, that is what it would be.

Senator HARRY F. BYRD, JR. That would be the largest part of your program?

Mr. RINTA. It is, and it would produce the greatest increments to capital formation because depreciation now is the most substantial part of cash flow from within the company itself.

Senator HARRY F. BYRD, JR. I was interested in those figures on page 2 which you presented on the GE study. I frankly did not realize the cash flow from depreciation would be that great in proportion to the total.

Mr. RINTA. Those are the figures they have, and it is typical. Depreciation is a very substantial part, and a majority of cash flow.

Senator HARRY F. BYRD, JR. Return to earnings represents a small part?

Mr. RINTA. That is earnings after taxes and dividends, of course.

Senator HARRY F. BYRD, JR. But it represents only less than 15 percent, it appears to me, of the total; is that correct?

Mr. RINTA. That is right.

DISC

Senator HARRY F. BYRD, JR. Give me your view on the value of DISC and whether DISC should be continued.

Mr. RINTA. When DISC was originally proposed, we favored it. We testified in support of it. Mr. Koch and I appeared. We do not have adequate statistics and we do not believe the Treasury or anybody else has to prove exactly at this time, having operated it a couple of years, as to the extent of the benefits of DISC in adding to exports of this country. But we believe that it should be continued at least until that can be better determined than it is now. We have no doubt that it has significantly increased exports.

Senator HARRY F. BYRD, JR. Do you think it has?

Mr. RINTA. Yes, and specifically from getting into the export business by many of the small companies which would never have thought of trying to export.

Senator HARRY F. BYRD, JR. Thank you, Mr. Rinta, and Mr. Chairman.

The CHAIRMAN. Do you agree with the action the House took on DISC?

Mr. RINTA. We would rather see it kept the way it is. What they did is better than repealing it.

The CHAIRMAN. Would you explain what they did?

Mr. RINTA. Basically, it is an incremental approach. DISC benefits would be granted for increases in export business above a base period.

The CHAIRMAN. So under their approach, you get a tax deferral on your export business, I take it, insofar as it exceeds what you were doing before, is that it?

Mr. RINTA. That is right; it is a tax deferral.

The CHAIRMAN. Will that amount to a substantial increase for some taxpayers, the way the House has it?

Mr. RINTA. Yes. I do not have the House report figures, but it would substantially reduce the estimated current revenues from DISC.

The CHAIRMAN. One thing people fail to take into account about some of these tax proposals is the jobs which are created by the investment tax credit or the DISC. If you repeal those provisions, you are not going to have those jobs.

Mr. KOCH. Exactly.

The CHAIRMAN. The President might be in error, but he said that the jobs in that public works bill which he vetoed would be about

$25,000 a job. I do not have any doubt insofar as making jobs by the DISC provision; it is not costing the Treasury anything. In fact, over the long run, I would suspect it would make the Treasury money.

Mr. RINTA. We make that statement on revenue impact and to the effect that there is an initial negative revenue impact. The position we take, for example, is that increased economic activity in not too long a time would offset revenue loss and produce greater revenues. This has been demonstrated not only here but in other countries.

MINIMUM TAX

The CHAIRMAN. A very dear friend of mine is a welder. He gets high pay for some of the projects on which he works, and a man can really make a lot of money if he is a good welder. That fellow is a single man, and when he finds himself moving up toward the 50 percent tax bracket, he arranges to be laid off. He doesn't quit. He tells the union to lay him off. The boss dismisses him so he can draw unemployment benefits. Then he proceeds to go hunting, fishing, or just sits around in the nearby bistro just passing the time of day watching football games and drinking beer and talking to the boys.

The weather gets nice after Mardi Gras, and he goes back to work until he gets into the high bracket again. One could say, tax him 70 percent. But, as a practical matter, you do not make anything by taxing him more. When that man is not working, it is costing us a lot of jobs. For example, on the offshore platforms, the limiting factor on how many oil wells we can drill depends on how many platforms we have. When that welder takes off, it means you do not have as many platforms, and you cannot hire as many roughnecks as you would on the drilling rigs. That means you don't have crew boats going back servicing the rig, so you have to lay some of those people off.

At the steel mill, if they do not have somebody to weld the pipes, there is no sense in making more. When that man quits working, he takes other people off the job, too. That man changes from a taxpayer to a tax eater for about 4 months out of the year and he changes about three other fellows from taxpayers to tax easters. Show me some estimate of where we are going to increase revenue by increasing that tax on earned income from 50 to 70 percent, as some advocate. I tell you that has just got to be an erroneous assumption. I believe that you would probably agree with that, would you not?

Mr. KOCH. By all means.

FEDERAL MATCHING FUNDS

The CHAIRMAN. A while back, our dear friend, Senator Ribicoff advocated giving 75 percent matching to States that provide social services for poor people. The initial cost estimate was only $48 million a year. The actual cost threatened to rise $4 billion. If you have to put up $3 every time somebody puts up $1, you ought to assume that fellow might put up some more dough. If you came in here and said, "I will match $15 against your $5.00," I would be trading $5 bills all day long.

The same mistake was made with regard to medicaid. That program was estimated to cost about $200 million a year, and now the total program is costing about $16 billion. When you start putting up all that Federal money to match State money, the State will put up more, and they will try to change their way of doing business so as to get the most Federal matching. Before we brought the social services program under control, Mississippi was getting ready to declare education and highways as social services. Mississippi didn't make it, but before we shut off the spigot, they wanted to ask us to put up $450 million for social services. It was estimated originally to cost $40 million for the whole program, and Mississippi tried to get $450 million just for Mississippi.

MINIMUM TAX

People fail to look at the consequential results of these things. They tend to want to look at these things and say that this many people are doing this and, therefore, if you double the tax on them, you pick up twice as much money. They fail to recognize that if you are going to put all that much tax on people, they are going to change their way of doing business.

It used to be that you would have a heavyweight champion fight about once a year or so. Muhammed Ali would have one fight. He would figure the Government was going to get it all anyway, so he would fight once a year. Now he can keep half the money, which means he pays half in taxes. You and I know every time he spends a dollar, that dollar bears all sorts of consumer taxes. He is absorbing the social security tax passed on to him as a consumer, and he is paying property taxes, and all sorts of other taxes.

But if you put the rate down to where it is not counterproductive, you would collect a lot more money on that man than putting the tax up whereby the time you make $50,000, he says at that point he is not going to do it. If he can't find a way to cheat, he is just not going to do anymore fighting. It is sort of foolish for Congress to pass these counterproductive laws. I hope we will learn a lesson one of these days.

I think you two gentlemen have given us fine suggestions. I think everybody ought to pay something to support this Government, and I think they all ought to pay a reasonable amount, no matter how socially desirable their activities are. But I hope we will stop the counterproductive things that cost the Government a great deal of revenue and result in all sorts of antisocial conduct.

You have testified for that concept, as I see it, and I hope that we can benefit from some philosophy of what you have suggested here.

Mr. KOCH. Your task is not an easy one, but we certainly hope this goes the way you would like for it to go, Senator.

The CHAIRMAN. Some of your people might be well advised to make a return trip to Washington. I think the Finance Committee is not going to tax you out of business. It just does not seem within the power of the U.S. Senate to destroy this country because, if it was, I am afraid this country just would not be here today.

[The prepared statement of the Council of State Chambers of Commerce follows:]

STATEMENT ON BEHALF OF MEMBER STATE CHAMBERS OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE BY GEORGE S. KOCH, CHAIRMAN OF THE COUNCIL'S FEDERAL FINANCE COMMITTEE AND EUGENE F. RINTA, EXECUTIVE DIRECTOR OF THE COUNCIL

Mr. Chairman and Members of the Committee on Finance, we appreciate having this opportunity to present our views on several of the important tax issues on the agenda of these hearings. The views and recommendations that we submit for your consideration are the result of extensive discussion and debate within the Federal Finance Committee of the Council of State Chambers of Commerce. Moreover, they have been endorsed by all of the 32 member state chamber organizations in the Council as listed on the last page of this statement.

The matters which we cover in this statement relate basically to the broad issues of capital formation and taxation of foreign source income. They include not only the basic issues but also certain provisions of the House-passed tax reform bill, H.R. 10612, and tax proposals in the President's budget for 1977 which bear on capital formation and foreign income taxation.

INCREASED CAPITAL FORMATION AND JOBS

Capital investment needs in the years ahead will be huge. Several studies in the last year or two have estimated the private domestic investment need over the next decade in the $4–4½ trillion range. This is about three times the total expended for capital investment in the decade ended in 1973. While there seems to be general agreement in these studies as to the overall dimensions of private investment needs during the next decade, there are differences of opinion as to the economic conditions and fiscal and tax policies under which the needs could be met.

For example, a Brookings Institution study last year indicated that capital needs of business in the 1974–80 period could be met if the Federal budget were in substantial surplus over this period. This is hardly a realistic expectation based on the past record. In contrast to the Brookings analysis, a study by General Electric Company placed needed capital investment by non-financial corporations during the 1977X80 period at $50 billion a year in excess of the amount available from conventional sources under present tax policies.

In its study GE placed the average annual need at $312 billion as compared with $183 billion invested in 1974. Available to meet this $312 billion annual need would be a naverage annual amount of $262 billion raised as follows: $120 billion from depreciation, $36 billion in retained earnings, $96 billion in new debt, and $10 billion from new equity issues. Thus the gap between capital needs and availability would be $50 billion a year for non-financial corporations.

While we recognize that estimating future capital needs and availability depends on assumptions which may or may not prove correct, it is our conviction that available capital will fall seriously short of expected needs unless the present bias against capital in our income tax system is substantially reduced. For this purpose we offer several recommendations. We fully understand that enactment of all of our proposals in one session of Congress may not be feasible, either politically or for budgetary reasons. But we do urge a significant start toward materially alleviating the tax burden on capital by a phase-in process which would have relatively modest initial revenue impact.

With reference to revenue impact, we emphasize the "initial" eeffct. In the usual estimates of revenue effects of changes in the tax laws, as in estimates of so-called tax expenditures, account is not taken of the impact of the changes on economic activity and, thus, on revenues. Our proposals would accelerate economic activity, create jobs, and increase both personal and corporate incomes, thus producing greater tax revenues.

We suggest several courses of congressional action for the purposes of reducing existing tax impediments to capital formation and encouraging investment in expansion and modernization of industrial facilities. Our recommendations follow.

Capital Cost Recovery

It is self-evident that expansion and continuing modernization of industry's productive facilities are essential to sound economic growth. The Congress has, of course, recognized for many years the important role of tax policy to generate internal funds for this purpose. It has enacted such measures as the accelerated depreciation methods in 1954, the investment credit in 1962 (subsequently suspended, repealed, and reenacted in 1971), and the Asset Depreciation Range system of depreciation in 1971.

Although the congressional actions in 1971 significantly improved the rate of capital recovery, existing depreciation allowances based on the outmoded concept of useful life still do not fully take into account the rapid pace of technological advances and attendant obsolescence, the liberal recovery allowances enjoyed by foreign competitors, and the ever-increasing cost of asset replacement in an inflationary economy.

Current and long-range capital investment needs require an immediate start toward permanent and substantial improvement over the present system of recovering capital costs through depreciation allowances. Our recommendation for this purpose is enactment of a capital cost recovery system which would significantly shorten the cost recovery period. As an option to the present depreciation concept, it would improve both the incentive and the financial ability of industry to increase investments to the higher levels needed in the years ahead. The basic provisions of the capital cost recovery system we propose would be the following:

1. The cost of machinery and equipment would be recoverable for income tax purposes over a period of five years.
2. The cost of industrial buildings would be recoverable in ten years.
3. The use of present accelerated methods of computing depreciation would be permitted for computing the annual capacity recovery allowance.
4. Capital recovery would be allowed to start as expenditures are incurred, rather than at the time the property is placed in service.
5. The investment credit would be available at the full rate with respect to the capital recovery option. For purpose of the credit the useful life of property for which a capital recovery allowance election is made would be the life that would have been applicable if the election had not been made.
6. The new system would be available with respect to investments made after the effective date of the legislation and such investments would be subject to adequate recapture rules.

The proposed capital recovery system would permit the recovery of capital costs in dollars more nearly equal in purchasing power to the dollars invested, thus producing a closer approximation of "real profits" as the tax base. Under the present system the corporate income tax in an inflationary economy is to a substantial degree a tax on capital.

In addition to its basic purpose of accelerating cash flow, the capital recovery system would be a major step toward simplification by eliminating most of the complexities of the present depreciation law.

A Permanent and Stable Investment Credit

We support the President's proposal that the investment credit be made permanent at the present 10% temporary rate. The credit has been an important source of funds for capital formation. But to be fully effective, both as a source of funds and as a device to mitigate the effects ofinflation, the investment credit must be both permanent and stable so that business can better plan investment programs. Certainty and permanency of the credit are vital for planning purposes. In this connection Congress should make it clear that the investment credit is available for all machinery and equipment, including equipment for pollution control.

To permit early recovery of initial cash outlays, the investment credit should be made applicable to expenditures as they are incurred. Property eligible for the credit should not be subject to a basis adjustment which would substantially offset the benefit of the credit.

Tax Treatment of Pollution Control Investments

Government-mandated investments for pollution control have been absorbing a substantial and increasing amount of funds available to business for capital investment. This obviously has made it more difficult to obtain funds needed to finance productive investments. Unlike such investments, pollution control facilities do not expand production, improve competitive position, cut costs, or increase earnings. For these reasons the taxpayer should be permitted to deduct the entire cost of certified pollution control facilities over any period of years he desires, including the immediate write-off of the facility in the year acquired.

Double Taxation of Corporate Income

We have long held that double taxation of corporate income has been a major deterrent to the financing of business by equity capital. For over 25 years alleviation and eventual elimination of this double taxation has been a major reform in our committee's proposals for a Federal tax system designed to encourage sound economic growth.

Clearly the double taxation of corporate income—first to the corporation when earned and then to the shareholder when distributed—has been a major factor in the rapid and dangerous rise of recent years in the corporate debt-equity ratio. Data published in the Federal Reserve Bulletin of August 1975 illustrates the trend. In just nine years from 1965 to 1974 the ratio of stockholders' equity to total assets of manufacturing corporations declined from 60.8% to 50.8%. Of total funds raised by nonfinancial corporations in financial markets, equities accounted for $11.4 billion, or 24.4% of the total in 1971 but declined to $10.9 billion and 19.8% in 1972, $7.4 billion and 11.0% in 1973, and $4.1 billion and 5.3% of the total in 1974.

The best way to cause a reversal of the trend toward ever-increasing corporate debt in relation to stockholders' equity would be a phased elimination of double taxation. Last summer the Administration proposed such action and the President repeated the proposal in his 1977 budget. While we fully support this objective, we prefer a different method of its attainment than that outlined by Treasury Secretary Simon last July.

Proposals for eliminating double taxation of corporate income basically involve one of three methods. They are: deduction by the corporation for income reported as dividends by stockholders, a credit to the stockholder for the corporate tax paid on dividends he receives, or a combination of these two methods. The Administration's proposal last year called for enactment of the combination method. We prefer deduction by the corporation because it is administratively simple and because it maintains horizontal equity between taxpayers with equal amounts of income.

Capital Gains and Losses

One of the causes of inadequate capital availability is the taxation of capital gains which reduces private capital in favor of government spending and lowers individual incentives to invest in corporate equities. Congress should make no change in present taxation of capital gains which would reduce either the existing incentives to nvesti or the savings available for investment.

The House-approved tax reform bill includes two provisions affecting capital gains which would have such adverse effects. One is the extension of the holding period for long-term gains from six months to one year. The other, and more damaging, change results from amendments to the minimum tax on individuals. These amendments would increase the rate of the minimum tax from 10% to 14%, would lower the exemption for preference items from $30,000 to $20,000 and phase out the exemption at $40,000 of preferences, and would cut in half the deduction for regular taxes paid. Since one-half of net long-term capital gains are defined as a preference item, the House amendments to the present minimum tax would add substantially to the tax burden on many capital gains. Consequently, we oppose these House amendments.

Corporate Tax Rates

We support the President's recommendation to make permanent the present temporary tax rates of 20% on the first $25,000 of corporate income and 22% on the second $25,000. This would be of material help in the financing of small businesses. We also favor lowering the overall corporate tax rate as soon as practicable. It is our view, however, that other capital formation measures we are recommending should be given higher priority than a reduction in the present 48% tax rate as proposed by the President.

Incentives for Broadening of Stock Ownership

The President's proposal to induce broader ownership of common stock by providing a tax deferral for funds invested in stock purchase plans would be helpful to capital formation. We suggest that, if this proposal should be enacted, it be extended to savings and investment generally and not be limited to common stock investments.

TAXATION OF FOREIGN SOURCE INCOME

During the last several years legislative proposals have been made in the House and the Senate impose heavier tax burdens on the foreign operations of American multinational corporations. It is argued in support of such proposals that the U.S. tax system encourages foreign investment by permitting a credit for taxes paid to foreign governments and by taxing earnings of foreign subsidiaries only when they are remitted to the United States. Some proponents of change claim that such foreign investment results in the exporting of U.S. jobs, both because it reduces potential exports and results in import of products manufactured by foreign subsidiaries which displaces domestic production of the same products.

The arguments that our tax system favors foreign investment, encouraging investment abroad, and that such investment results in export of U.S. jobs are without foundation. The reason why U.S. firms establish manufacturing operations abroad generally relates to market opportunities or marketing requirements. If a foreign market can be served from a domestic plant, it will be so served through exporting. All too frequently, however, obstacles are placed in the way of exporting. These include restrictive import duties, requirements that a percentage of the product be manufactured locally, on-site inspection requirements, governmental procurement practices, and other regulatory provisions. To overcome such obstacles and to gain or retain a place in that market it becomes necessary for the U.S. producer to manufacture in that market area. Since he cannot serve that market by exports from the U.S., his only alternative would be to leave the market to others.

Overlooked by the proponents for change is the fact that foreign operations by U.S. firms are not in competition with U.S. manufacturing operations but, instead, compete with foreign-owned and foreign-based manufacturers. In those cases where foreign subsidiaries do produce for import into the U.S., as in the case of the electronics industry, U.S. manufacturers have been forced abroad to meet the competition of foreign-owned and foreign-based manufacturers. Here, too, the alternative would be either to go abroad or leave to foreign competitors the U.S. market for such products. It is significant, however, that of the total world-wide sales of American manufacturing subsidiaries abroad only a few perc nt represent sales in the United States.

Some tax reformists seek el nination of the foreign tax credit and deferral on the ground that they are tax loopholes which unfairly subsidize foreign operations of American multinationals and deprive the U.S. Treasury of tax dollars to which it has a legitimate claim. They often support their opposition to the tax credit by comparing the U.S. tax liability of individual multinational companies with their world-wide incomes and thus indicate a relatively low U.S. tax burden for such companies. But such a comparison grossly misrepresents the true tax burden of multinationals. The only proper comparisons would be world-wide tax liability against world-wide income or U.S. tax liability against U.S. income.

The only purpose of the foreign tax credit is to avoid double taxation. It does not relieve the American company from income tax liability on its foreign income unless the foreign tax on that income is equal to or greater than the U.S. tax on the same amount of income. The tax credit cannot be used to reduce tax on any U.S. source income. Countries which use this method of avoiding double taxation of foreign source income include Canada, Germany, Japan, Mexico, and the United Kingdom. The other method for avoiding double taxation is to exempt foreign income from any domestic tax. This method is used by some 25 countries including France, Italy, and the Netherlands.

If the foreign tax credit were repealed, as some have proposed, the combined foreign and U.S. income tax would approach 75% on income earned in most industrial countries. Obviously, such a tax would place American overseas investments at a fatal disadvantage with foreign competition. But any change in the credit which would introduce double taxation would pose the threat of worse to come and would discourage American investment abroad. The effect could only be damaging to the U.S. economy in the long run.

With respect to deferral, proponents of change argue that unremitted earnings of American foreign subsidiaries should be subject to U.S. tax so that all of their income would be taxed on the same basis as the income of domestic corporations. This argument overlooks the fact that foreign subsidiaries are foreign, not U.S., corporations in which local investors often have substantial interests. The U.S. parent firm is a stockholder which has taxable earnings from its investment in the subsidiary only when it receives dividends from the subsidiary. In this connection, remitted earnings from U.S. foreign affliates typically exceed over half of their after-tax earnings. This compares favorably with dividend policy of our domestic corporations. Remitted earnings received by U.S. firms have grown from $2.3 billion in 1960 to $7.3 billion in 1971 and $17.7 billion in 1974. In fact, such earnings have been the most important single positive contribution to the U.S. balance of payments.

Nevertheless, the attacks on deferral continue although its elimination would produce relatively modest revenues, at best, to the U.S. Treasury which estimates the potential at $365 million a year. No additional revenues would be obtained from subsidiaries in countries with tax rates equal to the U.S. rate. In countries with lower rates an apparent potential would exist for additional U.S. revenues by elimination of deferral. But that potential could readily become nonexistent by action of the country in which the subsidiary is located.

Since the foreign subsidiary is a foreign corporation, it would appear that the only practical way for the U.S. to tax its retained earnings would be to impute such earnings as dividends received by the U.S. parent company. If that were done by Congress, it could be expected that the foreign government would tax the imputed dividends as well as remitted dividends. With the application of the foreign tax credit, no additional U.S. revenues would be obtained from earnings of subsidiaries in industrial countries and relatively little from less-developed countries with low tax rates. Thus the principal effect of eliminating deferral would be to place U.S. companies at a disadvantage with their foreign competitors in countries which have low tax rates or offer special temporary tax concessions for locating there.

The substantial benefits to the U.S. economy resulting from overseas operations of American multinationals have been cited to your committee before and no doubt will again be detailed by witnesses during the part of these hearings specifically allotted to taxation of foreign income. Accordingly, we shall not repeat them. But we do want to point out that revisions in taxation of foreign source income which would seriously affect U.S. multinational firms would also have long-term effects far beyond these firms and their millions of stockholders and employees. These effects would include:

Less dividends from foreign sources and, therefore, less capital for creation of domestic jobs.

Less exports by U.S. parent companies to and through their foreign subsidiaries and, thus, fewer domestic jobs involved in export production and trade.

Less need on the part of parent companies for goods and services of their domestic suppliers, with a consequent adverse effect on the suppliers' sales and employment.

Lower exports and less repatriated earnings, thus worsening our balance of payments.

We submit that the threat of these damaging effects to the U.S. economy is serious if Congress should enact tax revisions adversely affecting the competitive position of American operations abroad. We would add in this connection that experience with the present DISC legislation has been too short to determine its full incentive effects on U.S. exports and recommend that it be continued without change at this time.

This completes our statement. I am pleased to state that all of the 32 member state chamber organizations in the Council have endorsed the views expressed herein. They are:

Alabama Chamber of Commerce
Arkansas State Chamber of Comm.
Colorado Assoc. of Comm. & Ind.
Connecticut Business & Ind. Assoc.
Delaware State Chamber of Comm.
Florida Chamber of Commerce
Georgia Chamber of Comm.
Indiana State Chamber of Comm.
Kansas Assoc. of Comm. & Ind.
Kentucky Chamber of Comm.
Maine State Chamber of Comm.
Maryland State Chamber of Comm.
Michigan State Chamber of Comm.
Minnesota Assoc. of Comm. & Ind.
Mississippi Economic Council
Missouri Chamber of Comm.
Montana Chamber of Comm.
New Jersey Chamber of Comm.
Empire State Chamber of Comm.
Ohio Chamber of Comm.
Oklahoma Chamber of Comm.
Pennsylvania Chamber of Comm.
South Carolina Cham. of Comm.
Greater South Dakota Assoc.
East Texas Chamber of Comm.
South Texas Chamber of Comm.
West Texas Chamber of Comm.
Lower Rio Grande Valley Chamber of Comm.
Tennessee Taxpayers Assoc.
Virginia State Chamber of Comm.
West Virginia Chamber of Comm.
Wisconsin Assoc. of Mfgrs. & Comm.

The CHAIRMAN. I have a statement here by Mr. Stephen J. Rapp, chairman of the Citizens' Committee on Tax Reform. Is he here?

If not, I will ask that his statement be printed in the record at this point. I have read Mr. Rapp's statement and it certainly deserves the consideration of the committee. I would commend all Senators to pay attention to it.

[The statement follows:]

TESTIMONY OF STEPHEN J. RAPP, CHAIRMAN, CITIZENS COMMITTEE ON TAX REFORM

Mr. Chairman: The adoption of our nation's first peacetime income tax in 1894 led one Congressional supporter to predict, "The passage of the bill will mark the dawn of a brighter day [when] . . . good, even-headed democracy will be triumphant [and will] . . . hasten an era of equality in taxation and opportunity."

Today, some 80 years later, the majority of the American people do not view our income tax law as a triumph of democracy, but rather as a cause for disillusionment in our whole democratic system. There is a sense that the tax code benefits the special interests more than it does the ordinary citizens: that it provides credits, deductions, exceptions, exemptions, and special rates to those with economic and political power, while it forces the rest of us to pay the bills.

It was in response to this feeling that our committee was formed. As citizens we wanted to study the tax law, consider proposed changes, and then seek to have an impact on the tax reform debate in the Congress. Our committee includes people from varied backgrounds—from banking, farming, law, homemaking, labor accounting, education, and public service. We are all members of special interest groups, but we are all more importantly citizens of this country who believe that our taxes must be fair and be recognized as fair by a majority of Americans if our tax law is to have the people's compliance and if our political system is to have the people's confidence.

Our committee believes that our country would be better served by a tax system with sharply reduced rates and far fewer special breaks.

We recognize that the tax law is a useful tool of economic management, and that certain tax preferences can at times provide stimulus for investment, and employment, and economic growth. But we also note that many of these preferences often outlive their usefulness and benefit many who do not need the assistance. We therefore feel that tax preferences should be treated like appropriations with their benefits weighed against those of other public expenditures. As much as is possible they should be credits, like the investment tax credit, rather than deductions, and should have specific expiration dates.

We also recognize, that the tax system contains some disincentives to investment and places excess burdens on certain business activities. We favor efforts to eliminate the discrimination between debt and equity financing and are open to individual and corporate tax integration. We, however, oppose any tax changes that would shift the burden of tax off of large businesses and high-income individuals on low-to-middle income Americans. If indeed, there is a potential capital shortage, we believe that this shortfall can best be met by federal budgetary restraint combined with across-the-board tax reductions. We reject trickle-down economics, and all efforts to redivide the American economic pie in favor of those at the top at the expense of all the rest.

Specifically, we would ask the Finance Committee to clear for the Senate a bill including the following tax reform proposals:

1. An increase of the personal exemption to $900, with an alternative $225 personal credit. The increase of the personal exemption is needed to compensate for past inflation, and the alternative of the personal credit will provide much needed relief to families making less than $20,000.

2. Provide for automatic future adjustment of the personal exemption, personal credit, standard deduction, and low income allowance to reflect inflation. Inflation is already hard enough on low-to-middle income Americans without the hidden tax increase that comes from it.

3. Repeal mineral depletion allowances, and foreign tax credits for foreign mineral royalty payments. Eliminate tax deferral through DISC's and elim-

inate deferral of income of foreign based corporations. Limit artificial accounting losses by requiring that accounting losses can only be taken against related income. These three proposals would close major loopholes that have provided little if any real benefit to the economy.

4. Toughen the minimum tax by eliminating the deduction for taxes paid, decreasing the exemption from $30,000 to $5,000, and by raising the rate to 14%. The famed "loophole catcher" is itself so full of loopholes that as many as 402 individuals making over $100,000 are completely escaping tax liability each year. It would be preferable to attack some of the loopholes themselves, but without such an effort, a strengthening of the minimum tax is clearly in order.

5. Provide at least a $900 personal exemption from the social security payroll tax. A majority of Americans now pay more in payroll tax than income tax, and the levy is notoriously regressive, placing a heavy burden on low-to-middle income wage earners. Some of that burden could be relieved by providing a personal exemption to be financed out of general revenues.

6. Provide local governments with the option of offering taxable securities and of receiving an interest subsidy. The current tax exemption of state and local bonds saves local governments $3 billion a year in interest but costs the federal taxpayers $4 billion—90% of which goes to people making more than $50,000 a year. Providing local governments with the option would not only save the local and federal taxpayers' money, it would also open the local government bond market to lower bracket taxpayers who do not currently find the tax exempt bond rates to be economical.

7. Provide a 10% credit up to $1000 on the income of the second breadwinner in a two-job family. Such a proposal would recognize the additional costs incurred by working spouses and substantially eliminate the "marriage tax" which leads some couples to avoid matrimony or seek divorce.

8. Increase the estate tax exemption to $200,000 and provide that only one-half of joint tenancy property can be taxed to the surviving spouse. Inflated property values have made estate taxes a crushing burden on the family farm or business. For a widow who must prove that she made monetary contributions in order to escape paying tax on the entire property, there is often little alternative but to sell out. These changes and others could be financed easily by ending the practice of stepping up the basis of capital gains property at death—a move that could include provision of a credit for estate taxes paid on the death transfer.

Taken together these proposals would substantially improve the fairness of our federal tax system.

We hope that this committee and the entire Congress would consider these changes and others, and adopt in this year of 1976 a comprehensive tax reform bill that will indeed mark "the dawn of a brighter day"—a day of greater tax justice, and a day of greater public faith and confidence in our system of democracy.

The CHAIRMAN. We will adjourn now and meet at 10 o'clock Monday morning.

[The committee adjourned at 12:45 p.m., to reconvene at 10 a.m., Monday, March 22, 1976.]

TAX REFORM ACT OF 1976

MONDAY, MARCH 22, 1976

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

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

Present: Senators Long, Talmadge, Curtis, Fannin, Hansen, and Packwood.

Senator CURTIS. The committee will come to order.

We will call as our first witness Mr. Claude M. Maer, Jr., together with the panel that he has to present. Those who are going to participate will take seats along with Mr. Maer, please.

Mr. Maer, will you give your name and address to the reporter and tell us from whom you appear here.

STATEMENT OF CLAUDE M. MAER, JR., NATIONAL LIVESTOCK TAX COMMITTEE, ACCOMPANIED BY FLYNN STEWART, MEMBER; HENRY MATTHIESSEN, JR., FORMER PRESIDENT, AMERICAN HEREFORD ASSOCIATION; WILLIAM McMILLAN, EXECUTIVE VICE PRESIDENT, NATIONAL CATTLEMEN'S ASSOCIATION, AND BILL JONES, EXECUTIVE VICE PRESIDENT, NATIONAL LIVESTOCK FEEDERS ASSOCIATION

Mr. MAER. My name is Claude M. Maer, Jr. I am a partner in the law firm of Holland and Hart, Denver, Colo., and we are counsel for the National Livestock Tax Committee, an organization that has been representing the livestock industry in tax matters for over 30 years.

Also, with me, who is a member of the Executive Committee of the National Livestock Tax Committee is Mr. Flynn Stewart, who is a certified public accountant from Wichita Falls, Tex., and a rancher in addition, and a former president of the American Angus Association.

However, the Herefords are represented here and also a member of the American National Cattlemen's Association is Mr. Henry Matthiessen on my right, a former president of the American Hereford Association.

Also present from the American National Cattlemen's Association is Mr. Bill McMillan, executive vice president from the Washington office of that organization.

On my left is Mr. Bill Jones who is executive vice president of the National Livestock Feeders Association, Omaha, Nebr.

Finally, we are also speaking for the National Wool Growers Association. However, none of their representatives could be present this morning.

Because of the shortness of time, we will summarize our statement very briefly.

The CHAIRMAN. You have an impressive statement here. I will try to read it all and study it. We have some able staff members who will study it.

I think it deserves full study by every member of the committee and I will try to see that they do it.

Mr. MAER. Thank you, Senator Long. Obviously, like so many other businesses, the livestock industry is badly in need of capital. As we say in our summary, agriculture in general and livestock in particular are beset by all kinds of problems.

This capital should be able to flow into the industry unimpeded. However, we feel very strongly that we want capital in the industry on an economic basis and not on a tax shelter basis, because the tax shelters come and go.

As a matter of fact, some people feel that the use of livestock as a tax shelter in recent years has contributed to some of the economic problems of the industry.

FARMING TAX SHELTERS

We believe the tax shelter aspects in the livestock industry can be eliminated. We favor a two-point program. One provision which is in the House bill, H.R. 10612, is to limit the deduction for farm losses to the amount of capital at risk.

Very briefly what that means is that if an investor invests in a livestock business, he should only be able to deduct losses equivalent to how much actual money he has at risk in that enterprise.

Therefore, if there is nonrecourse financing, he would not be able to deduct any element of losses that result from such financing.

If he is not liable for the borrowing, he should not be able to deduct the losses attributable to such nonrecourse debt. We believe most of the tax shelter aspects in livestock in the last few years have been predicated on this so-called leveraging by means of nonrecourse financing.

If that is eliminated, it should eliminate 99.99 percent of the abuse in this tax shelter area.

The other advantage of the capital at risk limitation is it is very simple as opposed to some of the provisions now being considered.

Our second proposal to eliminate the shelters in livestock is that all limited partnerships including those investing in livestock and farming and ranching that are registered with the Securities and Exchange Commission should be taxed as corporations.

Being taxed as corporations, the losses would not flow through to the individual investors. That is where the tax shelter aspect has come from.

These two simple, very straight forward provisions, we believe, should eliminate the tax shelter aspects in the livestock industry.

Very briefly, to run down the rest of the provisions in H.R. 10612 the excess deductions account enacted in 1969 unfortunately, although well-intentioned and while it looks good on paper, just will not work.

It has not worked. It is too complex. It is just too impossible to administer. We have an example that we filed with the Ways and Means Committee a year or so ago where the excess deductions account was figured one way by the taxpayer, another way by his accountant, and a third way by the revenue agent.

After careful study, and we have been looking at this EDA for a number of years, we figured it a fourth way, and nobody really knows which was the right way. Therefore, we favor the removal of the excess deductions account provision from the tax law.

We are of the opinion that the limitation on artificial losses contained in the House bill and which has been advocated by the Treasury is just another EDA, maybe multiplied by about ten times.

It is very, very complex and would be impossible to administer and we urge that LAL not be enacted.

Finally, very quickly, there should be some amendments to the hobby loss provisions, section 133. These changes are outlined in our statement.

We feel very strongly the provision requiring mandatory accrual accounting fo rcertain farm corporations and partnerships should not be enacted.

By far the great majority of corporations engaged in farming and agriculture are small family businesses. However, they may not qualify under the family exemptions. It is really unfair to tax a corporate family farm differently from a similar family farm operated as a partnership.

The family exemption is not the answer. It is too arbitrary.

Finally, the Internal Revenue Service in recent years has been utilizing a test called the distortion of income test. If a particular ranch operation has a loss, the Internal Revenue Service may deny the deduction on the grounds that there has been a distortion of income because the ranch utilized the cash basis of accounting. On the cash basis which is traditional in livestock and farming, we feel there is no place for a distortion of income test.

Distortion implies a comparison with something, and the cash basis is the cash basis. It may be different from the accrual basis but on the cash basis there can't be a distortion.

This test injects an undesirable subjective aspect into the tax law.

Now, I would like to call briefly on Mr. Flynn Stewart, a member of the National Livestock Tax Committee, to see if he would like to add anything to this.

MINIMUM TAX

Mr. STEWART. Thank you, Claude.

I think you have summarized very well the position we have taken.

I might say just a word about the minimum tax. The minimum tax on certain interests can be desirable but it does need to be different from the minimum tax that is now in the law.

I believe that is the only thing I can add.

Mr. MAER. Mr. Bill Jones, from the National Livestock Feeders Association.

FARMING TAX SHELTERS

Mr. JONES. Mr. Chairman, Senator Curtis, Senator Packwood, the members of the committee who are here are well acquainted with the National Livestock Feeders Association.

In connection with this matter, I want to emphasize, although our membership covers a broad range of types and sizes of operations, the small farmer and producer does predominate.

In its policy positions and work on legislative matters, the Association truly speaks the voice of the bonafide operator and principally those with small to medium sized operations.

Also, the association has been very aggressive in pushing for tax reform and in particular the termination of the opportunity to use livestock operations as tax shelters.

We want capital to come in but on a competitive economic basis and not as a tax shelter. It is in this context I stress to you that we view the House changes as an overall. The LAL is unduly complex and as written will undoubtedly draw into its web a number of bonafide day-to-day smaller and medium-sized operations.

In contrast, the recommendations submitted by this group are simple and would be effective in accomplishing the stated purposes.

Mr. Maer has gone over these. The tax shelter abuse connected with livestock operations, as he has pointed out, is made possible by high leveraging through nonrecourse financing and the like. Our limit on farm losses to capital at risk would cure this particular problem.

Also the limited partnership registered with the SEC and sold publicly has been the main culprit vehicle used in the promotions to uninitiated investors.

Therefore, our recommendation here to require those registered with SEC to be taxed as a corporation would solve this particular problem.

So, there is no need to inflict the complexities of LAL on the industry and on bonafide operators to cure the problem.

In closing, might I just say one thing about treating corporations different from individuals or partnerships. Again, I emphasize to you that we represent smaller and medium-sized operators.

I think that we need to make it clear that contrary to much of the opinion on Capitol Hill, when we talk about corporations, we are not talking about large so-called outside or business corporations.

The committee needs to realize that a number of small family farms are incorporated as regular corporations. There are many reasons for this.

Some colleges and land-grant colleges are advising people not to go this route because it is very restrictive and very complex, so it does not meet the needs of all family farmers.

The family farm definition contained in the House bill explanation is kind of a Christmas-tree sort of definition which I think would be tremendously difficult to administer and you would find a great deal of non-uniformity from district tax directors from district as far as enforcement.

We want to emphasize there are a number of family farms incorporated as regular corporations.

We would say there is no need to single out corporations and treat them any differently from the way we would treat individuals or the partnerships.

Thank you.

Mr. MAER. Finally, if I may, Mr. Henry Matthiessen, who is a member of the American National Cattlemen's Association, would like to add one word.

The CHAIRMAN. Gentlemen, you have exceeded your 10 minutes. I will allow you another 2 minutes.

Mr. MATTHIESSEN. Thank you, Mr. Chairman.

I just want to say since our appearance here 6 years ago in 1969 as someone totally involved in the breeding end of this business, I have seen what you were trying to do in eliminating these abuses in the breeding field largely accomplished by the very simple recommendations that were made at this table at that time.

From my standpoint as I watch the industry now, the purebred business and the cow-calf business, I hear very little talk about that type of abuse any longer, and I see very little of it and I see a great many more people coming into the business now on a much sounder basis than before.

The CHAIRMAN. Senator Curtis.

Sentor CURTIS. Mr. Maer, what is the basic problem from which there arises the charge that there is an unjust tax shelter or tax shelter that is unjust?

Is it the problem over whether or not losses can be charged against all income of the taxpayer or is it something else?

Mr. MAER. Senator Curtis, the way I understand it, the problem that this bill is trying to get at, the tax shelter, is that the losses in these livestock businesses or farming businesses are not real losses.

The taxpayers are deducting the so-called artificial losses against the non-farm income. The House bill is attempting to get at that problem. We concur that that problem should be solved.

I think our difference with the House bill is in the manner in which it is done.

Senator CURTIS. You recommend to things primarily, both of which would appear rather simple. One would be that no one should deduct an agricultural loss in excess of his investment?

Mr. MAER. That is correct.

Senator CURTIS Do you think that would take care of quite a number of cases in which there are complaints?

Mr. MAER. We really do because most of the tax shelter programs that were sold in the marketplace in the heyday in 1972 and 1973 when they were really flying high and part of 1974 until the market broke were predicated on the ability to deduct at least 100 percent of the investment.

Some of them went as high as 300 and 400 percent of the investment. So, the arithmetic is very simple. It is one of those things you could not afford not to get into.

If you put $10,000 into a tax shelter and you could deduct $30,000 and you were in the 50-percent bracket, you came home with a net

$5,000 in your pocket. You were making money from the Government.

Senator CURTIS. Sometimes we think the simplest and best solution is the very last.

This is quite reasonable that a person could not lose any more money than he had in a shelter.

Then, your other recommendation is with reference to limited partnerships, treating those as corporations and therefore the individual would not have a loss but it would be the corporation; is that right?

Mr. MAER. That is right, the losses remain in the corporation and are not passed on.

Our proposal is only those partnerships which are registered.

Senator CURTIS. That leads me to a question. The answer may be very simple.

Is a limited partnership for the purpose of the Internal Revenue Code a well-defined mode of operation?

Mr. MAER. Yes.

The limited partnership is very well defined. As a matter of fact, as a result of a number of court decisions and rulings, it is really quite clear what constitutes a limited partnership.

There are certain tests that are made. If you qualify under those tests, it qualifies as a limited partnership.

Senator CURTIS. Sometimes they lack permanency and sometimes they don't. Often it is used for a one-shot operation?

Mr. MAER. That is correct. By all means, that was the largest vehicle that was used during the heyday of the tax shelters.

Senator CURTIS Have you had a chance to submit your suggested remedies to the Treasury Department?

Mr. MAER. Yes.

We have discussed this a number of times with the Treasury Department. This started in 1973, as you know.

Senator CURTIS. I mean the specific proposals you have made today.

Have they been submitted to the Treasury Department?

Mr. MAER. I don't know that we have had a meeting specifically with the Treasury since the House bill was finally passed; no.

Senator CURTIS. I hope that they will take due notice and go into it, because certainly if a simple solution does substantial justice, we should not spend our efforts trying to make it complicated.

Mr. MAER. I would not want to inflict upon anyone, much less the members of this distinguished committee, the reading of the explanation of the limitation on artificial losses that I reread coming in here yesterday.

It is quite a chore. We certainly have a great deal of respect for the Committee on Ways and Means and the staff, and they have done a very good job.

But, it is the concept that is the problem.

The first page of the Ways and Means Committee report states: "It is important to simplify the tax law and forms so the public may understand the law better and not make as much use of professional tax preparers as is the case today."

I don't think some of the provisions accomplish this.

SIMPLIFICATION OF THE IRC

The CHAIRMAN. There are some provisions in this bill which remind me of one I came across some time ago. I thought I would try to study it and figure out for myself what it did or did not do, and whether it would affect my own incomes.

I happen to have had a little bit of experience with tax law. I was not on the tax-writing committee at the time, but I had taken a course in tax law in college and thought I had some familiarity with the Internal Revenue Code, so I decided to look at this section.

I started about sundown. I proceeded to look at the cross-references and then looked at the cross-references that the cross-referenced sections took me to, and took the fingers on the other hand and tried to help hold my place and work to the cross-references that those led to and then go to pocket parts of each volume.

In short order, I ran out of fingers to hold my places. Then, having worked at all this, I continued to go back and forth and work and study it and read the committee report again.

By the time I got through, the sun was shining brightly. It was the next morning and I still could not tell you what that section meant. I did not have the slightest idea. I thought it might help me or hurt me, but I could not tell. That was just one item that I spent all night with.

We put a provision in the so-called Tax Reform Act of 1969 to say that a businessman would be permitted to keep 50 percent of his earned income, what he made by dint of his own sweat, toil, and hard effort.

That would have sounded simple enough, but someone suggested, hold on a minute now, do you want to take into account the fact that he had some sheltered income or capital gain? They decided that taking it into account might satisfy some of our liberal friends. That amounted to 150 pages of regulations.

I can't tell you today, if you have some capital gains and if you are in a number of businesses, whether you do have something regarded as sheltered income.

I am not going to spend 6 months staying up all night studying those regulations and the volume of additional regulations that they have down at Treasury and the Tax Court to tell you whether a person would or would not get some benefit.

TAX EXPENDITURES

I also object to the view that any time a businessman is permitted to keep so much as a dollar of what he earns, that this is a tax expenditure. That seems to proceed on the theory that since it is within the power of the Government to tax everything a man makes, the Government had a prior right to it and, therefore, anything that man is permitted to keep over and above expenses is something that the Government has given him.

In many instances, it is the difference between 50 and 70 percent of his income which is called a tax expenditure.

These people don't seem to regard it as a tax expenditure if a man works very hard and as a single person finds himself in the

50-percent bracket in a hurry because a welder or some other skilled worker, and he just quits and goes fishing, fixes up his boat and goes hunting the rest of the year. He does not exactly quit. He tells his union steward he wants to be laid off. He keeps welding holes instead of solid joints so the boss had no choice but to fire him.

Then he takes the rest of the year living on unemployment insurance money. Apparently, no one wants to seem to regard that as a tax expenditure when people just quit. They don't want to regard it as a tax expenditure when people go into new businesses because it is too demoralizing when it is all through.

TAX SHELTERS

I think I like your approach with regard to tax shelters. I think it is well to keep in mind that when you talk about the man going into a 3–for–1 tax shelter making money on the Government by losing money, you have to keep in mind the reason all that fiasco starts in the beginning is the Government imposes a 70-percent tax on the man's income.

At that point you exhaust the ingenuity of tax writers to make money out of that man, because he has just as much imagination as you have and if he can't muster that much imagination, he can always leave the country, go to Canada or Australia. But people have the potential for thinking of as many things as we can think of in writing some tax law, to make it completely demoralizing for those people to work; they can think of ways not to work or ways to cheat.

It would be far simpler to tax those people at a rate where there would be no point in worrying about shelters, where a doctor finds a second line of business to go into. But, how can you complain about shelters when you write tax laws that are totally counterproductive.

Mr. MAER. Speaking of the 150 pages of regulations, I might comment briefly on EDA.

With all due respect to this committee and to Congress, when EDA was enacted in 1969——

The CHAIRMAN. Wait a minute. We have so many concepts. Which is that?

Mr. MAER. That is the excess deductions account.

The CHAIRMAN. We have so many confusing things that are in this code it is hard to keep them in mind, even when you identify them by initials.

Mr. MAER. The excess deductions account was enacted in 1969 and that was aimed at taking ordinary losses and turning them into capital gains.

It was well intentioned and on paper it looked pretty good. Treasury tried to write the regulations after it was enacted. It was over 30 pages of single-spaced regulations in the Federal Register.

When they published the regulations, they offered the opportunity for a hearing. The National Livestock Tax Committee that we represent asked for a hearing. We went up and we sat and fretted with this thing for 2 or 3 hours with the representatives of the Treasury.

Finally, everybody threw up their hands and said there is no way to do this, and they have done nothing, and now the Treasury is in favor of repealing EDA and so are we.

We are afraid this LAL is EDA multiplied 10 times.

The CHAIRMAN. I am afraid you will find the brain trusts of the EDA are still around brain trusting LAL. You will find they could not even write the regulations to show people how to administer what they did the first time, and now they have come in with something more complicated than that.

I admire those fellows who serve in the Brookings Institution, but I hope they would keep in mind that some time when a farmer gets out there and wades in the muck and mire around his barnyard, he knows a little something himself.

Senator Packwood?

Senator PACKWOOD. Normally, the Tax Code allows deductions for two purposes: sometimes it is to encourage an individual to do something, such as interest on mortgages on residences. Another is to encourage outside capital to flow into a particular industry. Here is the variety of tax devices that we give to savings and loans encouraging them to put into housing.

I think historically most of the deductions that were initially farm deductions were intended for farmers, to encourage farming.

Some of these deductions have recently been used by outside capital to come into the farming industry. Is it necessary to encourage outside capital, nonfarming capital to come into the farming industry or given a fair tax break for farmers and a break on estate taxes—can you make it on just tax deductions, fair tax deductions for farmers alone?

Mr. JONES. Mr. Packwood, I would say first of all, all agricultural income needs outside capital. We do not generate sufficient capital within the industry to meet our needs.

For many, many years there have been large amounts of outside capital coming in.

Senator PACKWOOD. I don't mean the ordinary capital you borrow every year to keep your business going. I mean special investments such as doctors and lawyers put into farming.

Do you need that kind of encouragement?

Mr. JONES. No, not encouragement of that basis but just on a sound economic basis.

If the adjustments are equitable to the legitimate operator, that sufficient amount of capital will come in on that basis.

We are, as you know, rapidly becoming more and more a capital-intensive industry, but capital will be attracted on a pure economic kind of basis, and we do not need the kind of a shelter inspiration that we now have actually in this one area.

Senator PACKWOOD. I had not heard it called that before, but that is very good.

Mr. MAER. As I said earlier, there is quite a school of thought which feels that this tax shelter impact in the early 1970's could well have contributed to the severe recession or depression that hit the cattle industry in the beginning of 1974.

Senator PACKWOOD. I would like to see small farmers be able to stay in business and pass their farms on. In Oregon, many of the farms are small and they are capital intensive. A farmer and his kids can run a whale of an operation. I would like to find some way of keeping up his inspiration. If you will stay with us and work with us, I hope we can come up with a mutually satisfactory solution.

Mr. MAER. That would be just exactly what we would like to do.

Mr. JONES. I think the feeding industry gives an excellent example of what you are talking about. The feeding industry grew at a small base. When we did have a push here and highly publicized funds, we actually overbuilt. We propably overbuilt about 20 percent which is a kind of distortion we did not need.

The industry would have been better off without it. Certainly, we favor what you are talking about, the kind of outside investment so that we can grow on a very sound financial basis, where money does stay in and is used for capitalization.

Senator PACKWOOD. Thank you, Mr. Chairman. I have no other questions.

TAX EXPENDITURES

The CHAIRMAN. I would suggest one thing to you gentlemen: While you are in town, try, if you can, to go around and talk to as many of your Senators and Congressmen as you can.

Unfortunately, nowadays, we have other committees holding hearings on these subjects; for example, the Budget Committee holds hearings on tax expenditures.

The Congressional Budget Office makes a study on this subject. While I never thought those people were supposed to have jurisdiction over your business, they are now presuming they do.

The fact that this committee might hear you and agree with you after you have made a good case might not do a lot of good if it turns out that all of this campaigning and lobbying and working behind the scenes in the name of tax reform has you as one of its targets. You might find it did not do you any good to complain to the committee that writes the tax laws because your case was not heard by the average Senator.

The average Senator listens to more on a budget committee or from the Congressional Budget Office. So, I would urge you to try to see to it that other Senators hear your views.

The Senators here were impressed by what you have said. You gentlemen have made a fine presentation. Just on the face of it, I think my vote would be to parallel to what you have suggested to us after giving a great deal of thought to all this. Sometimes you might persuade those of us who hear you and think that you have won your case, but you may find that is not always the case at all.

Mr. MAER. We will certainly follow that advice.

Senator CURTIS. Mr. Chairman, I want to express my gratitude to these gentlemen for their fine contribution. I particularly want to welcome Mr. Jones from Nebraska, who has made a contribution here.

[Prepared joint statements follow. Oral testimony continues on p. 429.]

JOINT STATEMENT OF NATIONAL LIVESTOCK TAX COMMITTEE, AMERICAN NATIONAL CATTLEMEN'S ASSOCIATION, NATIONAL LIVESTOCK FEEDERS ASSOCIATION, AND NATIONAL WOOL GROWERS ASSOCIATION

SUMMARY

Estate and Gift Taxation

The existence and continuation of farm and ranch operations are seriously threatened by the federal estate tax. This is the result of unreasonably high valuations placed on farm and ranch land by Revenue Agents and the basic illiquidity of farm and ranch assets to pay the federal estate tax. An additional problem is caused by the failure in administering present federal estate tax law to recognize the value of a wife's contribution to the value of farm and ranch property held in joint names by the farmer and his wife.

Remedial legislation is urgently and immediately needed to correct these serious problems. The most pressing need is for legislation which would permit the federal estate tax valuation of farm and ranch land to be based upon such land's earning capacity or productivity for agricultural purposes. The federal estate tax laws should also be amended to recognize the wife's contribution to the value of farm or ranch property held in the joint names of the farmer and his wife. Support is also given to the proposals to increase, for *all* estates, the federal estate tax exemption from $60,000 to $200,000 and to provide a minimum marital deduction of $100,000 for property passing to a surviving spouse. Increases in the federal gift tax annual exclusion and lifetime exemption to reflect inflation since such amounts were established are also needed.

The proposal to tax capital gains at death, if enacted, would be the death knell for farm and ranch estates which are having extreme difficulty in paying even the federal estate tax; such proposal should, therefore, be rejected. The altrnative proposal relating to a carryover basis is also opposed since such proposal would create problems in both compliance and administration and since equity is achieved by permitting the heirs of a decedent to claim a basis in inherited property based upon the federal estate tax value of the property.

INTRODUCTION

Formed in 1942, the National Livestock Tax Committee (NLTC) is sponsored by a number of national, breed and state livestock associations throughout the country and has as its purpose maintaining and assuring equity and equality in the fields of federal income, gift and estate taxation for the entire livestock industry.

Representing over 300,000 cattlemen throughout the nation, the American National Cattlemen's Association (ANCA) is a voluntary, nonprofit, nonpolitical organization.

The National Livestock Feeders Association (NLFA), a nonprofit, voluntary, nonpolitical organization, represents stockmen in over 200 state and local affiliated associations.

The National Wool Growers Association (NWGA), a voluntary, nonprofit, nonpolitical organization, represents 22 state and regional organizations encompassing a 25 state area, where 90% of the nation's lambs and wool are produced.

NLTC, ANCA, NLFA, and NWGA speak for the entire red meat animal industry in the nation. In addition, NLTC represents dairy and horse organizations.

I. ESTATE TAXES—PROBLEMS OF VALUATION AND LACK OF LIQUIDITY IN ESTATES OF STOCKMEN AND INEQUITABLE TREATMENT OF SPOUSES

In the area of federal estate taxes, there are two serious problems, which are interrelated, facing the entire livestock industry. One problem concerns the present method employed to value interests in farms and ranches for federal estate tax purposes and the second involves the inability of the estate of a deceased farmer or rancher to pay the federal estate tax levied against the estate because of the basic illiquidity of farm and ranch assets. A third problem relates to the unfair treatment meted out to a surviving spouse of a deceased farmer in common law states where, under present federal estate tax laws, the surviving spouse is presumed to have contributed no value to the farm or ranch, with the result that the value of the entire farm or ranch is included in the deceased farmer's estate.

Unreasonably High Valuations of Farms and Ranches

In recent years there has been an alarming upward trend in the valuation of farm and ranch properties for federal estate tax purposes. The result has been higher and higher estate taxes at death. This, in turn, has forced the sale or liquidation of a number of substantial livestock operations, and threatens to force the liquidation of many farms and ranches whose owners may die in the future not owning sufficient nonfarm assets. In fact, according to a U.S. Department of Agriculture Study prepared by the Office of Planning and Evaluation in July, 1975, entitled "Alternative Futures for U.S. Agriculture: A Progress Report," it is stated that "one fourth of all farm real estate transfers are for the purpose of estate settlement." Even the sale or liquidation of a part of the farm or ranch land in order to raise enough cash to pay these large federal estate taxes causes a fragmentation of the farm or ranch as an operating concern and results in the inability of many family farms and ranches to continue to operate as an economic unit. In a statement presented at the Joint Hearing of the Select Committee on Small Business and the Joint Economic Committee of the United States Senate in Minneapolis, Minnesota on August 26, 1975 on the subject of the Impact of Federal Estate and Gift Taxes on Small Businessmen and Farmers, it was stated by Mr. Louis Woehler that estate and inheritance taxes take approximately 28% of a 160 acre farm and approximately 32% of a 320 acre farm based upon 1975 farm land values in the State of Minnesota. The effect of this trend is not only to threaten the continuation of the traditional family farm or ranch as a viable economic unit, but it also portends a potential adverse effect on providing the essential food and fiber needs demanded by the consuming public.

Referring to this serious problem, Dr. John A. Hopkin, an agricultural economist at Texas A&M University, says that society is the loser when an efficient, productive farm unit must be liquidated every generation in order to pay the estate taxes which are imposed. See Exhibit A attached hereto. A continuation of this trend of causing the sale of farm and ranch land to pay estate taxes reduces the capability of agriculture to supply food and fiber to the public and could result in an increase in the price of agricultural products. Furthermore, while it would seem prudent tax policy to encourage the retention of farm and ranch land for production of agricultural commodities, this policy is frustrated where such land is put to nonfarm uses by persons who purchase such land as a result of a forced sale caused by higher and higher estate taxes. Such nonfarm uses include not only utilization of agriculturally productive land for housing and industrial purposes, but also application of such land to recreational uses, such as resorts, hunting lodges, and dude ranches. Whatever the nonfarm use to which agricultural land is converted in these forced sale situations, the end result is the removal of needed land from agricultural production.

The primary reason for this upward trend in the valuation of farms and ranches is the requirement in the federal estate tax regulations that the estate tax be imposed on the "fair market value" of the assets owned by a decedent at the time of his death. In the case of real estate, Internal Revenue agents usually obtain a "fair market value" by a comparison of the land to be valued with the prices for which other land in the area has sold within a few years before or after the particular valuation date. Revenue Agents frequently follow the practice of applying the highest recent sales prices of nearby land to the particular farm or ranch being valued, even though such land was purchased for recreational, housing, industrial or some other nonfarm use. More often than not, these prices are vastly inflated, are no trutly comparable to the decedent's farm or ranch, and bear no relationship whatsoever to the income which the farm or ranch will produce.

A combination of the fragmentation of farm and ranch lands and sales of such lands at inflated prices has had an enormous influence on the federal estate tax values placed by Revenue Agents on larger tracts of such lands. Thus, Revenue Agents sometimes value a several thousand acre farm or ranch based upon the inflated price paid for a few acres of farm land by someone who is in the subdivision, recreation or some other nonfarm business or activity. In addition, while the estate tax valuation of large holdings of a particular stock owned by a decedent may be discounted by application of the "blockage" rule, Revenue Agents will generally not permit the valuation of large tracts of farm or ranch land to be discounted by use of a comparable procedure. Furthermore, Revenue Agents frequently refuse to give any consideration to other pertinent factors such as the earning capacity of the farm or ranch or the degree of ownership represented by the interest in the farm or ranch being valued in determining estate tax values.

Examples of Valuations

The following examples, taken from actual case histories, are illustrative of the acute problems caused by the present valuation practices utilized by Revenue Agents.

Example A.—This example involves a rancher who owned and lived on a ranch all his life until he died a few years ago. Although the rancher had operated his ranch in an economical and sound manner, he had accumulated losses of approximately $360,000 during the period 8 years before his death, primarily because of climatic conditions and low cattle prices. He even had to borrow substantial amounts on his life insurance policies in order to cover his operating losses and to provide for his family. This ranch, located on the southwestern part of our country, was valued at $15 per acre on the federal estate tax return, resulting in a total estate tax of over $19,000. In auditing this return, the Revenue Agent contended that the ranch should have been valued at $32 per acre, resulting in an estate tax of over $80,000. No recent sales of comparable land in the vicinity had been made except for the sale of 2,500 acres to an educational association for approximately $10 per acre. Four qualified appraisers stated that the valuation of this ranch could not exceed $16 per acre. As a result, considerable time was spent and costs incurred by the rancher's family before a settlement was reached on the per acre value of the ranch.

Example B.—In this case, the executor valued the farm at $137,100 for federal estate tax purposes. When the Revenue Agent audited this return, he fixed the value of this farm at $1,061,370. This higher evaluation was based upon the purchase of a few acres by an industrial firm sometime after the farmer's death. This matter was litigated in a court proceeding at considerable expense to the estate, where it was held that the value of the farm for federal estate tax purposes was $265,000.

Example C.—This example involves an elderly rancher, whose average annual gross income for the past several years has been only about $4,000. Based upon this rancher's own estimation of the "fair market value" of his ranch, federal estate and state inheritance taxes would total almost $38,000, more than nine times the average gross income from the property. If a Revenue Agent placed a higher value on this ranch property, these taxes would be even greater.

Example D.—In this recent case, a rancher died whose ancestors had homesteaded the ranch property. On the Federal Estate Tax Return filed by the rancher's estate, a tax of $7,900 was shown and paid based upon ranch assets which were valued at $736,000.[1] In auditing the return, a Revenue Agent increased the valuation to over $1,260,000 resulting in the assessment of an additional tax of $30,240 over that which had already been paid. The years prior to the rancher's death the ranch had shown an average annual income of only $4,400. Unlike many ranchers' estates, this particular estate was fortunate enough to be able to borrow enough money to pay the assessed tax deficiency. Ultimately, through the filing of a claim for refund in Federal District Court, the estate was able to reduce the additional tax assessed from $30,240 to $19,000. However, substantial legal expenses were incurred in securing this reduction in the unreasonably high assessed tax deficiency.

Example E.—In another case, the rancher's estate consisted of ranches located in several states. On the Federal Estate Tax Return one of the ranch properties had been valued at $393,000 based upon an independent appraiser's report; however, the Revenue Agent auditing the return increased the valua-

[1] Decedent's interest was about 10% of this amount.

tion to $720,000. This resulted in the federal estate tax, which was reflected on the estate tax return at $88,200, being increased to $126,200. Yet for a number of years preceding the decedent's death, the ranch had witnessed some profit years and some loss years, which when averaged showed in the aggregate a profit of only $1,800 per year. As in other estates, considerable expense was incurred in contesting the valuation which ultimately resulted in substantial reduction of the assessed deficiency, but still the rancher's estate was hard pressed to raise sufficient cash to pay the original tax plus the amount of the tax deficiency.

The foregoing examples underscore the problems facing the heirs of many farmers and ranchers in raising funds to pay federal estate taxes caused by these unreasonably high valuations. Because of the very high valuations assessed by Revenue Agents against farms and ranches, it is evident that in most cases the heirs will not be able to pay the federal estate taxes out of operating income, especially under present depressed economic conditions where farmers are selling their livestock for less than their total production costs.[2] Unless there are sufficient outside assets, which is seldom the case, the heirs will have to mortgage or sell all or a part of the farm or ranch property and livestock. Because most farms and ranches are already heavily mortgaged, it is frequently not possible to borrow enough money to pay these taxes. Moreover, the value of a farm or ranch is to a great extent based upon the entire tract, and sale of a part will disproportionately reduce the value of the whole.

Some persons have alleged that these escalating farmland values are caused by the relatively few persons entering the farming and ranching business for "tax profits" as opposed to economic profits. This allegation is refuted by studies which show that the primary causes of the rapid appreciation in farmland values are: (1) limited amount of land; (2) use as an inflation hedge; (3) urban booms; (4) acquisition by federal, state and local governments; and (5) desire to be a "part of agriculture." [3]

Lack of Liquidity—Inability to Pay Estate Taxes from Farm Earnings

The second major problem facing the livestock industry in the federal estate tax area is the inability of the estate of a farmer or rancher to pay the estate tax out of earnings and keep the farm or ranch intact as an economic unit because of the illiquidity of farm and ranch land. Reference is made to the discussion and analysis of this liquidity problem in Dr. John A. Hopkin's study which is attached hereto as Exhibit A. This liquidity problem has also been recognized by the U.S. Department of Agriculture in its 1973 report No. AER 242, "Increasing Impact of Federal Estate and Gift Taxes on the Farm Sector: Present Law and Proposed Changes."

Today the value placed on land and the price for which it might sell is all out of proportion to what it will earn. The economic fact is that ranch and farm land is selling now for prices upon which it is frequently economically impossible for a farmer to earn a reasonable return. Unfortunately, even in the light of this economic fact, many Revenue Agents refuse to give any consideration whatsoever to the earning capacity of a farm or ranch. Thus, from the point of view of earnings, there is a definite and serious discrimination in the estate tax field against farm and ranch land. The result is the imposition of an estate tax based upon the fair market value of what is owned, whereas the ability to pay the estate tax is based upon what the property can earn or what can be saved out of its earnings.

Estate taxes can only be paid by: (1) selling off part of the property, which often will seriously impair the value of a working farm or ranch which usually took a lifetime to assemble: or (2) from net income, and today's net income from farm and ranch property is very low in relation to market values. This means that in many cases the family which does not have substantial outside

---

[2] *Guidelines*, Volume I, February, 1975, published by American National Cattlemen's Association and Cattle Marketing Information Services, Inc.

[3] It was reported in the *Business Beef Bulletin*, September 10, 1971, published by the American National Cattlemen's Association based upon U.S. Department of Agriculture Studies, that urban growth is usually made at the expense of farm and ranch land, that 80% of land used for subdivisions and industry is from the top three grades of farm and ranch land and that about 2 million acres of farm and ranch land are lost each year as follows: 1,000,000 acres to wilderness areas, parks and recreation areas; 420,000 acres to urban development; 420,000 acres to reservoirs and flood control; and 160,000 acres to airports and highways.

assets just cannot pay the estate taxes and still continue to operate the farm or ranch, intact, as an economic unit and produce food and fiber needed by the public.

This liquidity problem is perhaps more acute in agriculture than in any other industry because of the large investment in land and the nature of farming and ranching operations.

Under present federal estate tax laws, the tax must be paid, unless an extension is granted, within 9 months after the farmer or rancher's death. This would place an insuperable burden on estates of farmers and ranchers to pay the tax if it were not for the provisions in existing law which permit at least some relief by granting an extension of time to pay such tax. In many instances, the estate of a farmer or rancher will qualify under either the hardship rule or section 6166 of the 1954 Internal Revenue Code which authorizes the estate to pay the tax over a period of up to 10 years. Where an estate does not qualify for such extension, it still may be possible under the more liberal policy adopted by the Congress in 1971 for the estate to obtain an extension of up to 12 months to pay the tax. However, in many cases even the 10 year extension rule will not be of substantial benefit and assistance since the earnings from the farm or ranch are often insufficient to pay the annual installments after living expenses are taken out plus the 7% interest (as of February 1, 1976) charged on the unpaid amount. The increase in this interest rate from its 4% rate prior to July 1, 1975 will further contribute to the unattractiveness or inability of electing to pay the estate tax over a 10 year period. In addition, there are significant administrative burdens imposed by the Treasury Regulations on the estate of a farmer or rancher in operating the farm or ranch after the decedent's death in order to preserve the right to pay the estate tax over the 10 year period. Written reports are required to be made by the rancher's estate to the Internal Revnue Service of transactions regarding the farm or ranch operation, which in essence causes the Internal Revenue Service to become involved in the farm or ranch business. For instance, certain withdrawals of funds from the ranch business or certain sales or dispositions of interests in the ranch must be reported and can cause acceleration of the payment of the estate tax. The Treasury Regulations also require the rancher's estate to apply all undistributed net income earned in the fourth and all subsequent years following the rancher's death to the payment of the remaining balance of the estate tax. Thus, while the 10 year extension of payment rule can be of value in some cases, the restrictions and limitations imposed by such rule on the operation of a farm or ranch and the increase in the interest rate on the unpaid balance of the tax can mitigate the intended benefit of paying the estate tax over a period of years. As one knowledgeable commentator has said, granting additional time to pay estate taxes is not a satisfactory solution to the problem if the taxes are so high that a sale of the business is required.

An associated problem results from the requirement that the estate tax return must be filed within 9 months after date of death. Where an estate consists of securities or similar property, there is frequently no problem in meeting this 9 month filing date. However, in the case of farm and ranch estates, it is often very difficult to meet this 9 month filing date because of the time required to gather all relevant data and to have the farm or ranch land appraised. This problem would be mitigated for farm and ranch estates if they were permitted to file the estate tax return within 15 months after date of death, as it was under prior law.

There exists today, as there has in the past, a severe cost-price squeeze caused by ever increasing costs which have far out distanced increases in prices.[4] This squeeze has been partially compensated for by farmers becoming more efficient and by the paper profit involved in the increase in farm and ranch real estate values as measured by sales. This situation has allowed farmers to borrow more money on their land to remain in business, with farm and ranch indebtedness now standing at record levels.[5] This burden will in all likelihood continue increase as total farm and ranch debt increases and as new mortgages are made and old ones refinanced. Needless to say, lenders

---

[4] *Guidelines*, Volume I, August, 1975, published by American National Cattlemen's Association and Cattle Marketing Information Services, Inc.

[5] "*Farm Real Estate Market Developments*, CD–80 (1975), published by Economic Research Service of U.S. Department of Agriculture.

may at some point refuse to continue to finance ranchers and farmers especially if there should be a significant and prolonged downswing in prices of livestock or land. Yet, all the family of a farmer or rancher without outside help can do to meet estate taxes is to borrow more money or get out of business. Without some relief, economic as well as tax-wise, the future of the industry as well as the effect on the consuming public, which depends on the industry for food and fiber, is extremely discouraging.

These severe federal estate tax problems faced by the estates of farmers and ranchers have been recognized by President Ford and over 100 members of the Congress, who have supported various legislative proposals to remedy these problems. All weather vanes point unalterably to the urgent need for immediate remedial legislation to correct these severe problems.

Failure of Revenue Agents to Recognize Contribution of Surviving Spouse to Value of Farm or Ranch

Farms and ranches are frequently held in joint names by the farmer and his wife. Both husband and wife operate the farm or ranch as a team, with the wife working just as hard as her husband. In such situations, the husband is usually the first to die, and where this occurs in common law states Revenue Agents usually contend that for federal estate tax purposes, the full value of the farm or ranch is includible in the husband's estate since the wife made no contribution to the value of the farm or ranch. To contest such contention through the administrative channels of the IRS or through court proceedings is very expensive and time-consuming. Estates of farmers and ranchers should not have to go to the time and cost of proving the obvious value of the wife's contribution to the farm or ranch in such circumstances.

Solution to Problems

NLTC, ANCA, NLFA and NWGA have been very concerned with the problem of higher and higher federal estate taxes caused by existing valuation policies and practices and by the illiquidity problem and have undertaken an extensive study of the subject. Representatives of NLTC, ANCA, NLFA and NWGA have discussed this prolbem and some alternative solutions with members of congress, as well as with administrative and technical staff personnel.

As a result of these conferences and studies, NLTC, ANCA, NLFA and NWGA have supported bills, such as S. 2600, which was first introduced in 1967 by Senators Curtis, Carlson and Harris and which would provide a more equitable method of valuing farms, ranches and other small businesses for federal estate tax purposes. Similar bills have been introduced in both the House and Senate in each subsequent session of Conrgess. In fact, a number of the members of this committee have introduced and supported bills to remedy these problems.

More recently, NLTC, ANCA, NLFA and NWGA have supported legislation of the type introduced by Senators Curtis (S. 1173) and McGovern (S. 2875) and by a number of other Senators and Congressmen on this very important subject. Each of these bills has recognized the problems concerning valuation of farm and ranch land and has provided that the executor or administrator of a farmer's and rancher's estate would be permitted to value such land based upon its productive or earning capacity for agricultural purposes.

NLTC, ANCA, NLFA and NWGA support and endorse the specific valuation formula contained in Senator McGovern's bill (S. 2875) which would apply not only to real property devoted to the business of farming and ranching but also to land used for the commercial production of trees as well as for recreational purposes and scenic open space. Under the McGovern bill, real property values would be determined by dividing the average gross cash rental (less state and local real estate taxes) for comparable land for the three years immediately preceding the death of the decedent by the average interest rate of all new Federal Land Bank loans for this same three year period. To qualify for such valuation, substantially all of the real property used for agricultural purposes would have to have been devoted to farming or ranching for sixty months preceding the farmer's death. Furthermore, the bill provides that if the real property is disposed of, other than by involuntary transfers, within five years after the decedent's death, then a recapture would be imposed which would be the difference between the federal estate tax based upon "fair market value" and the value determined by reference to rental earning capacity under the bill. Senator McGovern, in introducing S. 2875, stated that this bill would result in approximately a 21% reduction in values of central corn belt land over "fair market value" figures.

Precedent for Proposed Legislation

There is a growing body of law which provides a precedent for enactment of such proposed legislation, such as the Curtis, McGovern and similar bills, concerning federal estate tax valuation based upon productivity or earning capacity and for a solution to this problem. To date, over 40% of the states have enacted laws regarding ad valorem taxation which provide in one form or another for the assessment of agricultural land based upon its productivity or earning capacity, rather than on market value. These laws appear to have had the desired effect of granting needed relief and providing more equitable tax treatment for farmers and ranchers. Furthermore, such laws are designed to help keep agricultural land producing food and fiber and to provide restful green belts and open space areas so vitally needed in our modern society.

Recognition Should Be Given To Value of Wife's Contribution to Farm or Ranch Property

NLTC, ANCA, NLFA and NWGA support legislation which would recognize in common law states where farm and ranch property is held in joint names by a farmer and his wife that the work performed by thewife on the farm or ranch constitutes a contribution to the value of the farm or ranch for federal estate tax purposes.

Federal Estate Tax Exemption and Marital Deduction and Gift Tax Lifetime Exemption and Annual Exclusion Should Be Increased

There have been a flood of bills introduced in both the House and Senate, including S. 1173 (Curtis bill) and S. 2875 (McGovern bill), which propose to increase the federal estate tax exemption from $60,000 to $200,000 and increase the federal estate tax marital deduction to provide a minimum deduction of $100,000 on property passing to a surviving spouse. These provisions apply to *all* estates and not just to estates of farmers and ranchers.

NLTC, ANCA, NLFA and NWGA support the provisions of these bills regarding increasing the federal estate tax exemption from $60,000 to $200,000 and increasing the federal estate tax marital deduction to provide a minimum deduction of $100,000. The $60,000 federal estate tax exemption has remained unchanged since 1942 while land values have increased over 200% in some instances and stocks and other property have increased tremendously in value. This has resulted in the inequitable situation where 1976 figures are applied to 1942 dollars. Based upon the surge in the consumer price index since 1942, one commentator has stated that the federal estate tax exemption should be increased to $318,000 and that based upon land inflation during this same period, the exemption would have to be increased to $600,000.[6] With respect to the increase in the marital deduction, the Treasury Department has even proposed that there be an unlimited marital deduction for property passing to a surviving spouse since it is not appropriate to impose a federal estate tax on transfers between husband and wife.[7]

NLTC, ANCA, NLFA and NWGA also support an increase in the federal gift tax annual exclusion and lifetime exemption for the same reasons so as to reflect the effect of inflation on such amounts since they were established.

Remedial Legislation Urgently Needed

There is a present and most urgent need to change present federal estate tax laws which have resulted in the liquidation of a number of substantial size farm and ranch operations and the conversion of needed and productive farm and ranch land to nonfarm uses. NLTC, ANCA, NLFA and NWGA feel that the previously discussed legislative proposals and bills which would permit

[6] Statement of Louis Woehler to Joint Hearing of the Select Committee on Small Business and the Joint Economic Committee of the U.S. Senate on August 26, 1975 on Impact of Federal Estate and Gift Taxes on Small Businessmen and Farmers.

[7] Tax Reform Studies and Proposals, U.S. Treasury Department, 91st Cong. 1st Session (1969) at 20,119.

valuation of farm and ranch land on productive or earning capacity represent a fair and equitable solution to these problems, even though it is recognized that in some situations the family of a deceased farmer or rancher may still experience difficulty in paying such taxes. See discussion in Exhibit A.

NLTC, ANCA, NLFA and NWGA support, for *all* estates, an increase in the federal estate tax exemption and marital deduction, although such increases will not, standing alone, solve the present problem faced by farm and ranch estates. Such problem can only be effectively remedied if the estates of farmers and ranchers are permitted to value farm or ranch land based upon its productivity or earning capacity rather than "fair market value." NLTC, ANCA, NLFA and NWGA also support the proposal to increase the time within which the estates of farmers and ranchers must pay federal estate taxes, such as that advanced by President Ford; however, it is felt that such proposal, by itself, will not solve the problem facing estates of farmers and ranchers, as previously explained. See also discussion in Exhibit A.[8]

Most urgently needed, is legislation which would permit farm and ranch land to be valued for federal estate tax purposes based upon earning or productive capacity. According to the Economics Division of the Congressional Research Service, bills which provide a method for valuing farms and similar lands on the basis of current use rather than "fair market value," such as the Curtis bill and similar bills, would result in only a $20,000,000 revenue loss. On this point, NLTC, ANCA, NLFA and NWGA firmly believe that the continued operation of such economically efficient farms and ranches has a vital and far reaching economic effect upon the business community and the consuming public alike which more than offsets this small revenue loss. With the forecast of a possible crisis in our nation's food supply and the ever rising costs of doing business, it would seem prudent policy to structure our estate tax laws to help farmers and ranchers stay in business and remain productive.

NLTC, ANCA, NLFA and NWGA urge this Committee's review of these serious problems and the beneficial effect this proposed legislation, if enacted, would have on all farms and ranches.

II. CAPITAL GAINS TAX AT DEATH SHOULD NOT BE IMPOSED

NLTC, ANCA, NLFA and NWGA oppose the proposal to impose a capital gains tax on appreciation in value of property at the time of death or on property transferred by gift. Such proposal would be especially burdensome to farmers and ranchers. First, lack of liquidity, as previously explained, is a common plague of the farmer or rancher; thus, there are often insufficient funds to pay the estate and inheritance taxes, much less a capital gains tax at death. In essence, the taxing of capital gains at death is treating death as a sale of the property, yet no proceeds are generated from which to pay the tax. The adverse effect imposition of a capital gains tax at death would have on estates of farmers and ranchers is illustrated by Dr. Hopkin's statement which appears in Exhibit A.

The typical farm or ranch is an integrated economic unit and parcels cannot be sold to pay the estate and proposed capital gains taxes without lowering the value of both the part that is sold and the part that remains. Furthermore, farm and ranch land frequently cannot be sold within a few months of death since there are generally relatively few buyers, and, in order to make a sale at all, it is often required that the most desirable parts of the farm or ranch be sold, leaving the less desirable parts to be held by the heirs, making it most difficult for them to conduct an economic operation. Land is not like a portfolio of stocks which can be sold in part without loss in value.

Even proponents of the capital gains tax at death recognize that estates consisting of farms or ranches have a substantial problem in paying taxes imposed at death because of lack of liquidity and that imposition of a capital gains tax at death would aggravate this liquidity problem.[9] However, these proponents gloss over this problem with the veneer that the major share of

[8] Exhibit A, a statement to the House Ways and Means Committee, on estate and gift taxation, was made a part of the official files of the Committee.

[9] Kurtz and Surrey, *Reform of Death and Death Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 Columbia Law Review 1395 (1970) at 1389, 1397-93.

such estates consists largely of diversified stocks and securities, which is a misstatement of the facts for relatively few farmers and ranchers' estates consist even in small, much less large, part of diversified stocks and securities. According to The Balance Sheet of the Farming Sector, 1975, published by the Economic Research Service of the U.S. Department of Agriculture, preliminary figures for 1975 show assets are held by farmers in the following percentages: real estate 71.4%, livestock and poultry 4.7%, machinery and motor vehicles 10.7%, crops 4.5%, household equipment and furnishings 3.0%, deposits and currency 2.9%, U.S. savings bonds .8% and investments in cooperatives 2.0%. Because of their apparent scarcity, this study states that data is not available for estimating farmer's investments in corporate owned stocks. Therefore, it is quite clear that diversified stocks and securities do not compose a significant, much less a major share of farmers' estates.

Moreover, the typical farm or ranch yields a very low return on the investment, particularly at the current inflated prices for farm and ranch land. There are no excess earnings to put aside to provide for future death taxes, particularly when the tax burden is compounded by the addition of a capital gains tax at death.

The policy of the proposal, i.e. freeing capital that is "locked in" by the threat of capital gains tax during lifetime, is not applicable to the farming and livestock industry. A ranch is not an investment to be turned over by the investor routinely as in the case of an investment in the stock market. A ranch or a farm is acquired to be retained and developed and to be operated and maintained as a productive, economic unit.

Finally, extension of time for payment of the taxes is not a real solution, either, since the yield on farm and ranch properties, particularly at current price levels of land, is very low and there does not seem to be enough profit in the ranching business to pay off even the present federal estate taxes, much less an added-on capital gains tax at death.

Consequently, NLTC, ANCA, NLFA and NWGA urge this Committee to reject this proposal.

The Carryover Basis Alternative Should Also Be Rejected

An alternative proposal advanced is to provide for a carryover basis to their heirs of the decedent. One justification advanced for this alternative proposal is that the tax on appreciation in value will be payable when the property is actually sold, thus overcoming the very serious constitutional objections of imposing an income tax when no income has been realized as is the case in the capital gains tax at death proposal.

Analysis of such proposal, however, reveals it is undesirable in that it presents a number of serious problems. First of all, the administrative problems involved in determining a decedent's basis are difficult enough when the taxpayer is living and become increasingly unmanageable the longer the property is held after the decedent's dath. Secondly, it has long been felt by those charged with the administration of the tax laws that such a proposal is unworkable since it would be very difficult in many cases, if not impossible, to determine the cost basis of property acquired by a decedent many years previously. Further, the modification of this proposal to provide that the only appreciation to be taxed is that occurring subsequent to the enactment of the amendment would create an administrative nightmare similar to that which clogged the administrative channels and the courts for many years in the determination of March 1, 1913, value of property for purposes of determining gain on the sale of property owned by the taxpayer prior to the enactment of the first income tax law. The enactment of such a proposal might be a boon to the appraisers, accountants, and tax lawyers, but the increased administrative costs could well outweigh the increased tax revenue realized.

Additionally, since the decedent's property has been subjected to the levy and payment of an estate tax on the value of the property at the decedent's death, it seems only fair and equitable that this same value should be the tax basis of such property in the hands of the heirs.

Proponents of the carryover basis alternative point out that it is merely an adaptation of the existing law with respect to taxation of gifts of property given during lifetime where the basis of the donor is carried over and becomes the basis of the gift property in the hands of the donee. What this overlooks is the fact that a gift during lifetime is a voluntary act and the donor is alive and well and can assist the donee in determining the basis of the property. Such is not the case at death, and the requirements of equitable administration of the tax laws require a clean slate so that similarly situated heirs will be treated similarly for tax purposes. If the rule were otherwise, and a carryover basis were to be enforced in the case of death, a premium would be given to the heir who could produce the tax basis records of the decedent and the heir who could not would be required to employ lawyers and accountants to haggle with the Internal Revenue Service over the computation of the amount of gain involved when the heir elected to dispose of the property at a later date.

In summary, this Committee is also urged to reject the carryover basis alternative for the previously stated reasons.

III. SUMMARY

It is respectfully requested that the foregoing proposals and views be seriously considered. NLTC, ANCA, NLFA and NWGA would be pleased, as they have in the past, to work with the staff of this Committee in implementing the foregoing suggested proposals.

Statement of National Livestock Tax Committttee, American National Cattlemen's Association, National Livestock Feeders Association, and National Wool Growers Association

SUMMARY

Tax Reform

1. *Need for Capital.*—Being affected by weather, diseases, precipitous market fluctuations, government regulations, unchecked foreign imports and constantly increasing production costs, the livestock industry has a continuously expanding need for capital both from within and without the industry. This need is particularly pressing because of the drastic losses suffered by the industry in 1973–1975. However, this capital infusion should be made on an economic, not tax shelter, basis.

2. *Livestock Tax Shelters Can Be Eliminated.*—We favor a two-point program:

(a) Limit farm losses to capital at risk;

(b) Tax as corporations all limited partnerships registered with SEC.

3. *Excess Deductions Account (§ 1251) Should Be Terminated.*—Hopelessly complex, this provision is unworkable.

4. *Activities for Profit Provisions (§ 183) Should Be Amended.*—

(a) Statute of limitations waivers should be restricted when applying these provisions.

(b) Two out of seven year presumption should be extended to all livestock operations.

5. *Limitation on Artificial Losses (LAL) Should Be Rejected.*—Immensely complex, highly discriminatory and very costly, LAL should not be enacted. LAL is not necessary to curb abuses and would be another unworkable EDA for both the IRS and taxpayers to contend with.

6. *Mandatory Accrual Accounting for Certain Corporations and Partnerships Highly Discriminatory.*—We strongly oppose this provision. Most farm corporations are small family-owned businesses (Department of Agriculture Economic Report No. 241). The proposed family corporation exemption would not protect many businesses where more than one family is involved.

7. *A Minimum Tax is Not the Answer.*—A tax on a loss would not be fair. However, the imposition of a minimum tax on farm losses that exceed capital at risk would certainly curb abuses.

8. *Material Distortion of Income Test Not Applicable to Cash Basis Taxpayers.*—This test is meaningless and injects an undesirable subjective element into tax administration.

JOINT STATEMENT

INTRODUCTION

Formed in 1942, the National Livestock Tax Committee (NLTC) is sponsored by a number of national, breed and state livestock associations throughout the nation and has as its purpose maintaining and assuring equity and equality in the fields of federal income, gift and estate taxation for the entire livestock industry.

Representing over 300,000 cattlemen throughout the nation, the American National Cattlemen's Association (ANCA) is a voluntary, nonprofit, nonpolitical organization.

The National Livestock Feeders Association (NLFA), a nonprofit, voluntary, nonpolitical organization, represents stockmen in over 200 state and local affiliated associations.

The National Wool Growers Association (NWGA), a voluntary, nonprofit, nonpolitical organization, represents 22 state and regional organizations encompassing a 25 state area, where 90% of the nation's lambs and wool are produced.

NLTC, ANCA, NLFA and NWGA speak for the entire red meat animal industry in the nation. In addition, NLTC represents dairy and horse organizations.

PREVIOUS TESTIMONY AND PROPOSALS ON TAXATION OF FARM OPERATIONS

In 1969, as well in prior years, representatives of NLTC and ANCA appeared jointly before this Committee to testify on the subject of taxation of farm operations. NLTC and ANCA, working with the staff of this Committee and the Joint Committee on Internal Revenue Taxation, came forward in 1969 with positive proposals to help eliminate so-called abuses by a relatively small number of "tax profiteers" in agriculture and at the same time not substantially harm the legitimate industry. These proposals were ultimately adopted in the 1969 Tax Reform Act. NLTC and ANCA are of the opinion that such proposals have had the desired and intended effect of eliminating the "tax profiteer" in the industry, particularly in tax shelter breeding herd programs.

LARGE CAPITAL INVESTMENT REQUIRED IN FARMING AND RANCHING

Livestock operations require significant capital investment and normally require a number of years before profitable status is reached. Even when profits are earned, they produce a return on investment which is one of the lowest of all national industries. In addition, livestock is a very high risk business. Uncertain and damaging weather conditions, diseases, precipitous market fluctuations, government regulations, unchecked foreign imports, and ever-increasing production costs are constant threats to economic survival.

Being a capital intensive industry, it is essential that all valid sources of capital flowing into agriculture be encouraged so that abundant supplies of food and fiber may be provided our nation at reasonable prices. With some studies predicting a food crisis in coming years, and considering our nation's world position in agricultural production, it becomes increasingly important not to discourage the proper growth, development and continued vitality of the livestock and agricultural industry. Instead, such growth and development should be encouraged and fostered by our tax and other laws.

It is, and has been, the stated position of NLTC, ANCA, NLFA and NWGA that outside capital which is essential to the industry should enter on an economic basis—not as a tax shelter.

At present, the livestock industry is trying to recover from a dangerously depressed condition. It is estimated that losses in the cattle industry alone have been in the billions of dollars just for the last three years and that it will take a number of years for this industry to recover. To enact tax or any other laws which would discourage investment from within or without the livestock industry would seriously jeopardize its ability to provide an adequate supply of food and fiber to the nation. Therefore, any changes proposed in the tax laws should only be taken after long and careful consideration so that no permanent damage is done to the industry and it is permitted to continue to attract capital from outside sources on a sound and economic basis.

USE OF THE INDUSTRY AS A TAX SHELTER SHOULD BE ELIMINATED

The use of livestock breeding programs as tax shelters in the 1960's was effectually terminated by enactment of tax reform proposals prepared and advocated by NLTC and ANCA in 1969. Since then, cattle feeding has been used as a tax shelter and the real abuse has been in cattle feeding programs which publicly advertised write-offs in excess of cash invested, in some cases up to 400%, as a result of leveraging achieved through the use of nonrecourse loans. Due to market conditions and in some cases unsound management, many of these programs have gone out of business in the last two years, so that today there is not much tax shelter money going into these programs.

However, to cure any possibility that the abuses caused by these programs might reoccur, NLTC, ANCA, NLFA and NWGA recommend the adoption of a two-point programs: (1) limit farm losses to capital at risk (Section 207 of the 1975 Tax Reform Act [H.R. 10612]); and (2) tax all limited partnerships registered with the SEC as corporations. NLTC, ANCA, NLFA and NWGA believe that the adoption of this two-pronged approach will curb alleged abuses in the livestock tax area without substantially damaging the legitimate industry.

NLTC, ANCA, NLFA and NWGA also support Section 211 of the 1975 Tax Reform Act, dealing with the scope of waiver of the statute of limitations in the case of activities not engaged in for profit, and Section 203 of the Act, concerning termination of additions to Excess Deductions Accounts under section 1251 of the 1954 Internal Revenue Code, as amended ("Code"). NLTC, ANCA, NLFA and NWGA oppose, as not needed to curb the alleged abuses and harmful to the industry, Section 101 of the Act dealing with Limitation on Artificial Losses (LAL) as it applies to farm losses and Section 204 of the Act requiring certain corporation and partnerships engaged in farming to use the accrual method of accounting and capitalize all preproductive period expenses.

FARM LOSSES SHOULD BE LIMITED TO CAPITAL AT RISK

The capital at risk provision contained in Section 207 of the Act affecting farm losses was proposed by NLTC, ANCA, NLFA and NWGA to the Ways and Means Committee in 1975. This particular provision would effectively curb the few egregious tax shelter livestock feeding programs which advertised 400% write-offs as a result of nonrecourse financing or any other similar schemes which might be devised in the future. Further, this proposal would limit the amount of deductions in the case of a livestock feeding or other contract which had a guaranteed stop loss provision. Thus, as proposed by Section 207 of the Act, farm losses incurred could only be deducted to the extent of cash invested plus recourse loans, which would mean that farm losses would be limited to a taxpayer's potential personal financial liability in the farm or ranch activity. Since legitimate farm and ranch operations are financed by recourse loans, this proposal should not adversely affect them.

A number of questions have been raised regarding the provisions of Section 207 of the Act. It has been pointed out that the capital at risk provision should be interpreted so as to apply to the fair market value of assets which a farmer or ranches has acquired and not to the farmer or rancher's adjusted cost basis in such assets. NLTC, ANCA, NLFA and NWGA agree with this suggestion and respectfully request that, if this Committee adopts the capital at risk provision, it specify either in amendatory language or in the description of this provision in its Report that the full fair market value of assets acquired by farmers and ranchers be the criterion in determining the amount of capitalat risk in a particular livestock operation.

As passed by the House of Representatives, Section 207 had an effective date of September 10, 1975. NLTC, ANCA, NLFA and NWGA feel that if this Committee should favorably act upon this Section of the Act, its effective date should be changed so that it will apply prospectively from the date of its enactment into law.

LIMITED PARTNERSHIPS REGISTERED WITH THE SEC SHOULD BE TAXED AS CORPORATIONS

Commentators have called attention to alleged abuses caused by limited partnerships in a number of different industries where tax shelter programs have been widely advertised. These commentators have suggested that these abuses could be corrected if such limited partnerships which are registered with the Securities and Exchange Commission (SEC) were taxed as corporations. It is the opinion of NLTC, ANCA, NLFA and NWGA that any such abuses which exist in the livestock industry and which are not eliminated by the capital at risk proposal, can be terminated by taxing *all* limited partnerships which are registered with the SEC as corporations. This proposal is supported by NLTC, ANCA, NLFA and NWGA only if it applies to limited partnerships in all industries and provided there is a clause exempting existing limited partnerships from such coverage. Additionally, since limited partnerships are legitimately used by farm and ranch operations for the purpose of bringing in minors and other persons as limited partners and for achieving estate planning objectives, this proposal is limited to all limited partnerships which are registered with the SEC, since these are the ones which have been generally utilized for tax shelter purposes.

While the capital at risk and limited partnership proposals may restrict the flow of some outside capital into the industry, it is felt that the industry should be able to operate in a satisfactory manner with such provisions without serious adverse consequences.

SECTIONS 203 AND 211 OF THE ACT SHOULD BE ADOPTED; PROFIT PRESUMPTION IN 2 OUT OF 7 YEARS SHOULD APPLY TO ALL LIVESTOCK OPERATIONS

Section 203 of the Act provides that no additions will be made to an Excess Deductions Account under section 1251 of the Code after December 31, 1975. NLTC, ANCA, NLFA and NWGA support this provision as it is felt that section 1251 is hopelessly complex and administratively unworkable. The necessity for repealing section 1251 is not, to our knowledge, opposed by any group or entity, even including, we are informed, the Treasury Department.

Section 211 of the Act corrects a problem which currently exists with respect to the scope of the waiver of the statute of limitations in the case of activities not engaged in for profit. This Committee, in 1969, reported out a bill which amended the Code by adding section 183, dealing with the deduction of losses from activities not engaged in for profit. As presently written, section 183 provides a rebuttable profit presumption in the event a taxpayer has a profit in 2 out of 5 consecutive taxable years. In the case of horse operations, the presumption applies if there is a profit in 2 out of 5 consecutive taxable years. In the case of horse operations, the presumption applies if there is a profit in 2 out of 7 years. The law is presently interpreted to permit a person to take advantage of this profit presumption by filing a timely election to keep open all years during the 5 or 7 year period. This has the effect of allowing the IRS to examine *all* items on the taxpayer's returns for these years and not just those expenses relating to the activity for which the election was made. Section 211 of the Act would correct this situation by providing that where an election is made to waive the statute of limitations in order to take advantage of the profit presumption, the taxpayer's returns for these years could only be audited for items relating to the activity for which the election was made. NLTC, ANCA, NLFA and NWGA support this provision of the Act.

While support is given to the 2 out of 7 year profit presumption rule under section 183 of the Code with respect to operations, the major part of which consists of breeding, training, showing or racing of horses, NLTC, ANCA, NLFA and NWGA feel that this same presumption rule should apply to all livestock operations. This is based upon the fact that it normally takes 7 years or more in order for most livestock businesses to start showing a profit. See attached Statement of Donald E. Farris and James I. Mallet. who are professors and extension economists at Texas A & M University. Furthermore, livestock prices fluctuate widely causing some profitable years but also a number of unprofitable years. In addition, many livestock operations include the raising of horses as well as other livestock. To segregate the costs of raising horses from other livestock is a difficult, if not impossible, accounting problem and makes compliance and administration burdensome. Accordingly, compliance and administration would be facilitated and equity achieved if the 2 out of 7 year presumption rule applied to all livestock operations. Consequently, NLTC, A NCA, NLFA and NWGA respectfully urge this Committee

69-460 O - 76 - pt. 1 - 28

to amend section 183 of the Code to exten dthe application of the 2 out of 7 year profit presumption rule to all livestock operations.

SECTIONS 101 AND 204 OF THE ACT ARE NOT NEEDED TO CORRECT ALLEGED ABUSES IN THE LIVESTOCK TAX AREA AND WOULD BE HARMFUL TO THE INDUSTRY

Section 101 of the Act, referred to as the LAL provision, places a limitation on the deduction of so-called "artificial losses" which are incurred in agriculturaloperations. As applied to the livestock industry, LAL would cause hardships to legitimate livestock businesses. Furthermore, LAL would add undue complexity to the law which would make both compliance and administration difficult. It would also be costly to and would unfairly discriminate against stockmen and is not needed in order to curb the so-called abuses caused by a few "tax profiteers" in the industry.

The accounting burdens alone imposed by LAL would be monumental and would cost those legitimately engaged in farming and ranching the additional expense of hiring accountants to maintain sufficient books and records to comply with the provisions of LAL. A number of livestock tax accountants have observed that compliance with LAL will be more difficult than under section 1251 of the Code dealing with the Excess Deductions Account, which it is generally agreed should be repealed as provided in Section 203 of the Act.

Contrary to the representations of the sponsors of LAL that the $20,000 nonfarm income exemption will protect legitimate farmers and ranchers, its enactment *will* adversely effect substantial numbers oft hem. In the first place, the Report of the Committee on Ways and Means recognizes that many farmers and ranchers do receive nonfarm income (Committee Report No. 94–658, p. 40). In cases where this nonfarm income comes or can come anywhere near $20,000, the complicated record-keeping previously referred to must be maintained, because there is always the possibility that the nonfarm figure could exceed $20,000 and LAL would apply. Thus, the farmer or rancher with any substantial nonfarm income just can't wait around until April 15 to find out whether or not LAL applies for the preceding year. He will have to maintain or try to maintain all the records necessary to comply with LAL just in case he has a farm loss in a year when his nonfarm income happened to exceed $20,000. And anyone who says that legitimate farmers and ranchers don't have frequent farm losses is not living in the real world.

Moreover, the $20,000 nonfarm income exemption does not apply to trusts or to the many family farm and Subchapter S corporations which many farmers and ranchers use for the conduct of their business activities. Thus, the enactment of LAL will discriminate between farming operations conducted by family-owned and Subchapter S corporations and trusts on one hand and those conducted by individuals.

Consequently, it is the position of NLTC, ANCA, NLFA and NWGA that LAL as it applies to agriculture should be deleted from the Act and that any abuses in the livestock tax area can be terminated by adopting the two previously suggested proposals.

NLTC, ANCA, NLFA and NWGA also oppose Section 204 of the Act which would require certain corporations and partnerships engaged in farming to use inventories and capitalize preproductive period expenses. Such a provision would be highly discriminatory between farm and ranch taxpayers using different business organizations. Furthermore, many bona fide farm and ranch operations are incorporating for valid business purposes and most of them are small, family-owned businesses. Exempting Subchapter S corporations from such provision is not the answer, since many farm and ranch businesses are not eligible or do not desire to use Subchapter S. Moreover, exempting from this provision certain family-owned farm corporations would cause unforeseen inequality to many corporations where ownership resides in several families or in unrelated parties.

In most parts of the country, it is not uncommon for several families in a community to form a joint farming or ranching operation and have it incorporated. In such situations, a Subchapter S election may not be appropriate for various reasons, such as more than 10 sharehoders or a trust as a shareholder or because there is rental, mineral or other passive income. In such a corporation, the "family-owned" exception would not apply and the corporation would be required to use the accrual method of accounting and to capitalize all preproductive period expenses.

To deny use of the corporation as a vehicle to conduct farming and ranching operations in patently unfair. No other industry is singled out for such discriminatory treatment. In addition, undue complexity in compliance and administration would be created by this provision. Based upon an informal survey conducted of farm and ranch accountants, it was reported that if this provision should be enacted into law, the annual accounting costs for smaller farms and ranches would be increased by 100% to 300% and medium and larger sized farms and ranches would incur annual accounting costs alone of between $15,000 and $20,000.

APPLICATION OF ALTERNATIVE MINIMUM TAX TO LIVESTOCK TAX SHELTERS

It has been suggested that alleged abuses caused by "tax shelters" in all businesses, including agriculture, could be effectively handled by an alternative minimum tax provision which would apply to losses produced by all such "tax shelters." NLTC, ANCA, NLFA and NWGA feel that the proposals they have advanced regarding limiting farm losses to capital at risk and taxing all SEC registered limited partnerships as corporations should eliminate the alleged abuses in the livestock tax area. If an alternative minimum tax provision is proposed, NLTC, ANCA, NLFA and NWGA suggest that it apply to agriculture operations only with respect to farm losses that exceed capital at risk, since this, together with the proposal to tax SEC registered limited partnerships as corporations, would curb the alleged abuses in livestock operations.

MATERIAL DISTORTION OF INCOME TEST NOT APPLICABLE TO CASH BASIS FARMERS

In recent pronouncements by the Internal Revenue Service, an attempt has been made to apply the "material distortion of income" test to deductions taken by cash basis farmers and ranchers. There is no statutory authority for imposing this test, and in fact in three court cases, application of this test has been specifically rejected. Such a test is meaningless when applied to the cash method of accounting and injects an undesirable subjective element into tax administration. To eliminate expensive and time-consuming administrative controversies, NLTC, ANCA, NLFA and NWGA urge that IRS be instructed to cease its use of this test concerning cash basis farmers and ranchers.

SUMMARY

It is respectfully requested that the foregoing proposals and views be seriously considered. NLTC, ANCA, NLFA and NWGA would be pleased, as they have in the past, to work with the staff of this Committee in implementing the foregoing suggested proposals so that the livestock industry will be taxed on a fair and equitable basis, needed outside capital will be encouraged to enter the industry on an economic basis, and the industry will be permitted to provide adequate food and fiber to the nation at reasonable prices.

Attachment.

EFFECT OF VARIABILITY IN PRICES AND PRODUCTION CYCLES ON PROFITABILITY IN BEEF CATTLE

(By Donald E. Farris and James I. Mallet[1], Texas A&M University)

Profit in beef cattle operations have historically been very erratic. Most beef producers in the United States do not depend entirely on beef for their income for this reason. Typically beef cattle have provided a low return to land and as a result have been largely confined to land that is marginal for crop production.

[1] Professor and Extension Economist respectively, Texas A&M University.

Beef producers operate in all 50 states and their business takes many forms. Most farmers and ranchers have income from crops or other livestock to diversify their business and reduce risk from variability in prices, weather, pests and disease. In some areas of the country small farms that were formerly used for crop production are now used for beef production, but are part time farms or ranches where at least one member of the family works full time off the farm. This is another way that the business is diversified and risk is reduced. However, there are many areas in this country where specialized beef ranching is the standard kind of business, and the operator derives practically all of his income from cattle.

There is ample evidence that this kind of business has experienced relatively low incomes for many years except for a period during and following World War II, during the Korean War and near the end and following the Vietnam War. All were periods of rapid inflation and sharp increases in personal income of consumers (Table 1). The cattle price cycle has an overriding effect on the profitability of the cow-calf business. Historically this cycle has been 10 to 14 years in length, but it is extremely irregular and difficult to forecast (Figure 1).

To demonstrate the need for a tax policy that will permit the rancher and farmer to take the necessary risk to produce the beef this country needs, some examples have been developed. These exampls are designed to show that a well managed specialized beef operation can experience prolonged periods without profit, particularly if the operator starts his business at the beginning of a period of unfavorable prices or weather. It is not claimed that this represents the situation on a diversified livestock ranch or an operation started when land and cattle prices were depressed.

These examples are developed from research on ranching businesses from several areas of the United States, but for clarity a specific size and location is selected. This is a 4000 acre ranch in South Central Texas. The area is considered to be good ranching country requiring ten to 15 acres per cow. In many respects this operation parallels the same size ranch in the Sandhills areas of Nebraska. Winter feed costs are higher there, but the price of feeder calves usually averages a little higher.[3]

STARTING IN 1950 WITH A PRODUCING HERD

Assume that a rancher purchased a 400 acre ranch with a producing herd in 1950, a period of favorable beef prices. The ranch and cattle would have cost an estimated $175,000 or $44 per acre. The total investment for cattle, equipment and land is estimated at $237,000 or $987 per cow. Assume that the rancher borrowed half of the money to buy the land and two-thirds of that required to buy the cattle. The business covered cash costs and provided operator income the first three years, but for the next five years did not provide sufficient return to pay all of the interest charges on the land (Col. 4, Table 2). Low cattle prices during the mid-fifties resulted in six consecutive years (1952-56) with no return to the operator's equity, labor or management (Col. 5, Table 2). Prices improved in the late 1950's and there was a small return in 1958 and 1959 ($1244 and $1223). During the next nine years the ranch failed to show a profit. Then beginning in 1968 the business began to provide the operator with income above costs and 1972 was a good year, 1973 will apparently be even better.

In other words, this example showed a profit in only eight out of 23 years mostly because it spanned a long low side of the cattle price cycle.

The only way this operator could have stayed in business is if he had been able to get additional income from hunting leases, crop farming or outside income; or if he had owned the ranch free of debt from the beginning. In this case he would have averaged an annual income of $7500 from his equity, labor and management (Col. 3, Table 2).

[3] See "The Sandhills Ranch Business, 1970 and Comparisons With 1960 and 1965," by A. W. Epp and Robert Perry. Publication in process. Dept. Ag. Econ., Univ. of Nebraska. 1973.

TABLE 1.—PROFIT RATES FOR SELECTED LIVESTOCK AREAS [1]

[In percent]

Area	1956-60	1962-64	1965-67	1967-68
Cornbelt: Hog-beef fattening	5.25	4.62	6.19	4.26
Wheat: Wheat, small grain-livestock	5.67	12.09	7.41	(2)
Cattle ranches:				
Northern Rocky Mountain area [3]	8.15	5.99	4.40	5.28
Southwest	2.91	1.78	2.27	2.13

[1] Source: Farm Costs and Returns. Agricultural Information Bulletin No. 230, ERS, USDA, revised Sept. 1968.
[2] Omitted from ERS Bulletin 230 series starting 1969.
[3] Listed as intermountain region prior to 1968.

TABLE 2.—ESTIMATED INCOME FOR A 1-MAN RANCH IN TEXAS BASED ON 300 ANIMAL UNITS AND 4,000 ACRES, BEGINNING WITH A PRODUCING HERD, 1950-72

Year	Gross income from cattle	Income above cash operating cost [1]	Income above cash operating cost and interest on cattle [2]	Income above total cash cost [3]	Income to operator labor, capital, and management
1950	$21,202	$12,991	$9,772	$4,704	$1,032
1951	26,142	17,076	14,057	8,789	5,117
1952	20,549	11,483	8,464	3,196	−476
1953	13,782	5,286	2,267	−3,001	−6,673
1954	14,673	6,177	3,158	−2,110	−5,782
1955	14,170	5,866	2,847	−2,421	−6,093
1956	13,335	5,031	2,012	−3,256	−6,928
1957	15,784	7,192	4,173	−1,095	−4,767
1958	20,334	11,553	8,534	3,266	1,244
1959	20,391	11,514	8,495	3,227	1,223
1960	17,825	9,044	6,025	757	−1,265
1961	17,960	9,083	6,064	796	−1,226
1962	19,260	10,287	7,268	2,000	−22
1963	17,556	8,487	5,468	200	−1,822
1964	15,249	6,276	3,257	−2,011	−4,033
1965	17,165	8,000	4,981	−287	−2,309
1966	19,761	10,311	7,292	2,024	2
1967	19,019	9,473	6,454	1,186	−836
1968	19,898	10,160	7,141	1,873	−149
1969	22,573	12,454	9,435	4,167	2,145
1970	23,333	12,833	9,814	4,546	2,524
1971	29,079	18,102	15,083	9,815	7,793
1972	33,724	22,270	19,251	13,983	11,961
Total for period	452,764	240,949	171,512	50,348	−9,340
Annual average	19,685	10,476	7,457	2,189	−4,061

[1] Does not include interest payments on ranch and cattle.
[2] Includes 8 percent interest on two-thirds of the original cost of the cattle.
[3] Includes all cash costs plus interest payments on cattle and 6 percent interest on one-half of the purchase price of the ranch.

TABLE 3.—ESTIMATED INCOME FOR A 1-MAN RANCH IN TEXAS BASED ON 300 ANIMAL UNITS AND 4,000 ACRES BEGINNING WITH A PRODUCING HERD, 1960–72

Year	Gross income from cattle	Income above cash operating cost [1]	Income above cash operating cost and interest on cattle [2]	Income above total cash cost [3]	Income to operator labor, capital, and management
1960	$17,825	$9,044	$6,757	−$2,251	−$4,414
1961	17,960	9,083	6,796	−2,212	−4,375
1962	19,260	10,287	8,000	−1,008	−3,171
1963	17,556	8,487	6,200	−2,808	−4,971
1964	15,249	6,276	3,991	−5,019	−7,182
1965	17,165	8,000	5,713	−3,295	−5,458
1966	19,761	10,311	8,024	−984	−3,147
1967	19,019	9,473	7,186	−1,822	−3,985
1968	19,898	10,160	7,873	−1,135	−3,298
1969	22,573	12,454	10,167	1,159	−1,004
1970	23,333	12,833	10,546	1,538	−625
1971	29,079	18,102	15,815	6,807	4,644
1972	33,724	22,270	19,983	10,975	8,812
Total for period	272,402	146,780	117,051	−55	−28,174
Annual average	20,954	11,291	9,004	−4	−2,167

[1] Does not include interest payments on ranch and cattle.
[2] Includes 8 percent interest on two-thirds of the original cost of the cattle.
[3] Includes all cash costs plus interest payments on cattle and 6 percent interest on one-half of the purchase price of the ranch.

STARTING IN 1960 WITH A PRODUCING HERD

Had an operator started the same kind of business in 1960, he would have encountered a similar situation. Land costs were higher (about $75 per acre) but cattle costs a little lower. The total investment in the ranch and cattle would have been about $350,000 or $1458 per cow.

The first nine of the 13 year period the income did not cover all cash costs (Col. 4, Table 3). The business did not show a profit for the first 11 years. The higher cattle prices of 1971 and 1972 resulted in a profit but considering his investment it was still a low profit (Col. 5, Table 3). If the operator had owned the ranch free of debt at the start (1960) he would have received an average annual income of about $9000 (Col. 3, Table 3).

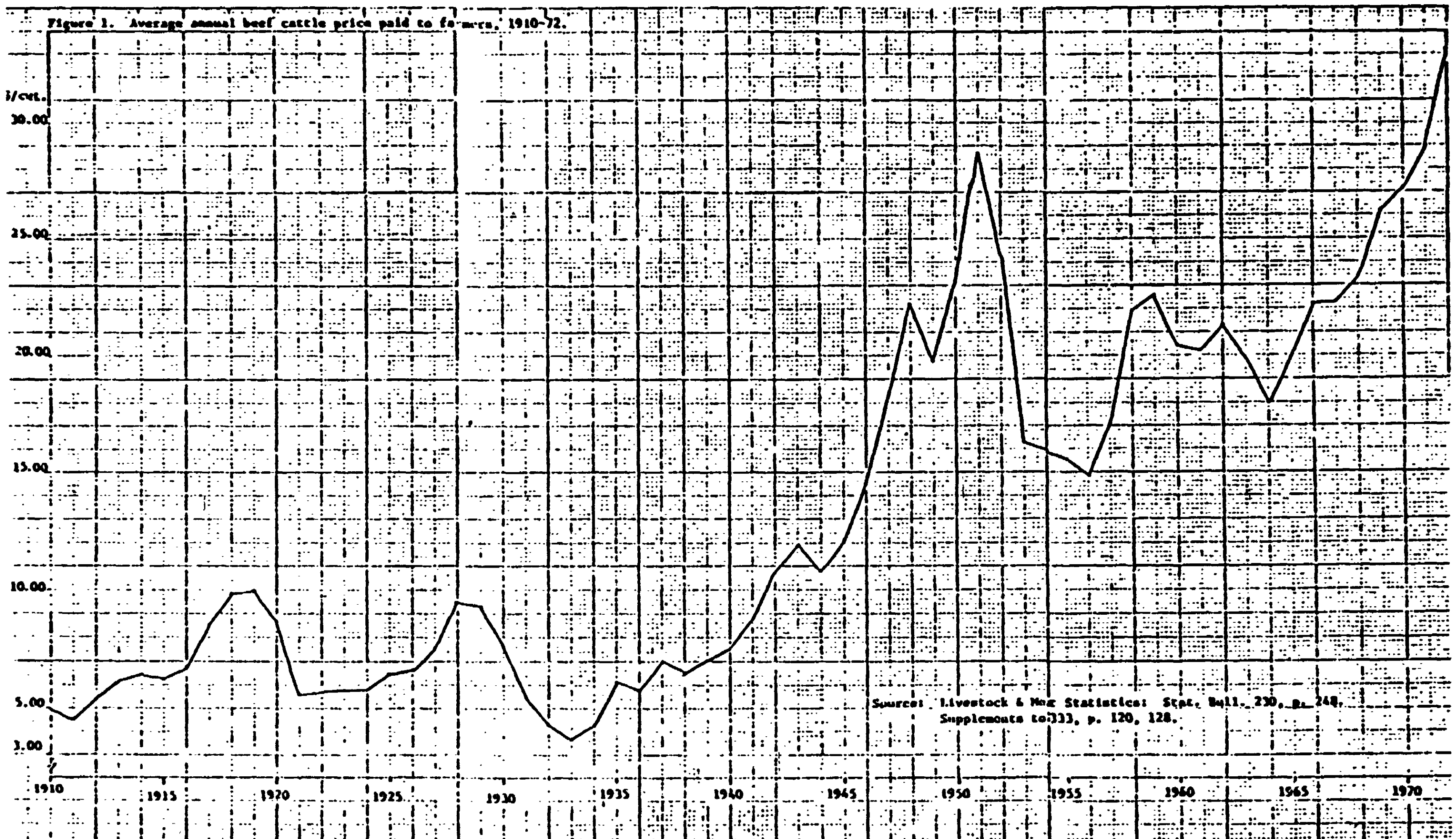


Figure 1. Average annual beef cattle price paid to fa-mers, 1910-72.

FIGURE 1.

STARTING A HERD WITH UNBRED HEIFERS

If we examine the same operations as previously but assume the rancher starts with unbred heifers rather than with producing cows, this adds at least one more year at the beginning without a profit. It demonstrates even more dramatically that the cattle cycle can result in even a well managed ranch undergoing a long period when there is either no profit, or if the land is owned free of debt, a very small profit. (Tables 4 and 5).

SUMMARY

Ranchers generally are experiencing good incomes for the first time in 20 years. There are some who expect it to be good throughout this decade. No doubt, the current high prices wil encourage some to expand and newcomers will be attracted to ranching. If prices continue favorable throughout the 1970's, it will be only the second time in history that this has happened. The other period was the decade that spanned the last part of World War II and the Korean War. Several years are required for the cattle industry to adjust to changes in world demand and supply conditions. The longer prices remain high, the longer will be the following periods of losses or low profits.

Diversified farming and ranching operations generally show more stable income and profits, but specialized ranching has experienced wide fluctuations in income and the tax provisions should recognize this characteristic of the business.

The present tax regulation (Internal Revenue Code 183 enacted in 1969) requiring a producer to show a profit two years out of five is unrealistic for many agricultural producers, and especially the specialized cattle rancher because of the wide swings in the cattle price cycle. The examples presented here show that this is even more unrealistic for the rancher just getting started or those in areas where a series of dry years are not uncommon.

TABLE 4.—ESTIMATED INCOME FOR A 1-MAN RANCH IN TEXAS BASED ON 300 ANIMAL UNITS AND 4,000 ACRES, BEGINNING WITH UNBRED HEIFERS, 1950-59

Year	Gross income from cattle	Income above cash operating cost [1]	cash operating cost and interest on cattle [2]	Income above total cash cost [3]	Income to operator labor, capital, and management
1950	0	−$6,076	−$9,083	−$14,351	−$16,373
1951	$21,960	11,818	8,811	3,543	55
1952	15,027	5,961	2,954	−2,314	−5,476
1953	13,782	5,286	2,279	−2,989	−5,663
1954	14,673	6,177	3,170	−2,098	−4,120
1955	14,170	5,866	2,859	−2,409	−4,431
1956	13,335	5,031	2,024	−3,244	−5,266
1957	15,784	7,192	4,185	−1,083	−3,105
1958	20,334	11,533	8,546	3,278	1,256
1959	20,391	11,514	8,507	3,239	1,217
Total for period	149,456	64,302	34,252	−18,428	−41,906
Annual averages	14,946	6,430	3,425	−1,843	−4,191

[1] Does not include interest payments on ranch and cattle.
[2] Includes 8 percent interest on two-thirds of the original cost of the cattle.
[3] Includes all cash costs plus interest payments on cattle and 6 percent interest on one-half of the purchase price of the ranch.

TABLE 5.—ESTIMATED INCOME FOR A 1-MAN RANCH IN TEXAS BASED ON 300 ANIMAL UNITS AND 4,000 ACRES, BEGINNING WITH UNBRED HEIFERS, 1960-72

Year	Gross income from cattle	Income above cash operating cost [1]	Income above cash operating cost and interest on cattle [2]	Income above total cash cost [3]	Income to operator labor, capital, and management
1960	0	−$8,781	−$11,374	−$20,382	−$22,545
1961	$15,511	6,634	4,041	−4,967	−7,030
1962	16,807	7,834	5,241	−3,767	−5,930
1963	17,556	8,487	5,894	−3,114	−5,277
1964	15,249	6,276	3,683	−5,325	−7,488
1965	17,165	8,000	5,407	−3,601	−5,764
1966	19,760	10,311	7,718	−1,290	−3,453
1967	19,019	9,473	6,880	−2,128	−4,291
1968	19,898	10,160	7,567	−1,441	−3,604
1969	22,573	12,454	9,861	853	−1,310
1970	23,334	12,834	10,241	1,233	−930
1971	29,079	18,102	15,509	6,501	4,338
1972	33,724	22,270	19,677	10,669	8,506
Total for period	249,675	124,054	90,345	−26,759	−54,778
Annual average	19,206	9,543	6,950	−2,058	−4,214

[1] Does not include interest payments on ranch and cattle.
[2] Includes 8 percent interest on two-thirds of the original cost of the cattle.
[3] Includes all cash costs plus interest payments on cattle and 6 percent interest on one-half of the purchase price of the ranch.

TABLE 6.—LAND AND MACHINERY VALUES FOR SPECIFIC YEARS, BASED ON 1967 AND ADJUSTED BY INDEX OF PRICES OF FARM REAL ESTATE, 1950-1970

Year	Index of prices of farm real estate (1950=$100)	Value of land and buildings (dollar per acre)	Index [1] farm machinery costs (1950=$100)	Value of farm machinery (per annual unit)
1950	$100	$43.90	$100	$16.16
1955	131	57.51	113	18.26
1960	171	75.07	138	22.30
1965	214	93.95	154	24.89
1967	246	[2] 108.00	167	[2] 26.99
1970	286	125.55	194	31.35

[1] Handbook of Agricultural Charts—1971, U.S. Department of Agriculture, Agriculture Handbook No. 423, p. 9.
[2] Boykin, C. C. et al. "Economic and Operational Characteristics of Livestock Ranches," Texas Agricultural Experimental Station MP-1055, Oct. 1972.

TABLE 7.—ESTIMATED CASH COSTS PER ANIMAL UNIT FOR RANCHING OPERATIONS IN RIO GRANDE PLAINS AREA OF TEXAS BY YEARS (1967=100)

Year	Index [1] production costs (1967=100)	Cash operating costs (per animal unit)	Noncash Costs (per animal unit)
1950	$86	$27.37	$6.74
1951	95	30.22	7.45
1952	95	30.22	7.45
1953	89	28.32	6.99
1954	89	28.32	6.99
1955	87	27.68	6.82
1956	87	27.68	6.82
1957	90	28.64	7.06
1958	92	29.27	7.21
1959	93	29.59	7.29
1960	92	29.27	7.21
1961	93	29.59	7.29
1962	94	29.91	7.37
1963	95	30.23	7.45
1964	94	29.91	7.37
1965	96	30.55	7.53
1966	99	31.50	7.76
1967	100	31.82	7.84
1968	102	32.46	8.00
1969	106	33.73	8.31
1970	110	[2] 35.00	[2] 8.625
1971	115	36.59	9.02
1972	120	38.18	9.41

[1] Handbook of Agricultural Charts—1971," U.S. Department of Agriculture", Agriculture Handbook No. 423, p. 7.
[2] Boykin, C. C., et al. "Economic and Operational Characteristics of Livestock Ranches," Texas Agricultural Experimental Station, MP-1055, Oct. 1972, p. 21.

TABLE 8.—GROSS INCOME FROM SALE OF CATTLE STARTING WITH A PRODUCING HEARD, 1950-72

Year	Feeder steers [1] 105 at 375 lbs	Feeder heifers [2] 81 at 325 lbs	Cull cows [3] 20.4 at 1,000 lbs	Total cattle sales
1950	$10,501.13	$6,318.79	$4,381.92	$21,201.84
1951	12,848.06	7,730.86	5,663.04	26,141.96
1952	10,060.31	6,053.43	4,434.96	20,548.70
1953	6,831.56	4,110.65	2,839.68	13,781.89
1954	7,469.44	4,494.47	2,709.12	14,673.03
1955	7,193.81	4,328.62	2,647.92	14,170.35
1956	6,705.56	4,034.83	2,594.88	13,335.27
1957	7,965.56	4,792.99	3,025.32	15,783.87
1958	10,178.44	6,124.51	4,031.04	20,333.99
1959	10,296.56	6,195.59	3,898.44	20,390.59
1960	9,064.13	5,454.01	3,306.84	17,824.98
1961	9,166.50	5,515.61	3,278.28	17,960.39
1962	10,001.25	6,017.89	3,241.56	19,260.70
1963	9,036.56	5,437.43	3,082.44	17,556.43
1964	7,792.31	4,688.75	2,768.28	15,249.34
1965	8,859.37	5,330.81	2,974.32	17,164.50
1966	10,005.19	6,020.26	3,735.24	19,760.69
1967	9,713.81	5,844.94	3,459.84	19,018.59
1968	10,194.19	6,133.99	3,570.00	19,898.18
1969	11,536.87	6,941.90	4,094.28	22,573.05
1970	11,871.56	7,143.29	4,318.68	23,333.53
1971	15,454.69	9,213.75	4,410.48	29,078.92
1972	18,112.50	10,530.00	5,081.64	33,724.14

[1] Average price of feeder steers. Livestock and Meat Situation. Economic Research Service, USDA 1972 and earlier issues.
[2] Feeder steer prices times 0.9.
[3] Commercial cow price. Livestock and Meat Situation, 1972 and earlier issues.

TABLE 9.—AVERAGE ESTIMATED COSTS AND RETURNS PER COW PER YEAR ON A SPECIALIZED 4,000 ACRE RANCH IN TEXAS WITH 240 COWS (300 ANIMAL UNITS)

[Per cow]

System and time period	Gross cattle income	Cash costs except land [1]	Total cash costs [2]	Total costs [3]	Net income [4]
Start in 1950 with a producing herd, 1950-72	$82.02	$50.95	$72.90	$98.94	−$16.92
Start in 1960 with a producing herd, 1960-72	87.31	49.79	87.33	96.34	−9.03
Start in 1950 with unbred heifers, 1950-59	62.27	48.00	69.95	79.74	−17.47
Start in 1960 with unbred heifers, 1960-72	80.02	51.07	88.60	97.58	−17.56

[1] Includes 8 percent interest on two-thirds of the cattle.
[2] Includes foontote (1) and 6 percent interest on half of the initial ranch cost.
[3] Includes all cash costs, interest and depreciation. Does not include charge for operator labor, management, or equity.
[4] Net income to operator labor, management, and equity.

The CHAIRMAN. Next we will hear from Mr. T. A. Cunningham, president of the Independent Cattlemen's Association of Texas.

STATEMENT OF T. A. CUNNINGHAM, PRESIDENT, INDEPENDENT CATTLEMEN'S ASSOCIATION OF TEXAS

Mr. CUNNINGHAM. Thank you, Mr. Chairman.

My name is T. A. Cunningham, and I am President of the Independent Cattlemen's Association of Texas.

I submit the following position statement of the association on S. 3157.

The Independent Cattlemen's Association of Texas, while still a relatively new organization, has a membership of in excess of 100,000 members.

The very depressed livestock market, the unrestricted importation of meat and meat products into the United States from foreign countries, and the apparent loss of recognition of the value of the agricultural and livestock industry to our United States were a few of the principal reasons which caused the rapid growth and interest in the Independent Cattlemen's Association of Texas.

ESTATE TAX

While I recognize that your committee is hearing testimony on the general subject of the Federal estate and gift taxes, it is the purpose of my testimony to set forth the association position on increasing the exemption for purposes of the Federal estate tax.

Let me spend just a moment with you setting the stage for the position which our association takes on this legislation. All of you are familar with the great size of the State of Texas.

You are also familar with the fact that there are many individual property owners within our State, and our farms and ranches vary in size from several acres to many thousands of acres.

Many of our people work a lifetime to pay for a farm or ranch which they have purchased only to get it paid for near the time of that person's death, but the cherished thought of being able to leave some real and tangible property to their children is foremost in their minds.

With the tremendously increased values on real property and the severe reduction of income from the sale of agricultural or livestock products, many citizens of Texas who die leave their estate and heirs faced with the burden of trying to carry forward the intentions of the deceased by maintaining ownership of the land within the family, but finding it impossible to do so because of the tremendous burden placed upon them by the Federal estate tax.

The Internal Revenue Code of 1954 relating to the exemption for purposes of the Federal estate tax provides for a $60,000 exemption.

Without taking into account the increased value of real property from 1954 to 1976, but considering the increase in the Consumer Price Index since 1954, we find an increase in services totaling 136 percent and in commodities totaling 82.3 percent and an overall increase of 97.8 percent or approximately 100 percent increase in the Consumer Price Index during these 21 years.

Since 1946 operating costs for pickups, tractors, fuel and operation have increased by 308 percent while beef is bringing less now than in 1946, according to the "Livestock Market Digest."

It is our association's position that it is time for the Congress to recognize that the $60,000 exemption in the 1954 Code does not properly reflect an exemption for 1976 and future decades but that the $200,000 provided in S. 3157 is much more realistic and we wholeheartedly endorse the increase of the exemption to this level.

We recognize that the increase in this exemption will result in a substantial tax reduction to the Treasury of the United States; however, it is our judgment that the principle of individual ownership of land is one of the basic principles upon which our country was founded and no tax imposed by our Government should be so severe as to prevent the reasonable ownership of property.

Many of our forefathers made their living from the soil and the land and the importance of the agricultural and livestock industry to the commerce of the United States cannot be overemphasized.

Its importance in achieving and maintaining the balance of trade with foreign countries should be, and I am sure, is of paramount concern to each of you.

Without the type of relief provided by legislation such as this, many small producers will be driven from the land and instead of the strength of our country which has been derived from the multitude of people who are involved in the production process, we could be faced with only large corporate producers that lack the individual identity and genuine concern and patriotism for this great United States, I would urge on behalf of the Independent Cattlemen's Association of Texas your favorable consideration of S. 3157.

Thank you for your time and attention.

The CHAIRMAN. Thank you.

Senator Curtis.

Senator CURTIS. The Federal estate tax was enacted many years ago to impose a tax on the transfer of large estates. Primarily due to the factor of inflation, the tax is not limited to that at all any more; is it?

Mr. CUNNINGHAM. That is right.

Senator CURTIS. I have introduced a bill which has a number of cosponsors. It would raise the estate tax exemption from its present $60,000 to $200,000.

It would increase the marital deduction which is now one-half of the adjusted gross estate to $100,000 plus one-half of the gross estate and it would also provide for a factor being injected into the valuation for estate tax purposes based upon what the property would produce.

Do you have any comment on that proposal?

Mr. CUNNINGHAM. Yes, sir.

We passed a bill in the State of Texas last year to tax agricultural land at its productive value instead of its market value.

Senator CURTIS. I mean on the $60,000 to $200,000 and the marital deduction and so on, the total bill.

Mr. CUNNINGHAM. We would certainly like to see it based on what the land produced. Even if you would raise this to $200,000, but let the valuations keep going as they are going and not according to production, it will rule out farming and ranching on that property.

Senator CURTIS. Raising the exemption is very important just as a matter of simple justice as well as the great number of people who have to meet this tax situation.

It is a simple way of taking out the small estates and relieving them of the estate tax which should be done because it is a tax intended to be imposed upon the transfer of large estates.

Mr. CUNNINGHAM. As far as production goes and employment in the private sector, this could very easily be the most important bill you have seen in 30 years.

Senator CURTIS. Thank you, Mr. Chairman.

The CHAIRMAN. It is unfortunately true that most of these revenue estimates do not take into account the kind of things you are talking about.

You said you just quit farming because the tax situation was such that after you got through with your taxes, it was not sufficiently rewarding to go to all the trouble.

I don't know how, but you and those who testified before you and those who will testify after you will have to start helping us find a way to take some of those things into account.

The largest single thing in the Tax Reform Act, if you talk about closing tax loopholes, was to repeal the investment tax credit. That was supposed to make about $2.9 million.

I am satisfied it lost us money. We did not make a nickel. The reason was that businessmen canceled their orders. They did not place new orders. They canceled plans that they had to expand further.

When you repealed the credit, the overall tax of the corporation moved up from about 36 percent of its income to about 48 percent.

People took another look at what they hoped to do for the future. I guess half of them went to tax lawyers to find a tax shelter to find some way of keeping what they were earning.

The result of all that was that we lost a lot of money. We found ourselves in a big recession and probably lost $3 to $4 billion rather than gaining.

The situation when people say, "If that is the way it is going to be, I had better get out of this business," is simply not taken into account in those revenue estimates. For example, the estimate is that if you repeal the DISC which encourages people to produce something and sell it overseas, you will increase revenues $1.5 billion pickup. But I believe it would adversely affect agriculture and other industry, and in the long run, it would cost us a lot of jobs and would not increase revenues at all. If you look at the tax breaks foreign countries are giving to put their exports into our market, and look at what little we are doing to offset that, they are probably doing 10 times as much to put the things they manufacture and ship into here. Much of this is at the expense of American labor and jobs.

Mr. CUNNINGHAM. Someone is going to have to understand the situation or we are going to have a different group of people farming and ranching in the future.

We in agriculture know more than anyone else about what we can and can't do and how much we are going to keep and whether we should work harder or less.

If you are going to remove unemployment, it has to be done in the private sector. The way to do it in the private sector is through the small business people and farming and ranching.

That has always been the backbone of this Nation and it will continue to be if they will allow it.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. I have no questions.

The CHAIRMAN. Next, we will hear from Mr. Robert P. Lederer of the American Association of Nurserymen, and he is to be accompanied by L. J. Donahue and John Manwell.

STATEMENT OF ROBERT F. LEDERER, EXECUTIVE VICE PRESIDENT, AMERICAN ASSOCIATION OF NURSERYMEN, INC., ACCOMPANIED BY JOHN MANWELL

Mr. LEDERER. Thank you, Mr. Chairman.

FARMING TAX SHELTERS

Our testimony is specifically addressed to the requirement that farming corporations other than subchapter S and certain family farms must use accrual accounting and maintain inventories. Nursery crops are uniquely and, we believe, accidentally affected by this proposed requirement. Because, unlike most of the other agricultural crops, our plants must often grow for a number of years before they become marketable.

Since 1922, for a very good reason, the Internal Revenue Service has actually forbidden our farmers "to inventory growing crops for the reason that the amount in value of such crops on hand at the beginning and end of the taxable year cannot be accurately determined."

In considering adoption of the accrual accounting and inventory proposal as it affects the growing of nursery plants, we urge you to consider the following:

One: Unlike other agricultural products, ours must be grown for as long as 10 to 15 years before becoming marketable and only at that time does it have value.

Two: Because the same block of plants—planted at the same time, cared for in the same manner—will contain widely differing sizes and qualities, the problem of taking inventory can be nearly impossible even if a reasonable way to make a sight count could be developed.

Third: Nurseries may grow in excess of 1,000 separate varieties of plants. Couple that with size and quality variations and, even if a value could be determined, the problem of taking inventory is insurmountable.

Fourth: Mortality among growing plants varies widely because of such factors as variety, drought, freeze, hail, rain, etc. Inventory, if it could be taken in a nursery, in many cases would not be related to growing plants, even a few days later. In addition, we never want to forget that the time of required inventory may find crops in some areas of the country completely covered by snow. A condition which may remain for many months.

Mr. Chairman, our testimony, which we request be made a part of the record of these hearings, makes a number of very practical points which we hope will receive the committees close attention.

There is one other point we would like to make, Mr. Chairman, concerning limits on losses and with your permission Mr. Manwell will summarize that point.

Mr. MANWELL. Mr. Chairman, we would certainly have to agree with your suggestion that the true answer to the tax shelter problem is to lower the rates enough to remove the incentives to go into all of these shelters.

Until that is done, the ingenuity of the taxpayer will always outrun that of the Government. Even the most ardent advocates of the House bill I don't think have suggested it is in the direction of tax simplification and we hold no brief for it.

If the LAL provisions are to be enacted it seems to us important to call your attention to one serious technical deficiency as it affects the nursery industry.

It is very common for the grower of nursery stock to dispose of the nursery stock he grows not only by wholesaling it to retailers but through his own garden center.

It is also common for him to dispose of it through a small landscaping operation. Typically, the growing, retailing and landscaping are conducted as an integrated operation.

There is nowhere in the House bill, so far as we can see, where there is an adequate definition of farm income versus non-farm income.

What is one's income from the business of farming and from nonfarming businesses against which one cannot use farming losses?

The average nurseryman certainly is in business for profit, but everyone is aware of the vagaries of farm income and it is not at all uncommon for nurserymen to have a series of losses.

There are provisions in the House bill which exclude losses caused by casualties but there is a great gap between saying in this law and proving what it was that caused a decline in a farmer's income this year.

We think it is important, therefore, that a man who carries on a growing business and disposes of what he grows through a small retail operation or landscaping be entitled, when he does have a loss in a growing operation, to a reduction in taxes on his selling activities or his landscaping.

We would suggest that if the LAL provisions are to be enacted there be a provision essentially along these lines.

It would provide if a taxpayer is engaged in the business of farming and is also engaged in one or more businesses which are directly related to this business of farming and are conducted on an integrated basis with the business of farming, the taxpayer shall be treated as engaged in a single business of farming.

Thank you.

Senator CURTIS. I was called from the hearing room just briefly and I did not get all of your presentation, but we do appreciate having you here. It is highly important that we have the recommendation of people who are paying the taxes.

As stated by the other witnesses before us, so many times a solution to a problem is so complicated as well as actually working a hardship, so we appreciate your testimony here and further consideration will be given.

The CHAIRMAN. I want you to know that if this Senator finds some way of doing it, we are going to make this law less complicated rather than more complicated.

I hope that we will have a law that will encourage you people to do more of what you are doing and not less. We want to try to pass a law that causes a free flow of capital in a free country.

If people are doing well in the nursery business, I don't see why people should not go into the nursery business or some other business. If some other business is doing good, they should go into that. That is where the whole capitalistic system has been so effective. Some people think it is very bad for anyone to make a good profit.

It is amazing how rapidly this economy can adjust to a problem if you let it. A while back, we had a shortage of sugar and the price skyrocketed. A lot of people thought we should go for price controls. The fact that Congress did not go into controls meant the beet producers increased their production 50 percent. You can't move that fast to shift over into cane production, but still those people increased production by 20 percent. In short order the world shortage was wiped out, and now the price of sugar is down to the point where the producers fear if we don't do something to help them protect their price, a lot of them will be forced out of business. When capital can freely flow into something or away from it, depending upon the economics of the marketplace justifying it, we find that the system works, if one will permit it to work.

Unfortunately, some people have not permitted this system to work.

Mr. LEDERER. Our primary consideration in this legislation is that we connot see where it will cost us one bit more taxes either way. We can see if this provision becomes law we won't be able to accurately calculate the tax.

All this system does is make more cheaters because there is no way to put a value on growing nursery stock until it is marketable.

The CHAIRMAN. You are saying your principal objection is that people in that business, when you spend more money in the hope of making a profit at some point, you really cannot predict what your tax liability will be or will not be.

Mr. LEDERER. Until we are ready to market, we can't tell.

Taking a small ceiling and accruing expenses to that, as long as 15 years before we get a marketable product is one we can't figure out how we can ever comply with.

The CHAIRMAN. My wife managed to persuade someone to go out and plant a lot of pine seedlings near a place we have in a rural area. We tried to get away from the pressures of urban living. Now they are all gone. The deer got them. I asked a forester if we could put something on those seedlings that might taste bad to the deer or make them sick so they would leave our seedlings alone.

He said it would probably act about the same as if you put syrup on them because they would eat them all that much faster. We have not found a way to answer that problem. Based on what you tell me, there are 50,000 other things to contend with so it is just better to wait and assess your profit where you find the thing is something you can sell.

Mr. LEDERER. That is exactly right.

The CHAIRMAN. Thank you very much, gentlemen.

[The prepared statement of the American Association of Nurserymen follows:]

TESTIMONY OF AMERICAN ASSOCIATION OF NURSERYMEN

The American Association of Nurserymen (AAN) is a national trade association representing approximately 2,500 member firms. Nurserymen are growers of plants used for enironmental improvement and to supply orchard growers and farmers. Typically the growing period is from two to eight years or more.

The Tax Reform Act of 1975 (HR–10612) contains a provision which would require corporations engaged in farming, except for Subchapter S corporations, to use the accrual method of accounting and maintain inventories. Doubtless unintentionally, this recommendation, if enacted, would be certain to have a disastrous effect on the nursery industry.

While some nursery plants are grown from seeds, an increasing proportion are grown from cuttings or by grafting. These nursery plants are then grown to saleable size. Most producing nurseries are on the cash basis of accounting, and use no inventories. Even those firms using the accrual method of accounting normally do not determine their inventories, and when inventories are used, it is believed that they include only plants that are purchased, not for further growth, but for early resale.

While we have no specific information on the number of production nurseries which are incorporated, a review of our membership records suggests that approximately half of the members of the AAN are incorporated.

Since at least 1922, with the promulgation of the ruling known as I.T. 1368, I-1 C.B. 72, it has been clear that nurserymen are treated as farmers, and that farmers: "Are not permitted to inventory growing crops for the reason that the amount and value of such crops on hand at the beginning and end of the taxable year cannot be accurately determined."

This ruling simply confirms the practicalities of the situation. A nurseryman may plant several thousand young seedlings. They will grow for several years, after which they will begin to be held. Because the natural growth rate of individual plants is not the same, and because there is a commercial demand for plants of varying sizes, the mature plants will then be sold in several different fiscal years.

There is no reasonable way that a nurseryman can count by size the number of growing plants in his field at the end of each year. Indeed, in a large nursery, it is altogether possible that the actual size of plants which are counted first may change before the inventory is completed. Even if they could be counted, there is no practical way in which a nurseryman could keep track of the cost of each individual plant. Finally, even if records of this type were possible, their cost would be prohibitive given the relatively low price of individual plants. In addition, relatively nonsophisticated growers engaged in business on a small scale neither have nor can afford the type of accounting help necessary to keep such inventories. Not a single firm in the business of growing environmental plants reaches the size considered by the Small Business Administration to disqualify it under the definition of small business.

IRS regulations specifically permit the nurseryman, as a farmer, to elect whether to file on a cash or an accrual basis. Regs. S1.471-6(a). They also provide that the cost of seeds or young plants purchased for further development and cultivation prior to sale may be expensed in the year of purchase. Regs. S1.162-12(a). With only occasional aberrations, the IRS has consistently followed a practice, for at least 50 years, of permitting nurserymen to take a current expense deduction for the cost of seeds and young plants purchased for further growth.

It is our understanding, based on the Ways and Means Committee's summary of its action in this matter that, under the pending legislation, all corporations engaged in farming, except Subchapter S corporations, would be required to use the accrual method accounting and to keep inventories.

This would clearly have a drastic effect on producing nurseries. It would change a uniform 50-year practice for most of our farmers. It would involve extraordinary practical difficulties and administrative costs, for the IRS as well as for the taxpayer, producing no significant additional revenue.

We are unaware of any abuses in the producing nurseries which could possibly justify such drastic legislation. It may be that there are corporations engaged in farming on a hobby basis, or even using the corporate structure as a vehicle for syndicated tax shelter operations. We are not aware of the existence of this practice in the nursery industry.

Thus, while it is conceivable that some types of supplies in some kinds of farming might be purchased in advance, and that the resulting deductions would distort income, it is not conceivable that this could happen with respect to growing nursery plants. The reason is that they are highly perishable, and thus must be purchased at the time when they are needed.

No significant revenue can be at stake in environmental plant production, because immature plants typically cost only a few cents in relation to the ultimate sale price many years later. In other words, the cost of the small plant is an insignificant part of the total cost of producing a mature plant. Nevertheless, expenditures for such plants do represent a substantial expense in absolute terms.

There are overwhelming practical difficulties in keeping track of inventories of growing environmental plants. For instance, inventories of merchandise can be readily counted on shelves, in bins or in other groupings of specified large quantities. By contrast, environmental plants grow in open fields. Even if there were the same number of plants in a row when first set out, the number diminishes each year due to disease, insects, weather and other attrition factors. The size of plants also differs since individual plants grow at different rates and hence have everchanging values. In addition, there are nurseries which are growing in excess of 1,500 varieties of plants. It is impossible to count accurately thouands of individual plants without regard to possible adverse fields conditions such as snow, rain, and mud.

Since the number of plants planted, far exceeds the number which survive to a saleable size and quality, it would be necessary to transfer the cost of the lost plants to those which survive. It would also be necessary to allocate production costs such as cultivation, fertilization, and pest control to various crops. Despite constant effort to develop a system, there is no existing standard cost accounting procedure available to nursery growers.

There is no logical place to draw a line in defining the "cost of goods sold" in the case of a farmer, and we respectfully suggest that there is no need to force farmers to use the inventory method of accounting which would require such decisions.

It must be borne in mind that most farmers are small businessmen. Not only are they without the same degree of management sophistication that one may expect of many businessmen, but they lack the support of organized accounting departments which businesses typically have. It simply cannot be expected that the average farmer will be able to comply with an inventory requirement. The result will be widespread noncompliance and enforcement chaos.

As a practical matter, this legislation, in its present form, will deprive nursery growers of any practical possibility of doing business in corporate form. No other farmers growing crops in the field are discriminated against in this way.

It is true the legislative requirement could be avoided in some cases by operating under Subchapter S. However, even many family nurseries would be unable to qualify for Subchapter S status because they have more than ten shareholders, have a trust as a shareholder, or have more than one class of stock. In any case, it would appear to serve no public purpose to require more extensive use of Subchapter S by small businessmen who have no other need to use it, especially considering the complexities of assuring compliance with Subchapter S.

We are not convinced that there is any possible abuse which would justify a change in the traditional accounting rules for farmers. However, if the Committee is convinced that such abuse exists, it can be solved by much less sweeping legislation, without making victims of an entire industry of small businessmen. A possible alternative would be to limit the extent to which farm losses could be used against nonfarm income, probably by establishing specific guidelines.

It is of critical importance if this alternative is used that there be an adequate statutory definition of what constitutes "farm income." It is quite common for a grower of nursery stock to sell some of his nursery stock at wholesale, to market some of it through a landscaping business which he may conduct, and to sell some of it at retail through a garden center also controlled by him. Typically, such operations are conducted as a single integrated business and it is important that the taxpayer should be permitted to continue to pool the income and expenses of these businesses if desired, and not be required to maintain separate records unless there is some business reason to do so. For example, a taxpayer under any limitation of loss provision should be permitted to apply any losses against the income of any one or more businesses which are directly related to his business of farming and are conducted on an integrated basis with his business of farming.

A second alternative would be to strengthen the existing "hobby loss" rules under Section 183 of the Code. It is not clear why these existing provisions are not adequate to deal with any tax shelter abuse areas, but it is possible that these rules could be extended to corporations generally and not merely to Subchapter S corporations. If this were done, however, it would be vital to permit the taxpayer to treat as a single integrated business one or more operations which are directly related to farming and are conducted on an integrated basis as suggested in the preceding paragraph.

A third alternative would simply be to disallow any current expense deduction as not "ordinary and necessary" if shown to vary in quantity and timing in such a way as materially to distort income. However, if this were done it would be essential to provide exceptions for types of purchases not susceptible of "stockpiling" such as perishable plants.

All of these alternatives would simplify enforcement and permit concentration on possible abuse situations while exempting established farming operations from the special limitations. For example, since most abuse situations presumably occur in the initial years of any farm venture, it should be possible to exempt the expenses of any farm operation which has been actively engaged in farming for five years or more.

The pending bill would require a change in practice of 50 years standing and impose an extreme burden on small corporations in attempting to comply with near impossible requirements, merely as a by-product of a reform aimed at others.

We respectfully urge that the requirement that farming corporations, other than Subchapter S corporations or certain family corporations, use accrual accounting and maintain inventories be deleted. Alternatively, it is suggested that the inventory requirement be revised to specifically exclude plant material which requires more than a single year's growth before becoming marketable.

The CHAIRMAN. Next, we will hear from Mr. Henry Barclay, Jr., the Forest Industries Committee on Timber Valuation and Taxation, accompanied by Edward Knapp, A. Felton Andrews, and K. C. Van Natta.

I am very pleased you gentlemen brought something here to show us what you are talking about [pointing to timber slices brought by witnesses].

Thank you very much.

STATEMENT OF HENRY BARCLAY, JR., FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION, ACCOMPANIED BY EDWARD KNAPP, A. FELTON ANDREWS; AND K. C. VAN NATTA

Mr. BARCLAY. Thank you, Mr. Chairman.

In our presentation, I should like to first introduce Mr. Edward Knapp and have him start our presentation.

Mr. KNAPP. Thank you, Mr. Chairman.

FARMING TAX SHELTERS

My name is Ed Knapp from Macon, Ga. I am a small forest businessman and an owner of approximately 350 acres. I am a bit surprised to be here because much of what I have to say seems so apparent.

Recently, the country has gone through a cutoff of oil from the Middle East and we are aware of what happens when supplies are in short supply.

Similar shortage supplies in our timber are predicted in the next 10 years. Congress only recently reacted with the forest incentives program for small nonindustrial owners and the Resource Planning Act which is designed to encourage fuller development of timber and other resources such as wildlife, water and the like on both natural forest and the State private timberlands.

These programs are well conceived and already seem to offer a great deal of promise but we still have a long way to go.

Now, in the name of tax revision, Congress is suggesting legislation which would fly directly in the face of these actions and do much to negate these favorable developments.

Let's examine some of the stated justifications for those provisions.

It is conceived by some that timber growing is a tax shelter. Timber growing is certainly no tax shelter to the million and a half private industry, nonindustrial timber growers in the south who hold roughly 70 percent of the commercial timberland.

It is a long-term proposition involving greater-than-average risk from fire, insects and disease and so forth. This is to say nothing of the rising ad valorem taxes.

My next point is that timber never before has been considered as a part of the concept of the limitation of artificial losses and frankly it just does not seem to fit the concept.

For such small owners to invest any substantial amount of their hard-earned income into forest development without hope of recovering any of these expenditures in the foreseeable future is unrealistic to say the least.

As far as these people are concerned, gentlemen, 20 to 40 years is not in the foreseeable future. This is especially true when one considers the investment alternatives.

The third forest report indicates an owner can, on the average, hope to receive 6 to 8 percent return on his timber investment over the long pull.

However, virtually the same return or better can be received from investments in savings and loan certificates with virtually no risk involved. Or the timberland owner who frequently is a row crop or cattle farmer can put the same capital in his farm activities and receive perhaps a greater yield—certainly, he can do this with tobacco, soybeans, and various other crops.

LAL, if enacted, would in my opinion, be a great deterrent to the small owner to grow timber. Yet, timber is a basic life-support consumer product.

It is the most economic material available for building houses to meet consumer needs and to provide a host of paper products that make our way of life possible. Small ownerships account for 59 percent of the Nation's total timberland and offer the greatest opportunity for stepping up the country's timber production.

Furthermore, these owners are not interested in growing crops of timber if they cannot make a reasonable profit. Yet, the economics of LAL seem to entirely disregard these facts.

Up to here, I have discussed the impact of LAL proposals on the individual tree grower. However, corporate timber operations are also at risk under the House proposal. Section 204 of the bill which was intended to apply to farm corporations, will require timber growing corporations to use the accrual method of accounting and would require capitalization of timber-growing expenses which, heretofore, have been fully deductible as necessary for the preservation and maintenance of timber assets.

On another point, the House bill would extend the holding period for capital assets from the existing 6 months to a 1-year period. In the case of timber harvested under section 631(a), the required holding period is 6 months prior to the first day of the year in which the timber is harvested resulting in a potential overall holding period requirement of up to 18 months.

Since timber is already at a disadvantage with respect to other capital aspects, I would recommend the committee alter this provision so the required holding period for timber would be no longer than 1 year for capital gains purposes. For administrative simplicity, I would suggest the evaluation date remain as the first day of the taxable year.

Mr. Chairman, this completes that portion of the testimony with regard to LAL.

MINIMUM TAX

Mr. Henry Barclay will continue with regard to the added tax.

Mr. BARCLAY. Mr. Chairman, Senator Curtis, I am a certified public accountant from Birmingham, Alabama, and have been in the practice of public accounting since 1936 except for 5 years, 1942–47, during which time I was comptroller of an industrial manufacturing company. Since 1948 a significant part of my efforts have been related to representing timber owners and users but with respect to tax accounting, income tax and other tax matters. Some of my clients have what might be considered large acreage ownerships. Most of them own small- or medium-sized timberland. As Ed said, I will address my comments to the minimum tax amendments contained in this bill.

It is my uderstanding that over 85 percent of the minimum tax collections under present law have been derived from the additional tax on the capital gains deductions.

Prior to the Tax Reform Act of 1969, the maximum effective tax on capital gains was 25 percent and with the Tax Reform Act of 1969, this was raised to a maximum effective tax rate of 35 percent plus the effect of the minimum tax on preference items which could amount to an additional 1.5 percent for a maximum tax effective rate of 36.5 percent.

Under the proposals contained in this bill, the minimum tax rate would be increased from the present 10 percent to 14 percent. The $30,000 annual deduction against the tax preference items would be lowered to $20,000 and actually might be eliminated completely in some cases.

Of even greater significance, the deduction for the Federal income taxes paid with respect to the year or carried over from prior years would be eliminated entirely.

Under the proposal in this bill, the income tax applicable to capital gains would amount to as much as 42 percent.

The increase from the pre–1969 maximum rate of 25 percent to the maximum rate of 42 percent which would be possible under H.R. 10612 represents an increase in tax on capital gains, of a potential of 68 percent.

Persons who realize capital gains do so as a result of placing capital at risk in any one or more of several different ways. The timber owner certainly has capital at risk, subject to uncertain market conditions and uninsurable possible losses from fire, wind, ice storms, infestation and ingestion by deer as had been pointed out by the chairman.

We have that same problem in plantations in the Southeastern part of the country.

In view of the risk assumed by the timber owner and the long-term nature of the investment from germination to merchantability, it is my feeling that the capital gain reduction available to the timber owner should not be considered a tax-preference item.

Another factor which in my opinion should be considered is the effect of inflation which tends to reduce the capital available for investment in capital goods. The Consumer Price Index increased from 116 in 1970 to 167 in January of 1976 or 44 percent.

As we all know, most everything that we buy now costs more than it did in 1970.

For instance, a log-hauling tractor and trailer unit which cost $26,850 in 1970 would cost $41,800 today, an increase of 55 percent.

A tractor used in logging and which would have cost $49,444 in 1970 would cost $72,800 today, an increase of 85 percent.

The proposed increase in the minimum tax on preference items as applicable to the capital gains resulting from the sale of timber would tend to aggravate the burden of replacing the processing facilities and replacing timber cut for use.

I feel that all persons should bear their fair share of the tax burden, but I am opposed to the minimum tax on a limited number of items on which it is now imposed and which is proposed to be radically increased under this bill.

The minimum taxable income approach which has been proposed as an alternative to the minimum tax on preference items in my opinion could result in a fairer sharing of the total tax burden, assuming that the portion of the base against which the alternative tax is used at the normal rate is not excessive. I recommend your consideration of this approach for the sharing of the tax burden.

Mr. Chairman, this concludes the formal part of our presentation. I would like to introduce to you Mr. Felton Andrews who is a timberland owner from Memphis, Tennessee, on my right, president-elect of the Forest Farmers Association and Mr. K. Van Natta from Ranier, Oregon, at the end of the table, another timberland owner and president of the Oregon Small Woodlands Association. We are available for questions, and we thank you for this opportunity.

I would like to state you have a choice as you have looked at these two pieces of timber, you can let nature grow it this way and/or we can work at it and this is what you can have in 50 years.

The CHAIRMAN. In terms of board feet, what would be the difference in those two trees, one that had been managed for 50 years and one which had not?

Mr. KNAPP. This is cut for pulpwood and this would be cut for logs or lumber.

The CHAIRMAN. All the wood can be used even if you only use sawdust to create energy. How much more do you have?

Mr. KNAPP. Volumewise, 6 to 1 and perhaps 10 to 1 valuewise.

The CHAIRMAN. It seems to me that is minimal. One is probably worth ten times as much as the other in terms of what you have to offer.

Senator CURTIS. I have two questions submitted by Senator Packwood to Mr. Van Natta.

FARMING TAX SHELTERS

What would you estimate the impact of LAL to be on the capital formation for timber in the Pacific Northwest? Is it the same as the impact in the Southeast?

Mr. VAN NATTA. I would expect it to be worse in the West. We have a longer rotation, our expenses are greater, the examples of which would be temporary roads, taxes, and labor. This would discourage outside investment of capital and potentially productive timberland which would be necessary to get maximum production for future generations. Nationally, we are already many years behind in rehabilitation of forest lands and we need more outside capital rather than less.

I personally live on a family tree farm in Northwest Oregon purchased by my family in 1940 and subsidized by other enterprises for 33 years before it could pay its own way.

Did you have another question, sir?

Senator CURTIS. Is the impact the same in the Pacific Northwest as in the Southeast United States?

Mr. ANDREWS. I would like to make a statement on the impact of the Southeast and especially in listening to what Senator Long said this morning. My family, for the past 25 years, has been investing considerable money into planting pine, and improving our hardwoods. We thought during this whole time that we were looking at a 25 percent maximum tax rate, but before we had a chance to cut our first trees, that was increased almost 50 percent. You are sitting here talking about increasing them again on us. Besides when you add LAL to that, we don't see much money from the private sector going into private timberland improvement work, for pine planting and so forth.

Frankly, we need money from every resource we can get.

Now, to improve these timbers, it is a crying shame we are not exporting 10 times the pulpwood from the South that we are today. Our family has spent a little over $100,000 on strictly black jack oak pine; if you let it sit there without management 100 years, it will not be worth a dime. For two years we have had six people working full-time cutting our timber. Very shortly we will double that to about 12 people on hand that I promise you there would not be a single person out there working if we had not invested that money in management.

If you are going to discourage the investment of capital, you are very definitely going to discourage the creating of jobs as Senator Long said.

I will sit here and tell you, frankly, this LAL would be a boon to us who have already invested this money because you are going to cut out a lot of our competition and it is going to put money in our pocket, but all you are going to do is force the people who need this wood to keep their business going, to buy up the small timberlands. You will just have greater concentration of the woodlands in fewer hands.

Senator TALMADGE. Mr. Chairman, I regret I was not here to hear the entire panel, but I want to welcome one of my friends and constituents, Mr. Knapp, from Macon, Georgia. Mr. Knapp, would you invest your money in timber today?

Mr. KNAPP. I stated in the beginning of my statement I own about 350 acres. I guess if I had been smarter years ago I would own 3,500 acres now and it might have been a good investment at that time. However, with inflated prices, with the additional competition for land, the urban sprawl that we have, I can hardly say that I would invest in land now to grow trees. What I would want to do and as this gentleman said with his lands which he already has, he has the lands now and they need to be put into greater productivity. I think this is one of our great challenges. The land is there. We have over five million acres in Georgia alone that is pretty much brushland. It is not producing the proper species and we should be growing pine on our uplands basically in the South.

There is a tremendous amount of that land that is just laying there waiting to be put into greater production. The paper industries are doing it, but we need all the incentives we can on the small landowner to put this land into production.

If we are going to meet the resource needs that we have, and we all talk about the year 2000, we are going to need a tremendous amount of fiber. The renewable resource we have we need to be nurturing and we don't need any more interferences from a regulatory standpoint. You know, we have enough problems from fire and insects and disease and windstorms and hurricanes, but as Dr. Ed Stamm told this committee 10 years or more ago, I must reiterate that one of the greatest dangers we have to growing timber is the Congress itself.

If they would just settle down on what we have had and what they enacted when Senator George was here and the capital gains benefits, and quit changing the rules every other year or every year, because this is something that you grow, over 20 to 100 years.

Senator TALMADGE. What is the life cycle of a pine in Georgia?

Mr. KNAPP. I would say to grow it to saw timber is 35 to 50 years, depending on how big you want that tree to grow to maturity. In any respect we can't grow a tree in much less than 15 years before we can begin to make the thinnings.

Senator TALMADGE. That is the first thinning on pulpwood, so it is 15 years from the time you plant the trees until you get the first income from the tree, is it not?

Mr. KNAPP. That is right.

Senator TALMADGE. For 15 years, that income is very minor, about 10 cords per acre or less?

Mr. KNAPP. It certainly never comes up to cover your costs.

Senator TALMADGE. You get the ultimate return at about the 52d year?

Mr. KNAPP. That is correct, and that is a lifetime.

Senator TALMADGE. Sometimes it is more than a lifetime.

Mr. KNAPP. I am 60 years old today, Senator Talmadge, and I am proud to be presenting this. I feel like I have some experience behind me in these 40 years.

Senator TALMADGE. All during the 52 years you have to pay ad valorem taxes.

Mr. KNAPP. 51 of them.

Senator TALMADGE. In addition to that you have to keep fire and insects out of your forest and that costs money, does it not?

Mr. KNAPP. It certainly does.

Senator TALMADGE. And the tax bill the House sent over here would prevent you from protecting your timber once you planted it, would it not?

Mr. KNAPP. It certainly delays recovery and certainly discourages people from considering such investment. When we need so much capital formation.

Senator TALMADGE. Thank you, Mr. Knapp. I have no more questions, Mr. Chairman.

The CHAIRMAN. I once tried to defend some poor soul who had a way of spending most of his life in the penitentiary. It seems he was accused of stealing an iron that was used to iron clothes, but the crime seemed pretty severe because he knocked in the back of a garage and took an iron and while the poor man was in the penitentiary, we had reformed our criminal code to make it a crime of burglary that a person entered any structure whether it was a dwelling place or anything else. This fellow said that he had gone to the penitentiary last time for stealing chickens, but he got into trouble because he had to push open the door of the chicken coop. He was very careful this time not to touch the door because he knew it would be breaking and entering. I told him unfortunately while he was serving for the chicken stealing, that we reformed the criminal code and abolished the distinction between breaking and entering so it really did not make any difference whether he touched the door or not to get at the iron.

He said that just didn't seem right. Could they do that? He was subject to a very serious crime by virtue of the way the law had been changed.

By the time you people are paid, you may very well have planted your tmber back at a time when the government was proceeding on the theory that it would tax away from citizens that which was required in order for those people to support the government. I fear that if some of our ivory towers have their way, by the time that timber is harvested, they will have a law that a person will be taxed for his existence. If that were the case, you would not plant the timber for money, but let nature take care of it.

Did I understand the accountant to say you would be paying a capital gains of more than 50 percent?

Mr. BARCLAY. At the rate of 42 percent.

The CHAIRMAN. So you would pay 42 percent taxes, a capital gain on something it took 50 years to grow.

Mr. BARCLAY. That is why I expressed the opinion I do not think the capital gains deduction which is allowable for timbersales under 631 (a) or (b) should be a tax preference item because we do not have the flexibility that the person in the tax market has. When we commit ourselves when we first plant timber to a minimum period as has been pointed out by Mr. Knapp and Senator Talmadge that the first money we are going to get back is in 15 years from the date that the date that the seed first germinates or is first planted, and then this is not going to be a major item of income. During this time, we have had these annual costs which under this bill would be deferred in some cases. This is the cost of our fire lanes, the cost of pruning the trees to improve the quality, the cost of supervision, management and that sort of thing. We are not talking about the capital items. The original cost of planting we all recognize is a capital investment. We just want some money left to make that capital investment.

Under this bill we have here, the minimum tax is 14 percent and we have a potential maximum capital gains tax of 35 percent, so that the 14 percent applied to the capital gains deduction which is half of it, would result in another 7 percent addition or 42-percent tax rate effective maximum.

The CHAIRMAN. Plus that money that you invested in the beginning over that 50-year period was then worth three times as much as the dollars that you finally managed to get back after taxes.

Mr. BARCLAY. I would say, based on the inflation we experienced in recent years, it would be worth that much.

The CHAIRMAN. Thank you very much.

[The prepared statement of the Forest Industries Committee on Timber Valuation and Taxation follows. Oral testimony continues on p. 465.]

STATEMENT OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

SUMMARY

Purpose of the Forest Industries Committee on timber valuation and taxation testimony

To support continued capital gains treatment of timber proceeds, as provided in sections 631(a) and (b) of the Internal Revenue Code; and to improve the application of capital gains treatment as a means of stimulating new private sector timber production and improved management of existing timber stands to assure adequate supplies of forest products for the future.

History of capital gains treatment of timber

Prior to enactment in 1944 of the present timber capital gains provisions, timber income was eligible for the capital gains rate only if the asset was treated as non-renewable—that is, if liquidated by the owner in a lump sum sale without regard to sustained yield production. If the owner managed the asset for continuous timber production, the ordinary income tax rates applied. The 1944 Act eliminated this disincentive to public interest management of private forest resources and granted to timber growers essentially the same tax treatment as applied to other capital assets.

Tax Policy and Forest Resource Productivity

The granting of tax equity to timber growers had a profound impact on the state of the nation's total timber resources. The steady annual decline in timber inventories was reversed. Sustained yield management became the norm rather than the exception. New growth has exceeded harvests in every year since 1944. In 1974, approximately 1,188,000 acres of private land were planted to trees and the reinvestment capabilities made possible by equitable tax treatment have resulted in the introduction of new technologies to enhance the productive capabilities of private forest lands.

Timber Supply and Demand

To meet projected consumer requirements for wood products by the year 2000, it is essential that even higher levels of investment be achieved now and in the very near future. An investment today in new forest production will not mature for 20 to 60 years, depending upon the species planted and the geographic area. The United States Forest Service predicts a timber shortage—at present rates of investment—of 20 billion board feet per year by the year 2000. That is the equivalent of 1,400,000 single family homes each year.

Timber in an Era of Resource Scarcity

Timber is perpetually renewable. In fact, the total resource can be greatly expanded if sufficient investments are made. However, if it becomes necessary to substitute other materials for products normally made of wood, it will mean using exhaustible and irreplaceable mineral resources—petroleum for plastics, steel, aluminum, concrete, etc. The energy consumption for conversion of timber to structural products is much less than for other materials. Pollution costs are also much less.

Economics of Timber Production

Capital gains treatment is by no means a "windfall" to the timber industry. Surveys of effective tax rates in the industry show them to be substantially higher than reported average effective rates for other resource industries. The 1969 Revenue Act, by increasing the capital gains rates, had additional impact on the industry.

The rate of return in the timber industry is historically below other industries, and conditions are very volatile because of dependence on housing construction cycles. Projected rates of return on timber growing alone—from planting through eventual harvest—are extremely low. Surveys indicate that timber growers reinvest a large percentage of timber harvest proceeds in new production. This is made possible largely through the capital gains treatment, both in terms of after tax earnings available for reinvestment and in terms of the incentive effects of anticipated future capital gains treatment.

Recommendations of the Forest Industries Committee on Timber Valuation and Taxation

The Forest Industries Committee strongly opposes those provisions in H.R. 10612, the House-passed Tax Reform Act, which would discourage needed investments in private timber resources. Particularly damaging would be the proposed "Limitation on Artificial Losses" (LAL) with the requirement for maintaining a "deferred deduction account" for pre-production expenses of timber growing; and the proposed increases in the minimum tax for individuals, which would be principally an additional tax on capital gain.

Thus, the Forest Industries Committee on Timber Valuation and Taxation:

A. Recommends retention of sections 631(a) and (b);

B. Recommends that if LAL or the other amendments related to tax shelters (Titles I and II of the bill) are adopted in any form, timber growing should be excluded from their provisions;

C. Opposes an increase in the present holding period requirement for timber (which is already more stringent than for other capital assets); and

D. Recommends either the elimination of capital gain from the minimum tax or a revision to make it a true "minimum tax" rather than an additional levy on already taxed capital gain income.

STATEMENT

The Forest Industries Committee on Timber Valuation and Taxation is a voluntary organization supported by over 4,000 timber owners who share the objective of stimulating additional forest plantings, more intensive management and improved conservation practices on the privately owned forest lands of the United States. A list of cooperating associations which support this statement is attached.

The principal public policy objective of the Committee is the attainment and preservation of equitable Federal tax provisions to reflect the long term nature of forest investments and the unique risks involved. The importance of such policy in attracting sufficient investment capital to assure adequate timber resources for today's needs and for the future cannot be overestimated.

In the years since 1944—when Congress extended capital gains treatment to the full range of qualified timber transactions rather than only to lump sum, liquidation-type sales—spokesmen for timber growers have, on several occasions, reported to the Congress on the effects of that action on private sector timber supplies and management improvements.

We are pleased to do so again because the record of those 30 years is a positive one. During that period the stewardship of private owners over lands comprising approximately 70% of the nation's commercial forest acreage has seen a complete reversal of the earlier trends of declining timber resources. The contribution of equitable tax treatment to that accomplishment is, we believe, indisputable.

History of Timber Taxation in the United States

We are attaching to this statement a document on the evolution of Federal timber tax policies. It describes in greater detail the close correlation between investment and timber yield and the impact of equitable tax treatment on the rate of productive investment.

In summary, the record demonstrates that the pre-1944 policy of non-recognition of the capital nature of managed timber assets was a contributing factor to the almost total lack of investment in forest renewal and in sustained yield management of existing timber properties. That policy, which denied capital gains treatment of long term investment in timber—except as timber assets were disposed of in a lump sum type sale—actually was a powerful incentive for wholesale liquidation of timber and for the conversion of timber land to other uses.

The enactment in 1944 of what are now sections 631(a) and 631(b) of the Internal Revenue Code reduced that incentive to liquidate or "cut and get out." Capital gains treatment was extended to a wider range of timber transactions instead of applying only to lump sum sales in which the owner retained no economic interest. Three basic types of transactions may now be subject to capital gains treatment:

(1) Where timber is sold outright for a lump sum, gain or loss may be recognized to the extent of the dicerence between the proceeds of the sale and the adjusted cost basis.

(2) Where timber is harvested for sale or use in the owner's trade or business, gain or loss may be recognized to the extent of the difference between adjusted cost basis and the fair market value of the timber as of the first day of the tax year in which it is cut. (It should be emphasized, however, that any income derived from subsequent sale or processing of the harvested timber is subject to ordinary income tax rates.)

(3) Where timber is sold under a contract in which the owner retains an economic interest until it is cut, gain or loss may be recognized to the extent of the difference between the proceeds of the sale and the adjusted cost basis.

The holding period for timber is somewhat more stringent than that applying to other capital assets. Timber must be held for at least 6 months prior to the first day of the tax year in which the harvesting takes place. Thus, in effect, the holding period requirement for some timber can be a full year longer than for other capital assets.

Forest rejuvenation costs must be capitalized and no deduction of these expenses can be made against current income. Casualty loss deductions are severely limited. These and other factors applying to the tax treatment of timber are described in greater detail in the accompanying "History of Timber Taxation in the United States."

Issues to be Addressed

In any evaluation of tax policy as it applies to timber, the paramount consideration must be the state of the resource in terms of national needs and the relationship between tax treatment and those needs. Therefore, our statement will be addressed to such factors as: (1) Projected timber supply and demand, (2) the role of timber in an era of resource scarcity, (3) the economics of timber production, (4) the relationship between tax policy and forest resource productivity, and (5) comments on specific provisions in H.R. 10612, the House-passed Tax Reform Act.

Timber Supply and Demand

A forest products company operating in the Southern Pine Region planted 117,600 acres in 1974. Another company operating in the Western states, planted 66,700 acres on their Douglas Fir sites. A farmer in New England also planted trees this past year—as did many other forest farmers, individuals and forest products companies from coast to coast and border to border. In total, it is estimated that 1,188,000 acres were planted by the private sector in the most recent year for which data is available.

All of these tree planters have one thing in common and that is a very uncommon faith in the future.

The seedlings planted this year will not reach economic maturity for many years. Some in the South may be harvested for pulpwood in 20 years but a Southern stand will not be ready for harvesting for lumber or plywood for 30 to 40 years. The reforested area in the Pacific Northwest may be ready for a silvicultural thinning harvest[1] in 25 or 30 years—where small diameter trees are removed to stimulate growth in the remainder of the stand. But, it will be

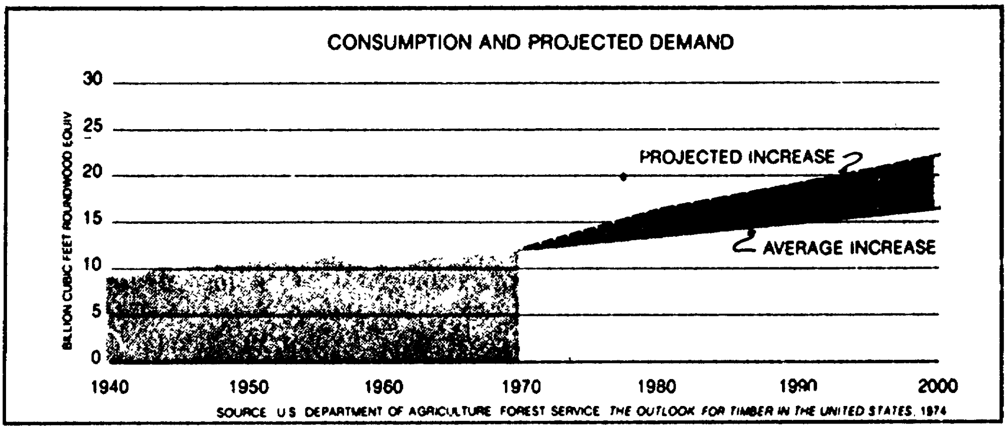
[1] This excludes consideration of pre-commercial thinnings which may occur from 10 to 20 years.

40 or 60 years before the full stand is ready for conversion into structural lumber or plywood. The forest farmer who plants a tree today is not likely to be the same forest farmer who harvests it 30 to 50 years from now.

The significance of these time frames involved in timber production is obvious. While timber is unique among all the basic natural resources in its renewability and adaptability to intensified production through good management, it does take a long time to grow trees. A policy which fails to project timber supply and demand estimates several decades into the future and a policy which fails to recognize the need for action today to meet those projections is not a valid policy.

For example, the "Third Forest Report" on the potential of the Southern Pine Region indicates that even in that area—where growth is fast and rotation periods are shorter than in some other areas of the country—timber stand improvement work will have to be completed by 1985 if the South is to meet its fiber requirements by the year 2000.

The U.S. Forest Service, in its 1973 comprehensive report, "The Outlook For Timber In The United States," tells us where we are going in terms of total timber supply—both public and private—and in terms of projected consumer demands. The study concludes that by the year 2000 the U.S. could experience a shortfall in timber production of over 20 billion board feet per year (an amount equal to the requirements of 1,400,000 single family homes each year).



CONSUMPTION AND PROJECTED DEMAND

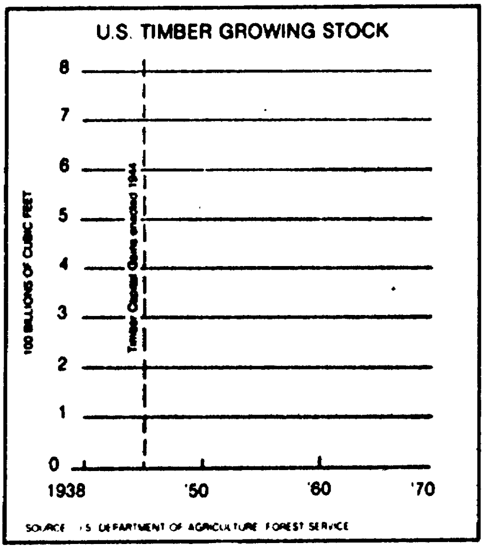
SOURCE U S DEPARTMENT OF AGRICULTURE FOREST SERVICE *THE OUTLOOK FOR TIMBER IN THE UNITED STATES*, 1974

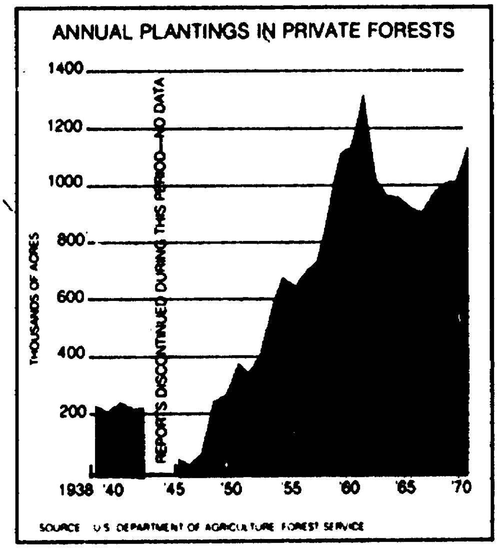
Home building is not the only sector which would be adversely affected. Over 5,000 consumer products are derived from forest products—commodities which either contribute to maintaining the American standard of living or which—in other cases—are essential to education, communication, sanitation and health.

We are here today as spokesmen for timber growers. But like everyone else in this room and everyone else in this nation, we are consumers of forest products; and we are concerned about the consumer impact of wood shortages; and we are concerned about those public policies which affect forest productivity for consumer uses. In order to achieve the goal of meeting consumer requirements, a viable timber growing industry must be in existence.

Prior to 1944 the nation's timber stocks were declining at an average rate of 7 billion cubic feet per year. Since that time the volume of growing wood fiber has increased until today it is approximately 175 billion cubic feet more than in 1944. And, while the gap between growth and removals is now narrowing, the nation's total timber growth still exceeds annual harvests. This dramatic change in the status of the nation's timber resources over the past 30 years was realized in spite of greatly increased harvests to meet growing consumer requirements. It can be attributed to higher levels of investment in improved forest management, expanded research, increased use of professional forestry personnel, and improved government-industry cooperation.

The dynamic contributions of the private timber sector during this period are probably best demonstrated by the dramatic increase in timber planting since 1944.





Adjusted to exclude new plantings generated by the Soil Bank Program

Demand for timber products rose 65%[2] over the past three decades. Comparable or even greater increases are expected in the future, particularly when we now know that potential substitute materials (plastics, aluminum, steel, etc.) are expected to be in short supply and would require more energy to process.

A Lesson From the Past

In view of these projections the question must be asked, "Is it possible to avoid these projected shortages?"

We believe it is, and the basis for that belief lies in the performance of the private timber sector in the years following 1944 when the tax penalties on timber investments were relieved through enactment of the timber capital gains provisions.

Trees planted in the early period of that private forest renaissance are only now reaching economic maturity. During the next two or three decades the increased demand for wood products projected by the Federal government and others will be partially met by harvests from plantings made 20 or 30 years ago. Without that increased supply, we would likely be in the same condition as in those years prior to 1944 when timber resources were in dramatic decline. Or, to relate the situation to more recent events—it would be a replay of our current domestic energy supply problem.

During the bleak years prior to 1944, frequent predictions of timber famine were made by forestry and resource experts. They weren't wrong. If the conditions existing at the time had continued, the shortage would already be upon us. The credit for avoiding it belongs to the Congress and to the foresight of those who maintained that timber resources deserved to be treated as any other capital asset and their conviction that the resulting financial investment in forest management would increase production.

We can think of no other major economic activity where an initial investment requires such a long period for capital recovery. This handicap is one which must be addressed and considered by the Congress and by Executive Department policy makers today if we are to properly anticipate and prepare for the timber needs of the United States by the year 2000 and beyond.

Sustained Yield Timber Management

When we talk about the capital gains treatment of timber income we are really talking about the dual concepts of sustained yield timber management and tax equity.

Sustained yield management is that which insures the on-going productivity of forest lands following a timber harvest—and throughout the many years required to complete the timber growing cycle.

[2] Excluding fuel wood.

Prior to enactment of the timber capital gains provisions in 1944, there was no tax equity for sustained yield management. Consequently, few timber owners could afford to practice it. The tax law said, in effect, if you liquidate a timber asset and in no way take steps to stimulate another crop, you will be treated the same as if you had disposed of any other long term capital asset. But, if you manage your timber assets for ongoing, sustained yield production, you will have to pay twice as much in taxes. Such were the circumstances prior to 1944, and they just as accurately represent the circumstances that would prevail if sections 631(a) and (b) were not a part of the Tax Code today.

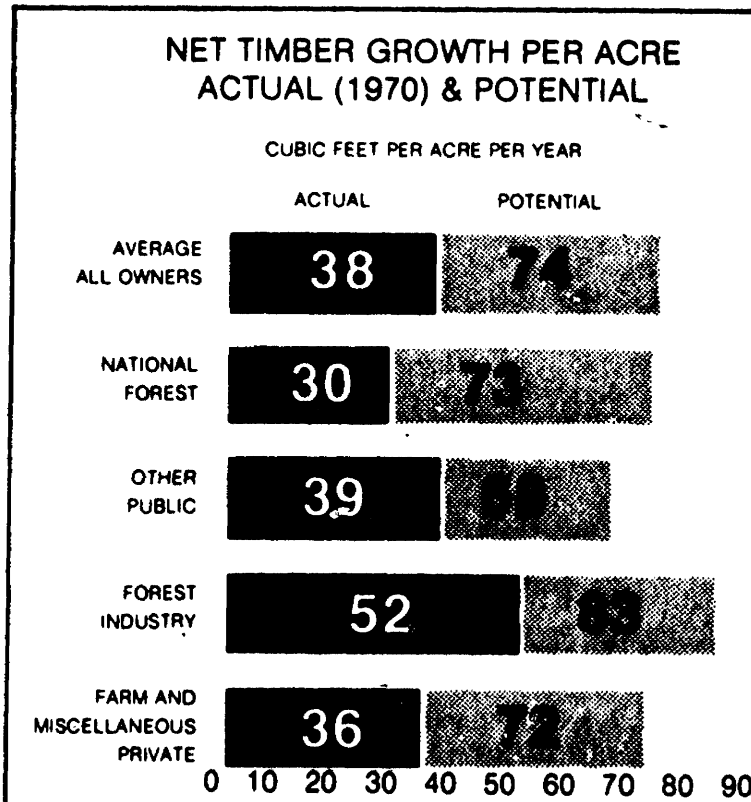
Today's tax treatment of timber can in no way be termed a "loophole" or a "tax shelter." It is itself a product of tax reform—a reform just as meaningful to the national needs today as it was when first enacted in 1944.

Timber in an era of Resource Scarcity

Once due consideration is given to the lengthy growing cycle of timber and compensatory measures are incorporated into the system to provide some element of equity with other capital investment opportunities, we can then turn to the positive aspects of timber as a national resource.

Unlike fossil fuel and mineral supplies which can become scarce or even unavailable as a result of continued consumption, timber can remain a staple in the human scheme forever. With genetically improved seed stocks and the use of intensive management, production per acre can be greatly increased over present averages.

One indication of the benefits of a high level of capital investment is the average growth per acre on lands managed by industrial owners. These lands, on average, now benefit from greater initial investment and annual expenditures than do the other major ownerships. Industrial forest lands, according to Forest Service studies, produce 52 cubic feet of new wood per acre each year. The average among all ownerships—public and private—is 38 cubic feet per acre per year.



SOURCE U S DEPARTMENT OF AGRICULTURE FOREST SERVICE. *THE OUTLOOK FOR TIMBER IN THE UNITED STATES* 1974

All ownerships, however, can benefit from more intensive management, as the above chart indicates. At optimum management levels, forest industry lands could produce an additional 81 cubic feet per acre . . . other private ownerships (including farm and small woodlot) could produce an additional 86 cubic feet per acre . . . national forest lands could produce an additional 48 cubic feet per acre on portions designated for commercial harvest . . . and other public forests (State, county, Bureau of Land Management, etc.) could produce an additional 29 cubic feet per acre.

This potential incremental growth represents nearly a 100% increase over present production on all ownerships. If that optimum production could be achieved over the next 25 years, it would more than make up for the 20 billion board feet deficit anticipated by government studies (which are predicated on present levels of management).

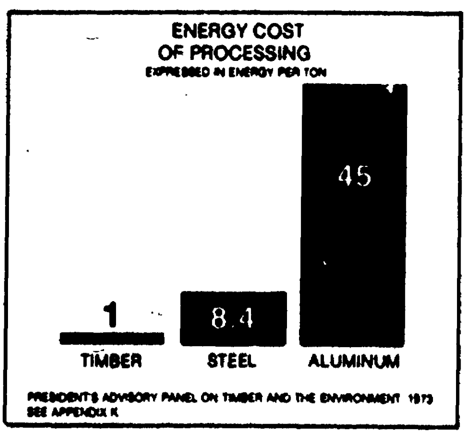
As dramatic as these potential improvements are, we believe they are conservative. If the Forest Service, in making the estimates, had considered the level of management now being conducted on some of the better managed industrial lands, and had used such information as the basis for the projections, the data on potential production from all ownership classes would show even greater opportunities.

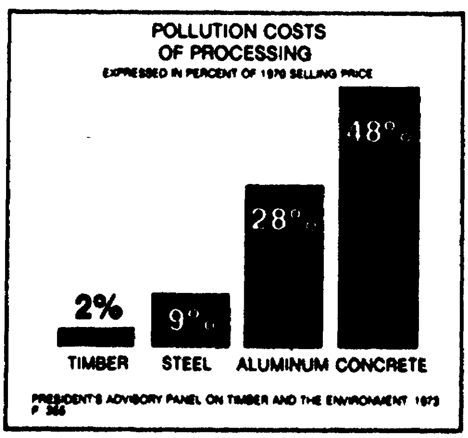
There is no better way to demonstrate the beneficial effects of modern forest management than to show you these cross sections of trees. (Tree samples were provided the Committee during oral testimony.) The paired cross sections are from trees of the same age, species and geographic area. The differences in tree sizes and volumes of wood produced are directly attributable to such practices as proper site preparation, pre-commercial and commercial thinning —and, in some cases, fertilization and other intensive management practices. These samples show you what we mean when we talk about the potential for improving the nation's private forest resources through increased capital investment.

Only a few short years ago, it might have been argued that the issue of maximum timber production and supply was not that critical. Substitute products were coming on the market. Others were anticipated. But the raw material basis for the substitutes are plastics, aluminum, steel and concrete. We know that petrochemical plastic feedstocks cannot be considered an abundant material source—nor can the other exhaustible mineral resources. Along with wood, each has its place, but it is no longer feasible to consider them as alternatives in applications for which wood is best suited. And certainly, the potential use of substitutes can no longer be considered as a viable alternative to the adoption of public policies to encourage the maximum production from the nation's forest lands.

In addition to the quality of renewability, wood has significant environmental advantages over other materials in the processing stage. Timber products are produced and processed with much lower energy requirements and with relatively little adverse environmental effect. Processing steel for construction, for instance, takes four times the energy of processing lumber for the same purpose. For aluminum, it takes 20 times the energy. The accompanying chart shows the comparison in terms of energy per ton of production.

Production of wood substitutes also creates more air, water and solid waste pollution than does the production of wood. Much of wood fiber can be recycled. What is not is biodegradable and returns to the earth. The accompanying charts compare the low pollution cost of processing timber compared with other substitutes.



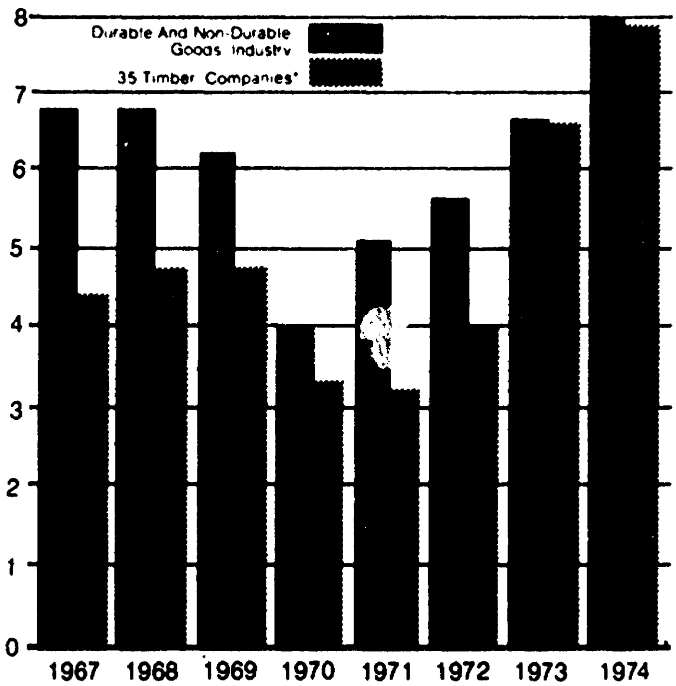


The Economics of Timber Production

Historically, low rates of return on timber have been a factor in discouraging investments in forest management. Return on investment has been far below the average of other industries. Reports of the Federal Trade Commission indicate the return on lumber, paper and allied products for the period 1964 to 1973 was 5.8% compared with a return of 6.4% for all durable and nondurable goods produced.[8]

The accompanying graph on Average Return on Assets, comparing the totals of durable and nondurable industries with the record of 35 timber companies (representing two-thirds of industrial forest ownership) demonstrates that return on timber investment is very volatile because of fluctuations in market demand. It shows that, in most years, return is much below other comparable industries.

AVERAGE RETURN ON ASSETS



*END-OF-YEAR ASSETS

SOURCE STAFF STUDY BY THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

University and government studies also show low expected after tax rates of return on timber land in all regions of the country and in all categories of ownership. The range of expected returns indicated in the accompanying table reflects varying site and growing conditions. The studies cited in the table demonstrate the marginal feasibility of long term investments in forest planting and management. These rates of return—ranging as low as 1% in certain species and regions—have been adjusted to reflect average Federal taxes, including capital gains treatment.

---

[8] After 1973 no breakdown is available showing lumber as a separate category. Using paper and allied products alone the comparison for the latest available decade, 1965 to 1974, is 5.7% for paper and allied products and 6.6% for all durable and non-durable goods.

PREDICTED RATES OF RETURN
ON TIMBER INVESTMENTS
(AFTER TAXES)*

AREA	RATE OF RETURN
North Central and Eastern	1.0 - 4.2%
Southern	0.7 - 8.3%
Rocky Mountain	1.1 - 6.5%
Pacific Coast	
Redwood	1.1 - 3.6%
Douglas Fir	1.1 - 4.1%

**Measured on most suitable investment opportunities, including conversion to other species.*

SOURCE U S FOREST SERVICE
DIVISION OF FOREST ECONOMICS & MARKETING RESOURCES
NOVEMBER 19, 1973
Unpublished data as adjusted for federal taxes by staff of Forest Industries Committee on Timber Valuation and Taxation

The problem of low financial return on timber is compounded by factors related to the poor liquidity of capital invested in timber growing.

The initial investment in land preparation, roads and plantings is, like most other things in our economy, becoming much more expensive. The annual costs of maintaining the investment—interest and debt retirement, property taxes, protection from fire, insects and disease—are also higher than ever. And these expenses continue for many, many years before there is a single dollar of return to the investor.

In the meantime the investor faces the threat of possible loss of assets through fire or other hazard. It is significant that casualty loss insurance is simply not available on standing timber, at any price. This is a reflection of the magnitude of the risks undertaken by those who launch a timber growing enterprise.

We have with us some photographs which graphically illustrate those risks. In the case of fire, a timber resource can be totally destroyed—with little, if any, salvage value to the owner. In the case of wind, ice, disease or other casualties, the value of the asset is greatly diminished and its capacity for production is seriously impaired for many years.

And then there is the final risk. After making the initial investment decades earlier and after meeting the burden of annual management costs year after year, the landowner finally sees the timber attain harvest size. He is then subject to the vagaries of a market that is notoriously sensitive to declines in the home building industry. The home building industry is one of the few we know of that can be in a full scale depression when the rest of the economy is booming.

So the combination of low predicted rates of return, high carrying costs and the natural and economic risks involved in timber growing will make it extremely difficult to attract the level of capital investment required to make the nation's timber lands sufficiently productive to ward off anticipated shortages.

We know, however, that adjustments in Federal tax policy affecting timber can have direct and immediate impact on the level of forestry investments. Unfortunately, the impact can be adverse as well as positive.

Tax Policy and Forest Productivity

In any discussion of the impact of tax policy on forest productivity, it is essential to emphasize at the outset at what point the tax situation enters into the economic decision making process.

It first must be stated that there are no ongoing special tax benefits for growing timber. The reduced capital gain rate applicable to timber is simply the same treatment afforded all other capital assets. There is nothing in timber tax treatment comparable to percentage depletion. The "cost depletion" applying to timber cannot be annually deducted against ordinary income, but is a one time deduction taken when the timber is harvested. It is nothing more than the same "cost recovery" applicable to other capital assets. Most modern accounting references to timber cost depletion use instead the phrase "cost of timber harvested," since the use of capital cost basis to reduce proceeds before applying the tax rate is simply a proper accounting procedure and is not a tax benefit.

The capital gain determination is made only when gain has been realized—that is, when the timber is harvested or sold. For an individual taxpayer, one-half of the gain is taxed at the applicable ordinary income rate, with an optional 25% maximum rate on the first $50,000 of gain. The remaining 50% of gain is considered a "tax preference" under the existing minimum tax provisions, and the taxpayer is assessed an additional tax on that portion. Thus, the effective capital gains rate for individuals in the highest tax bracket is now 36.5%, ranging downward for those in lower tax brackets.

For corporate taxpayers, gain on timber and other capital gain is taxed at the flat rate of 30% and adjusted for the minimum tax to an even higher rate.

There is yet another factor which should be put into proper perspective if we are to understand the role of timber capital gains in the economic decision making processes of potential investors in timber growing.

As noted earlier, the capital gain tax benefit is received when the timber is harvested and the gain is realized. Because of this, we have heard it said and seen it written by various critics that the application of capital gains is an incentive to cut timber rather than an incentive to grow timber.

To those in the business, this is a preposterous notion. But upon reflection, we can see that, unless this issue of the economic decision making process in timber is understood, such interpretations can be perpetuated and may gain credence simply through repetition.

So the record should be set straight.

Timber being grown for commercial use is going to be harvested when two essential conditions are met: first, when the physical growth rate passes the point of optimum production; and second, when there is a demand for forest products in the marketplace. Both conditions will normally prevail.

For an example, we could look at the situation of an owner of old growth timber, where new growth per acre per year has passed the optimum. If the market is in serious decline and prices are down, he may sell some but he is not going to want to sell it all in an already bad market. He will wait until there is an increase in consumer demand. And, similarly, the owner of immature timber will not be encouraged by capital gains tax treatment to sell before the trees reach the optimum market condition—assuming he has confidence that the same tax treatment will be in effect when harvest conditions are improved.

As a final look at this issue, we have only to go back to the pre-1944 period when most timber transactions, as they are conducted today, were not eligible for capital gains treatment. If the suggestions of today's critics were true, then timber harvesting in those years would have been discouraged and the nation's inventory of timber would have increased to provide a cushion for future need. The evidence, however, shows exactly the opposite. The resource was in a state of serious decline. Harvesting was then, as now, governed by market conditions.

Where then does capital gains enter the picture in today's timber economy?

For the answer to that we must look to what happens after the harvest, because it is at that point that landowners and timber managers must decide the future use of the land.

They will first take into account the fact that the capital gains tax rate has allowed the retention of a larger share of the proceeds from the just completed timber harvest or sale than would have been possible at ordinary income rates. Therefore, the reinvestment capability is improved.

Next they will take into account the anticipated cost of management over the long range growing cycle and the expected future return on the investment. There are many uncertain elements in this evaluation, but if the decision makers have confidence that the eventual proceeds will be taxed at the reduced capital gain rate, it will help offset some of those uncertainties.

It is more likely then that the decision will be made to invest in prompt reforestation and in management practices to improve the growth rate in the new growing cycle.

Capital gains treatment is clearly an incentive to grow timber.

That is what Congress intended when it changed the law in 1944, and the record demonstrates that it does just that. Surveys indicate that the amount of timber proceeds reinvested in the land by timber owners greatly exceeds the value of the capital gains tax saving. In fact, without the capital gains saving, today's rate of investment in the resource simply could not be sustained. And, as indicated earlier in our statement, even today's level of investment is not adequate to meet future requirements for wood and fiber.

The Revenue Act of 1969

One of the reasons for our deep concern today is the impact already being felt from the increased capital gains rates put into effect following enactment of the Revenue Act of 1969. Prior to 1969 and dating back to the 1944 enactment of the timber capital gains provisions, the rate on capital gain of individuals was one-half of the applicable ordinary income tax rate, with a maximum of 25%. Corporate capital gain was taxed at a flat rate of 25%.

The 1969 Act increased the maximum individual rate to 35% and the corporate flat rate to 30%, and made both subject to an additional assessment under the minimum tax. Admittedly, this increase affected all taxpayers with capital gain, not just timber owners. But the significance in terms of its impact on timber growers is twofold: first, many of those who planted trees in the 1940's and 1950's did so with the expectation that the existing ratio between capital gain and ordinary income tax rates would remain the same, regardless of increases or decreases in the basic tax tables. Having acted on that assumption, they later found that, even though they had yet to derive any return on their investment, the rules had been changed; and secondly, at the very time when government studies were demonstrating the urgent need for increased private investment in forest resources, the tax rates were changed to reduce after tax income for reinvestment and to further discourage the inflow of new, outside capital for investment in timber production.

The cost of these changes in the year 1971 to the 35 larger timber companies is estimated to have been about $27 million. This compares with over $190 million of investment made by these companies in that year. By the most conservative estimates, it is anticipated that well over $20 billion of investment in timber reforestation will be required to merely maintain the present trends in forest investment of those companies between now and the year 2000.

It must be emphasized that this estimate does not take into account the need for significant increases in the rate of investment on forest lands not now being managed intensively and, therefore, not included in the above estimates.

To reach the goal of self-sufficiency by the year 2000, virtually all commercial forest lands will have to be managed more intensively; therefore, the total investment requirement to meet that objective is certainly much higher than any figures derived from today's trends.

Effective Tax Rates of the Forest Products Industry

It is appropriate that the Congress would want to evaluate the extent to which capital gains treatment has reduced the tax liabiliy of the forest products sector. Contrary to the belief of some, the capital gains incentive has not been a "tax bonanza" to the industry. According to one survey conducted by a member of Congress, the average effective Federal corporate tax rate for certain industries eligible for such tax benefits as depletion allowances, capital gains, investment credit, DISC, accelerated depreciation, etc. was 29.6% in 1971, 29.0% in 1972 and 27.1% in 1973 (the last year studied).

In those same years, a survey conducted by the Forest Industries Committee on Timber Valuation and Taxation of companies accounting for approximately 68% of commercially owned forest land in the U.S. indicated that the average effective tax rates of those companies were 38.6%, 37.0% and 38.9% respectively. Their average effective tax rates over the five year period 1969 through 1973 were 38.7%.

By this comparison it is clear that timber capital gains treatment does not represent a "windfall" to the forest products industry particulary when it is understood that other tax provisions affecting non-timber assets account for a portion of the differential between the industry's average effective rate and the statutory corporate income tax rate.

Timber Taxation in Other Countries

In those free market economies where forest taxation practices have been studied, there has been a universal acceptance of the concept that timber producing property is a unique capital asset and that tax incentives are essential to overcome the inherent handicaps to investment and higher productivity. The countries reviewed in the studies include Great Britain, Norway, Sweden, Holland, West Germany, France, Finland, Switzerland, Brazil, Australia, New Zealand and Japan.

The range of tax incentives (usually including two or more) were special capital gains treatment, ordinary income preferences and exemptions, ad valorem exemptions, estate tax deferral, rapid depreciation, casualty loss provisions, value added. income averaging and allowances for expensing capital improvements.

The trend in these countries, contrary to what we are experiencing in the U.S., is not to reduce tax incentives for timber production but to broaden and improve them.

Adverse Provisions in House-Passed Bill (H.R. 10612)

The so-called "tax reform" bill passed last year by the House of Representatives and now pending before your Committee contains two proposed revisions in the Internal Revenue Code which would—whether intended or not—discourage the level of investment needed to improve the nation's renewable timber resources.

These are:

(1) the Limitation on Artificial Losses (LAL);

(2) the Minimum Tax Amendments.

It is imperative that the devastating effects of these proposed changes be fully understood.

Limitation on Artificial Losses (LAL) as it Would Apply to Timber Growing

We believe, for several reasons cited in our statement, that the purposes for which LAL were designed have no relevance whatsoever to the growing of timber—except for the penalties it will impose on legitimate investments in timber management.

Government reports (which are cited elsewhere in this statement) all point to the need for more intensive management of timber lands in so-called non-industrial private ownerships. Forest management experts and forestry scientists agree that much of this acreage is in a low producing condition for lack of adequate management expenditures. It was for this reason that Congress passed the Forestry Incentives Act of 1974, a program to assist small timber ownerships in undertaking more intensive management programs.

The "pre-production expenses" which, under the provisions of the House bill would make timber growers subject to LAL, are the same expenditures which the United States Forest Service, State forestry agencies and others are virtually pleading for owners to make as a step to avoid a national timber shortage. Similarly, to disallow accelerated depreciation on equipment for effective forestry management and to impose the other LAL penalty provisions hardly seem compatible with that major public policy objective.

For individuals, family owned corporations and Subchapter S corporations not now capitalizing pre-production expenses, the LAL provision would not allow farm related "accelerated deductions" in the year in which incurred, to the extent that such deductions exceed the taxpayer's income from such operations. Under the provisions of the bill, pre-productive timber management expenses would be included. These deductions would have to be suspended in a "deferred deduction account" until a future year in which the taxpayer derives income related to the deductions.

The "accelerated deductions" provision would apply to (1) pre-productive period expenses, (2) pre-paid expenses, and (3) accelerated depreciation during the productive period and would apply to timber growing as well as to customary farm crop production.

In addition, Section 204 of the House-passed bill would require non-family owned and non-Subchapter S corporations to use the accrual method of accounting and would require capitalization of timber growing expenses which heretofore have been fully deductible as necessary for the preservation and maintenance of timber assets. The financial consequences of such a requirement over the many decades of the timber growing cycle are staggering. Some say that this effect of the House bill was "unintended" but whether intended or not it poses a dire threat.

The language of H.R. 10612 and the accompanying Ways and Means Committee Report do leave considerable uncertainty as to the application of the term "pre-productive period expenses." But we must assume that—if it were enacted—the language would be interpreted by Treasury and IRS to include virtually all normal timber management and protection expenses. There seems to be even some disparity in various parts of the Committee Report on the question of deductibility of interest and property taxes.

The expenses covered by the LAL provisions are not capital in nature and the changes proposed in H.R. 10612 would represent a radical departure from the traditional tax treatment of legitimate timber management expenses. The tax penalties would be so severe as to virtually preclude the development of new forest resources by taxpayers not having mature timber stands from which current income is derived because it is only against such current and related income that the ongoing expenses of new forest development and management could be deducted for tax purposes.

The $20,000 exemption in the LAL provision is virtually meaningless in terms of timber growing expenses. While it might exclude the smaller ownerships from the onerous provisions of the bill, it would not help many of those who have sufficient volumes of timber under management to make commercial, sustained yield production practical. Nor would it help to simply raise the amount of the exemption. No matter where the cut-off was applied realistically, the results would be inequitable to some growers and the next effect would be to hinder the desired level of investment in viable timber growing enterprises.

The enactment of LAL in its present form would necessitate the premature harvest of vast quantities of timber whose owners could not afford the tax penalties for managing the asset to economic maturity.

No more effective method could be devised for erasing the progress of 30 years of enlightened public policies encouraging timber production. It would even be worse than the pre-1944 era described earlier in this statement.

And all this for reasons unrelated to the concept of "artificial losses" as defined in the LAL provisions of the House bill. The pre-productive period expenses in the LAL provisions of the House bill on the surface apply to agriculture generally but they exclude all grains, oil seed (for example, soy beans), fiber, pasture, tobacco, silage, forage crops and livestock (other than poultry). Thus, it is estimated that over 80%[4] of total agricultural output, according to the Agriculture Department, is excluded from these LAL provisions. The inclusion of timber with its long growing cycle, high risk and high illiquidity of investment and essentiality as a natural resource together with poultry and the balance of the agriculture area, seems anomalous.

It is interesting to note that the LAL concept introduced in 1969 for farm products did not include timber nor was timber included in LAL when the Committee last acted upon it in 1974. There have been no proposals made on which hearings have been held nor discussions in the Ways and Means Committee or on the House floor suggesting that timber should be a part of LAL.

It is paradoxical that timber growing, while specifically excluded from the definitions of farming activity in all sections of the Internal Revenue Code where favorable benefits are provided, is now proposed to be included as a farm operation for purposes of LAL.

---

[4] Based on percent of total cash value of agricultural production sold. Assumes total output is non-syndicated. Data from 1969 *Census of Agriculture*. Items presently estimated to remain under LAL are: orchards 4.2%, horticultural crops 2.0%, vineyards, berries and vegetables 4.3%, poultry 9.0% and timber 0.2%.

This is especially puzzling since LAL, according to its proponents, is designed to cope with the "tax shelters" concept. A "tax shelter" is often thought of as a situation where ordinary income is offset by non-cash deductions and particularly involves those operations which lend themselves to syndication and leveraging.

These practices are not present in timber growing. There is no current depreciation or percentage depletion allowance. Planting and other start-up costs are capitalized and these actual cash expenditures (technically "cost depleted") are recoverable only when the asset is harvested or sold generally no sooner than 20 to 100 years later. There is no "accelerated depreciation" or anything like it applying to timber.

(The "accelerated depreciation" applicable to forestry equipment is a separate and relatively minor matter and is discussed below.)

The expenses of maintaining timber assets are true cash expenditures with no so-called "artificial losses" to offset non-timber income. And, unlike the typical "tax shelter" investments, there are no quick turn around possibilities. Once the intial capital investment is made, the owner faces a long period of annual cash expenditures to hold the asset to economic maturity.

As for "leveraging" there is little opportunity for that since lenders are not anxious to provide funds for such long term risk ventures as timber growing. In fact, one of the major problems most timber producers have is that of financing the kind of management practices essential to improve the state of the nation's timber resource base.

As for the other element prominently mentioned in the House Committee Report—that of syndication—we are not aware of anyone offering timber properties or shares in timber properties with the promise of "sheltering" current non-timber income. The Committee Report states ". . . the number and volume of publicly syndicated investments in almost all areas of agriculture have increased substantially." If the statement is intended to include timber as is the case in other "agricultural" references in the Report, then it is clearly mistaken. Those of us in the forestry business would be aware of such activities if they were prevalent. And we would be very surprised if anyone could make the syndication concept work because the opportunities for short term tax benefits of the nature described in the Report are simply not there.

If the complex LAL formula is applied to timber growing, it will not add to but will reduce Federal tax revenue since it will discourage investments in timber growing enterprises by certain taxpayers. And it will add significantly to the already substantial accounting problems faced by timber owners over the long growing cycle. In some cases, timber expenditure accounts would have to be maintained for 40 to 100 years to comply with the proposed provisions.

The greatest impact would be on the small and medium sized ownerships which may not receive income from timber cutting annually in large enough quantities to cover their "timber management costs."

Also, it would discriminate against new investors in timber growing enterprises relative to those which have been in operation for a number of years and have now stabilized into a sustained yield pattern where there is sufficient timber-related income to utilize current expenditure deductions.

And all would come at a time when public agencies and elements of the private sector economy dependent upon increased forest production are appealing for greatly increased planting investments and timber management expenditures.

House-Passed Minimum Tax Would Build in New and Greater Inequities

The present minimum tax, enacted as part of the Tax Reform Act of 1969, imposes a special 10% tax on so-called preference income. "Preference income" is defined in the Act as the value of certain deductions, such as accelerated depreciation, depletion allowances, certain interest deductions and others, including the "untaxed" portion of capital gain. Other deductions and income were excluded from the definition.

Before calculating the minimum tax under current law, the taxpayer is eligible for a $30,000 deduction from the total of all "preference income," and he can then deduct the amount of taxes already paid. The 10% tax rate applies to the balance.

The tax was imposed on both individual and corporate taxpayers.

The proposed minimum tax amendment, as contained in the House-passed H.R. 10612 would make several changes. The minimum tax rate would be increased from the present 10% to 14%. The $30,000 deduction would be lowered to $20,000 and would be phased out completely for taxpayers with $40,000 or more in "preference income." And, of even greater significance, the deduction for "ther taxes paid" would be eliminated entirely.

No significant changes are made in the definition of "preference income."

The proposed new minimum tax provisions would apply only to individuals and partnerships. The existing provisions would continue to apply to corporations.

Minimum Tax Would be, More Than Ever, an "Added Tax"

If there was ever any doubt that the term "minimum tax" was a misnomer, the provisions of the House bill should lay that doubt to rest. The proposed elimination of the deduction for other taxes paid strips away all pretense that it is designed to reach those who pay no taxes. It is purely and simply an added tax on already taxed income.

Most of those who presently pay no taxes by virtue of various deductions and tax-exempt provisions will continue to pay no taxes.

Those who already pay taxes but who have the benefit of certain deductions and incentives purposely provided for by law will pay up to an additional 14% on the value of those deductions because the proposed law would completely ignore their regular tax paid—regardless of how high it might be.

Under the proposed amendements, capital gain—which traditionally, prior to 1969, had been taxed at 50% of the ordinary income rate or a maximum of 25%—would be taxed at rates up to 42% of the gross gain.

This can hardly be termed a "minimum tax"—especially when viewed in the context of the well established justification for reduced rates on capital gain—to encourage savings over consumption, to encourage risk taking, to reflect higher replacement costs resulting from inflation, and to prevent the lock-in of investment capital in non-productive or low-producing enterprises.

There Could be a Real Minimum Tax

During House consideration of H.Rfi 10612, an amendment was offered by Rep. James Jones to make the minimum tax consistent with its avowed purpose. Jones proposed a "minimum taxable income" or MTI approach. Studies prepared by Treasury Assistant Secretary Stanley Surrey in 1968 proposed similar language as a fairer, more effective, and less complicated means of achieving the objective Congress set out to achieve in 1969. Also, in 1973 the Treasury Department proposed similar language.

In essence, the MTI would be an "alternative tax" whereby the beneficiary of certain deductions, preferential rates and/or exemptions would calculate tax liability in two ways and pay the higher of the two.

First, the taxpayer would determine the amount of taxes due under all regular provisions of the Internal Revenue Code (with the exception of the existing minimum tax, wihch would be repealed). The alternative would be to start with adjusted gross income, apply a reasonable exemption, deduct such items of extraordinary medical expenses, casualty losses and charitable contributions, then add in all "preference deductions" and "preference income." Normal tax rates would then be calculated on one-half of the sum. The taxpayer would then be required to pay the higher of these two tax calculations.

Such a method would result in a true minimum tax on economic income and would treat all income alike for purposes of the additional tax assessment. It would not, however, impose unfair additional taxes on income which has already been taxed at high rates.

For these reasons, we urge that the Congress consider the adoption of the following tax provisions and policies to make the tax laws consistent with the acknowledged national objective of improving timber supplies:

(1) The capital gains treatment of timber harvest proceeds should continue to be the cornerstone of tax policy to encourage investment in new forest production and improved forest management. Its effectiveness has been amply demonstrated.

(2) In view of the unique aspects of timber (principally the long growth period, relative illiquidity and high uninsurable risk)—aspects that place it at a disadvantage compared to other capital investments—as well as the public interest aspects that weigh in favor of increased timber production, we urge that the tax rate differential be restored to the pre-1969 level.

(3) The six month qualifying holding period for assets should be retained rather than extending it to one year as proposed in the House bill. Any lengthening of the holding period would discriminate against some true capital investments and would place many small operations in the forest products industry at a competitive disadvantage in their need to invest in raw material supplies for short term and intermediate term needs. The holding period requirement for timber is already more demanding than for other assets—extending to 18 months in some circumstances. The House bill would make it 24 months. Therefore, if the minimum holding period for all assets is extended to one year, language should be adopted to ensure that the applicable period for timber assets also not exceed one year.

(4) The inclusion of capital gains as "preference income" for purposes of the minimum tax does not conform to the stated purpose of the minimum tax. Capital gains are already taxed at the full statutory rate authorized by Congress. The legislative history of the minimum tax clearly indicates that it was designed to cope with problems that arise from other than capital gains treatment. Yet, Treasury Department figures show, that for individual taxpayers, the additional tax on capital gains generates over 70% of minimum tax revenue.

These individual taxpayers would be further penalized if the provisions of H.R. 10612 were to be enacted. We believe its purpose would be better achieved and the adverse impact on the acknowledged national need for increased capital savings and investment would be remedied if capital gains were deleted from the definition of "preference income."

(5) If the minimum tax concept is to be retained the formula should be revised to make it a true minimum tax rather than an additional tax on certain forms of taxpayer income as at present. The suggestion of an alternative tax on "economic income" is more equitable than the minimum tax under present law or as proposed in the House bill. Such a true minimum tax would also take care of the "tax shelter" abuses which the Limitation on Artificial Losses (LAL) proposal is intended to cope with, thereby eliminating the pressures for enactment of such a complex and inequiable addition to an already overburdened Tax Code.

(6) If LAL or the other amendements related to tax shelters (Titles I and II of the bill) are adopted in any form, timber growing should be excluded from their provisions. The long cycle of investment distinguishes timber growing from the "farm operations" covered in Section 101 of H.R. 10612. This distinction also brings with it elements of sustained risk and lengthy illiquidity which are unique to timber growing operations—the renewing of the nation's only renewable, critical resource.

Therefore, we strongly recommend that timber not be considered a farming activity for purposes of the LAL provisions—just as it is not at present considered a farming activity for purposes of other farm tax provisions in the Code.

Conclusion

Mr. Chairman, we hope that the information provided and the suggestions made in this statement will be helpful to the Committee in its consideration of tax policy, particularly those aspects of import to timber growers.

Thank you.

FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION

COOPERATING ASSOCIATIONS

Alabama Forestry Association, Montgomery, Alabama.
Alaska Loggers Association, Inc., Ketchikan, Alaska.
American Hardboard Association, Chicago, Illinois.
American Institute of Timber Construction, Englewood, Colorado.
American Paper Institute, New York, New York.
American Plywood Association, Tacoma, Washington.
American Pulpwood Association, Washington, D.C.
American Turpentine Farmers Association Co-op, Valdosta, Georgia.
American Wood Preservers Association, Washington, D.C.
American Wood Preservers Institute, McLean, Virginia.

Appalachian Hardwood Manufacturers, Inc., High Point, North Carolina.
Arkansas Forestry Association, Little Rock, Arkansas.
Associated Cooperage Industries of America, Inc., St. Louis, Missouri.
Associated Oregon Industries, Salem, Oregon.
Association of Consulting Foresters, Wake, Virginia.
California Forest Protective Association, Sacramento, California.
Eastern North Carolina Lumber Manufacturers Assn., Inc., Weldon, North Carolina.
Federal Timber Purchasers Association, Denver, Colorado.
Fine Hardwoods-American Walnut Association, Chicago, Illinois.
Florida Forestry Association, Tallahassee, Florida.
Forest Farmers Association, Atlanta, Georgia.
Georgia Forestry Association, Atlanta, Georgia.
Hardwood Dimension Manufacturers Association, Nashville, Tennessee.
Hardwood Plywood Manufacturers Association, Arlington, Virginia.
Industrial Forestry Association, Portland, Oregon.
Kentucky Forest Industrial Association, Lexington, Kentucky.
Louisiana Forestry Association, Alexandria, Louisiana.
Lumber Manufacturers Association of Virginia, Sandston, Virginia.
Maine Forest Products Council, Bangor, Maine.
Marine Hardwood Association, Augusta, Maine.
Minnesota Timber Products Assn., Duluth, Minnesota.
Mississippi Forestry Association, Jackson, Mississippi.
Mississippi Pine Manufacturers Association, Jackson, Mississippi.
Missouri Forest Products Assn., Jefferson City, Missouri.
National Christmas Tree Growers' Association, Milwaukee, Wisconsin.
National Council of Forestry Association Executives, Columbus, Ohio.
National Forest Products Assn., Washington, D.C.
National Hardwood Lumber Association, Chicago, Illinois.
National Oak Flooring Manufacturers Association, Memphis, Tennessee.
National Particleboard Association, Silver Spring, Maryland.
New Hampshire Timberland Owners' Association, Gorham, New Hampshire.
New York Forest Owners Assn., Syracuse, New York.
North Carolina Forestry Assn., Raleigh, North Carolina.
Northeastern Lumber Manufacturers Association, Inc., Glens Falls, New York.
Northern Hardwood and Pine Manufacturers Assn., Inc., Green Bay, Wisconsin.
Ohio Forestry Association, Inc., Columbus, Ohio.
Oklahoma Forestry Association, Ada, Oklahoma.
Oregon Forest Protection Assn., Portland, Oregon.
Oregon/Washington Silvicultural Council, Portland, Oregon.
Pacific Logging Congress, Portland, Oregon.
Pennsylvania Forestry Assn., Mechanicsburg, Pennsylvania.
Society for the Protection of New Hampshire Forests, Concord, New Hampshire.
South Carolina Forestry Assn., Columbia, South Carolina.
Southeastern Lumber Manufacturers Association, College Park, Georgia.
Southern Forest Products Assn., New Orleans, Louisiana.
Southern Forest Products Assn., Atlanta, Georgia.
Southern Hardwood Lumber Manufacturers Association, Memphis, Tennessee.
Southern Oregon Timber Industries Association, Medford, Oregon.
Southwest Pine Association, Phoenix, Arizona.
Tennessee Forestry Association, Nashville, Tennessee.
Texas Forestry Association, Lufkin, Texas.
Timber Products Association, Inc. of Michigan and Wisconsin, Crandon, Wisconsin.
United Hardwood Forestry Program of Fine Hardwoods/American Walnut Association, Columbia City, Indiana.
Virginia Forests, Inc., Richmond, Virginia.
Washington Forest Protection Association, Seattle, Washington.
Western Forest Industries Association, Portland, Oregon.
Western Forestry and Conservation Association, Portland, Oregon.
Western Timber Association, San Francisco, California.
Western Wood Preservers Institute, Portland, Oregon.
Western Wood Products Association, Portland, Oregon.

A Brief History of Timber Taxation in the United States

At the beginning of European colonization of America, it has been estimated that approximately one-half of the area now comprising the United States was forested. After 300 plus years of frontier expansion, agricultural development, and—in the last century—phenomenal population growth and urbanization, one-third of the nation's total land area is still forested. Of the 750 million acres of forest, approximately 500 million acres are classified as "commercial" —that is, lands not withdrawn from timber harvest and which are capable of producing over 20 cubic feet of new wood each year.

Seventy percent of these commercial timber lands are in private ownership. In the early days of nation building, private forest holdings provided virtually all of the timber used for all purposes, including fuel. For most of this period, timber was considered to be an inexhaustible resource because, as population grew and geographic boundaries expanded, there were always new supplies to help support needed development. It was a close parallel to the familiar story of America's land—more way always there as civilization moved westward.

However, with the closing of the "frontier era" about 1890, policies changed to meet the new circumstances. In 1891 the first national forest preserve was established, and new additions followed until today approximately 18% of the commercial forest lands are now a part of the National Forest System. But until World War II timber harvesting from the national forests was relatively insignificant, and pressures continued on private lands to provide wood for building materials, for paper and other products.

In relating the history and the potential of private forest utilization in the U.S., former Chief of the Forest Service, Edward Cliff, wrote: "These private forests sold the key to the future of the nation's timber supplies." In a comprehensive report, "Timber: The Renewable Resource," prepared for the National Commission on Materials Policy, Mr. Cliff wrote, "Projected demands for timber in the decades ahead make it clear that the private forests of America must supply greatly increased flows of saw logs, pulpwood, and other forest products. Regardless of the rate of cutting of National Forests and other timber in the next 15 or 20 years—eventually the pendulum of demand will swing back to even greater reliance upon the private sector. . . . Since many years of lead time are required to produce an inventory of saw log material, consideration of future supply problems is equally urgent. In any such consideration, the role of the privately owned forest land must be paramount. There is no viable alternative."

Other recent studies by Federal agencies and commissions have emphasized the necessity of reliance on increased production from the private forest sector if the U.S. is to avoid a costly and damaging shortage of forest products by the year 2000.

Some of these studies, such as the 1973 report of the President's Advisory Panel on Timber and the Environment, have cited Federal tax policy as being critically important to the achievement of adequate financial investment in intensive timber management.

Because of the current interest in questions of resource taxation, capital investment needs, and projected shortages of many raw materials, it is appropriate to review the history and impact of Federal tax policies on the production of timber, our only fully renewable natural resource.

Early History of Timber Taxation

Prior to the adoption of the income tax in 1916, most public revenues were derived from customs fees and taxes on property. To the extent that taxes were then a factor in forest management decisions, periodic levies against forest property were certainly one factor among many which weighed against the active management of forest land from one generation to the next. Consequently, cut-over lands were usually converted to agricultural use or were frequently abandoned and natural regeneration occurred over a long period of time.

When the 16th Amendment was adopted and the Federal income tax was instituted in 1916, there was at first no provision for distinguishing between ordinary income (from wages, salaries, business profits, dividends, rents, etc.) and from the gain realized from the sale of a long held capital asset. Within a very short time, however, Congress recognized the personal injustice and the devastating economic consequences of a tax system that only took a portion of the nation's current income for public purposes but also a portion of the capital base upon which that income was derived.

In 1921, the capital gains tax was incorporated into the system. A lower rate was established on gain from the sale of capital assets, a rate which took into account the elements of risk and inflation and which helped to avoid the economic stagnation that resulted from "locking-in" investments in non-productive capital assets.

At that time, timber was recognized as a qualified capital asset along with land and improvements for farm or business use, commercial properties, and equity interest in such enterprises, but only if the timber was liquidated by the owner in a lump sum transaction. If, on the other hand, the timber owner chose to manage the resource on a sustained yield basis—if he replanted or managed it as an ongoing investment through selective or periodic harvests—the owner was denied capital gains treatment. Also, if the owner harvested timber for processing in his own plant, he was denied capital gains treatment. These anomalies came about because of the ruling that transactions such as these indicated that the timber was held primarily for sale to customers in the ordinary course of trade or business, rather than as a capital asset. Thus, timber which might have required a lifetime to bring to economic maturity was treated, for tax purposes, the same as a food crop planted in the spring and harvested in the fall, or inventory in a hardware store, or as other non-capital assets.

The tax laws at that time fostered a continuation of economically wasteful and counter-productive practices on private forest lands. Owners who wanted to practice sustained yield forestry faced such formidable penalties on investment of new capital in reforestation and management that most simply gave up and conformed to the dictates of a tax law that encouraged wholesale liquidation of timber assets. It was, in reality, a legacy of the pioneer days when timber didn't have to be managed because more could always be found over the next hill.

By the advent of World War II, due to a combination of many factors, including the tax burdens, millions of acres of prime timber land had been converted to marginal production of annual farm crops. Cut-over lands were forfeited for property tax payments because it was not economically feasible to invest large sums of capital in a new growing cycle. In every year during this period the annual timber harvest exceeded the new growth on remaining forest lands. By the 1940's the consensus of the experts was that the United States was headed for a timber famine, and the pace was being accelerated by the negative incentives in the existing Federal tax laws.

1944 ACT OF CONGRESS

In 1944, Congress eliminated this major disincentive to sustained yield private forestry. By extending capital gains treatment of timber transactions to sales of managed timber resources and to the transfer of timber assets for manufacture in a mill operated by the timber owner, Congress declared it to be in the national interest to stimulate capital reinvestment and improved management on the 70% of the nation's timber lands in private ownership. This brought an unprecedented response from timber land owners—large and small, individual and corporate—who were philosophically committed to the concepts of sustained yield forest practices but had heretofore been denied the economic opportunity to put such practices into effect.

Before 1944, the inventory of growing stock on private forest lands was declining by 7 billion cubic feet per year. Following enactment of timber capital gains, the trend began a reversal and by 1970—in spite of increased harvests—the nation's inventory of standing timber had actually increased by 175 billion cubic feet.

As the bill was being debated on the Senate floor, the late Senator Alben Barkley said it was "an act of justice to those who grow timber over a period of a generation, or half century, and who are entitled to just treatment no matter in what manner they dispose of the timber." The enactment of section 117(k) in the Revenue Act of 1944 placed an owner who cuts his timber or disposes of it under contract on the same basis, tax wise, as an owner who sells his timber outright. Both are doing the same thing in terms of disposing of a typical capital asset. And, in fact, transactions under the new provision of law were more likely to be in the public interest than were the liquidation sales which previously had been exclusively entitled to capital gains treatment.

Section 117(k) was later incorporated into the Internal Revenue Code of 1954 as sections 631(a) and 631(b).

Section 631(a) provides that a taxpayer who owns or has a contract to cut standing timber, and who—after complying with the holding period requirements—cuts such timber himself for sale or use in his trade or business, is entitled to capital gains treatment on the difference between the capital cost and the fair market value of the timber on the first day of the taxable year in which the timber is cut.

Section 631(b) affords capital gain or loss treatment in the case of timber disposed of by the owner under provisions of a cutting contract wherein the owner retains an ecoonmic interest (for example, if the owner designates which trees are to be cut and is paid by the thousand board feet as the timber is removed).

HOLDING PERIOD FOR TIMBER

To qualify for capital gains treatment under section 631(a), timber must have been held for a period of at least 6 months and 1 day prior to the first day of the tax year in which the timber is sold or harvested. For example, if a taxpayer on a calendar year buys timber on June 30 and harvests it on the following January 1, he is eligible for capital gain or loss treatment on the difference between the capitalized cost and the fair market value as of January 1st. However, if the same taxpayer were to buy the same timber on July 2, he would have to hold it until January of the next succeeding year (or 18 months) in order to qualify. Under section 631(b) the holding period is measured from the time of acquisition of the timber until it is disposed of. In effect, the simple 6 month rule applies.

CAPITAL GAINS RATES

Prior to the Revenue Act of 1969, the effective rate on long term capital gains of individuals was one-half of the ordinary income tax rate, or a maximum of 25%. For corporations the maximum rate was 25%—a 23% differential from the prevailing ordinary corporate income rate of 48%. This level of capital gain tax benefit had prevailed (with minor variations) throughout the 25 years that landowners had responded to the 1944 timber growing incentive. Yet, from the over 20 million acres planted to trees during the period, very little timber had yet been harvested by the time the 1969 Act was passed.

The 1969 Act raised the maximum rate from 25% to 35% on individuals and from 25% to 30% on corporations. In some instances the Act also made corporations and individuals on long term capital gains subject to additional assessments under the minimum tax provisions. By this action, Congress effectively cancelled a portion of the earned tax benefit for those timber growers who had invested large sums of capital and many years of effort and expense in the expectation that the differential between ordinary and capital gains tax rates would remain constant.

Since 1969, there have been repeated threats to further reduce or even eliminate the capital gains benefits. Clearly it would be undesirable if, as a result, the confidence of potential investors in reforestation and new forest development is shaken.

Various government and university studies have demonstrated that the capital gains treatment of timber income serves as only a partial offset to the very low rate of return to be expected from a long term investment in timber growing.

TIMBER DEPLETION

Timber is eligible for cost recovery as are all other capital assets. Since cost recovery for timber is not claimed for tax purposes until the timber has been harvested, it is referred to as "depletion" under the tax law even though it is merely the recovery of the capital investment attributable to each unit cut. Obviously, therefore, the cost deductions for timber bear no relationship to the "percentage depletion" applying to certain mineral income. In the case of percentage depletion, a flat percentage of gross income is deductible for as long as the property is operated, and the total deduction over the operating life can exceed the capital cost. Cost recovery (tax depletion) for timber is based on the amount of timber cut during a given tax year and its capitalized cost. If a taxpayer pays $10,000 for timber and cuts 10% of it in a year, he is entitled to a cost depletion deduction of $1,000. When all of the original timber has been removed he is not entitled to any further deduction (cost depletion) even though new growth may permit continued operation of the timber stand. Of course, if additional capital investments are made in the management of the new growth timber, then new increments are made to the capital account and will ultimately be deductible as the timber is cut to the extent of those capital investments.

EXPENSING OF FOREST MANAGEMENT COSTS

As with other assets, certain costs of maintaining forest property are deductible against current ordinary income. Such costs include property taxes, interest on loans, fire, disease, and pest control, and labor and equipment costs related to maintenance of the asset. Other costs, however, such as site preparation, planting, permanent structures, certain equipment and repairs, and similar costs resulting in permanent improvement of the timber asset must be capitalized, and their value is included in the capital account.

REFERENCE—"TAX TREATMENT OF TIMBER"

For additional information on the application to timber of various provisions of the Internal Revenue Code, IRS rulings, court cases, etc., readers are referred to "Tax Treatment of Timber" by Charles W. Briggs and William K. Condrell, published by the Forest Industries Committee on Timber Valuation and Taxation, 1250 Connecticut Avenue, N.W., Washington, D.C. 20036. The Committee also publishes the annual Timber Tax Journal with topical articles, proceedings, speeches and case studies on the tax treatment of timber.

The CHAIRMAN. Next we will call on Mr. C. M. Gatton, president, Bill Gatton Chevrolet-Cadillac, Inc.

STATEMENT OF C. M. GATTON, PRESIDENT, BILL GATTON CHEVROLET-CADILLAC, BRISTOL, TENN.

Mr. GATTON. Mr. Chairman, my name is C. M. Gatton. I am not here representing the automobile industry or my particular business. I am from Bristol, Tennessee.

I am here because I have seen a trend over the last 10 years where we seem to be going in the direction that will deny people in the future the opportunities which were available to me.

The three or four primary things I have covered in my prepared statement I know you will read. There are two major points that I would like to summarize briefly and then I would be happy to answer any questions that you might have.

LIMITATION ON NONBUSINESS INTEREST DEDUCTION

The first of these is the limitation on investment-interest-expense. Up until 1972, there was no limitation on how much interest a person could deduct. From 1969 through 1972, it was a preference item. Prior to 1969 any amount could be deducted.

But under the bill as passed by the House of Representatives, it cuts the limitation to a person's investment-income, plus $12,000.

Now, I started out after graduation from graduate school and $12,000 in debt working in a bank for six months, after that I borrowed $25,000 from my father and went into the automobile business, a Volkswagen agency. After about 4 years in the automobile business, I was about $350,000 in debt. I had borrowed $200,000 and went in with a group that purchased control of a bank. I borrowed $76,000 for the purchase of land, bought a home and there was no way that I could have deducted the interest on that if the proposed legislation had then been in effect.

Last year—for 1975—I will pay almost that much in Federal income tax—personal and Corporate. So I think the Government has gotten a pretty good dividend out of allowing me the opportunity to deduct the interest.

Furthermore, I think this provision is biased, very strong in favor of the superrich. To take a couple of names we all know, Senator Kennedy, or Nelson Rockefeller, if they wanted to borrow $6 million to buy a bank or start a new business, they would have no trouble deducting the interest because they have sufficient investment income to deduct the interest against, but for you or I this would be next to impossible because we don't have that kind of investment income.

A third reason I think it is bad: The velocity of interest rates have vascillated so substantially in the last 2 years.

Let's take the example of a man who has $30,000 a year in investment income. He would be in pretty good shape. He could borrow $600,000 to go into business, and with the $12,000 limitation, he could deduct it all. If the interest goes to 12 and a half—it was just recently on the prime rate—and his rate at the bank goes to 14 percent, he is paying $84,000 in interest and he can't deduct but $42,000 and the cash flow problem with this is obvious. It could bankrupt the man.

I am no expert on taxes. I am not a CPA, and I am not a tax lawyer, but I have a couple of courses in tax law in graduate school, as you mentioned you had, Senator Long.

MINIMUM TAX

On the item of capital gains as it was mentioned here earlier, it comes out to 70 percent of half the gain and as preference income—minimum tax section—under this new bill is 14 percent of the other half of the gain, making a total of 42 percent of the total gain. This is an increase over what the maximum tax was on capital gains in 1965, just 11 years ago, an increase from 25 percent to 42 percent or an increase of 68 percent in the total overall tax on capital gains.

Now, I don't object to the minimum tax as much. Being opposed to a minimum tax is like being opposed to motherhood, and I am not opposed to that, but I think the overall implication is obvious. You can't get people to invest when they must borrow the money, cannot deduct the interest, and must pay out 50 percent of their profits as they go along in State and Federal taxes, and if they ever sell out they have to pay an additional 42 cents out of every dollar of the retained earnings—of the other half—of the profit in capital gains and minimum tax. This just does not leave much incentive for anybody to go into business or make an investment.

I would like to read a couple of examples I have here. First: A man buys a tract of raw land 10 years ago for $100,000. He sells the land for $200,000 10 years later. Most people would agree, pretty smart. Assuming this man has other income which puts him in or near the maximum tax bracket, under the new tax law on preference income he would pay out $42,000 in capital gains, including the preference tax, leaving him a total of $58,000 profit plus the $100,000 he started out with. That is an average return after taxes of 5.8 percent a year, but we have had 71.2 percent inflation from January 1966 until January 1976. When you apply the inflation factor to it, he actually has $7,764 less in 1966 dollars than when he started. So, while the man looks pretty smart, he has not come out too well.

Another person, and this is an example of an outstanding business, one that is extremely profitable for its size, in the top 2 or 3 percent of the small independent business operators in the United States, but this person buys a business in 1966 for $325,000. He makes approximately $200,000 a year before taxes. After taxes, his taxes for State and Federal income taxes, not to say all of the other taxes he pays, will approximate 50 percent. In 10 years he will increase the net worth of that business from $325,000 to a $1,325,000. During that period he would have paid out $1 million in State and Federal income taxes. That sounds pretty good. But what he has left is inflated inventories, accounts receivables and so forth based on inflated prices. If he sold out under this new tax bill, out of the $1 million capital gain, he would pay $415,000 in capital gains taxes, and I am allowing the benefit for the maximum tax on the first $50,000. This would leave him $910,000. Again applying the inflation factor. The Consumer Price Index in January 1966 stood at 95.4, and this January it was 166.7, that is an increase of 71.3 per cent, and in 1966 dollars, which is what he put in the business, he would have left $531,000 or a profit of $206,000. In 10 years this would be $20,623 a year and that works out to 6.3 percent average return in 1966 dollars from what he started with. If you based it on a compounded figure, it would work back down to less than 5 percent.

Two hundred years ago the cry was the British are coming. Now, 200 years later, the cry is the British are just about gone and if you failed to see the CBS news report on Great Britain last week, I hope you will view it when you have a chance, because we are following perilously close in their footsteps. I am concerned. This investment expense limitation denies a person in the future the opportunity I had when I started. If I ever wanted to sell my business, at 42 percent, there is no way. I would be forced by such a confiscatory tax to sell the corporate assets, keep the corporate shell as a real estate or personal holding company and let it go through my estate and avoid the capital gains tax and preference tax altogether. I think either the capital gains should be eliminated from minimum tax or a step reduction should be permitted which I have outlined in my prepared statement—it is on page 11—to reduce the overall impact on capital gains. It is not the minimum tax, but the overall tax on capital gains—when roughly 50 percent of the profit has been paid out of the business in State and Federal taxes over the years to begin with—that bothers me and that I feel is wrong.

I will be happy to answer any questions.

The CHAIRMAN. I was in England for a short time this last year. I became acquainted with an Englishman who was about a third generation manufacturer. The tax situation there as well as the government socialism of industry has advanced to the point where

69-460 O - 76 - pt. 1 - 31

that young man wanted to explore with me the possibility of him leaving England and coming to the United States to see if he might make a success out of himself over here.

I must confess, the sort of thing you explained here makes clear what I advised him, that if he wants to go somewhere to achieve something by dint of hard work, he had better start looking in places like Canada, or Australia, rather than the United States. It is very, very difficult for a person with a lot of knowledge and zeal and desire to work to realize a gain as was glorified in those Horatio Alger stories I read when I was a boy.

Senator Curtis?

Senator CURTIS. I know Senator Bill Brock of this committee has a very high regard for you and on his behalf I want to thank you for this committee. It is my understanding he was in Tennessee over the weekend and did not get here for these hearings.

Where do you live in Tennessee?

Mr. GATTON. I am from Bristol. I started out in the Volkswagen business in Owensboro, near where I grew up on a farm. My two brothers farm and are in the cattle and country ham business in western Kentucky.

Senator CURTIS. I wouldn't take the time because we have several weeks of hearings to go over, but I want to assure you that I am very much in favor of the viewpoint that you expressed.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. I have no questions, but let me join Senator Curtis in saying how much I am impressed with your testimony.

The CHAIRMAN. You don't appear on behalf of an association, but I must say, Mr. Gatton, you are speaking for a great many Americans when you say what you say today.

Mr. GATTON. No one has paid my expense. I am concerned because I see the trend going in the direction of eliminating incentive. I don't think anyone would deny if the Federal Government placed a 100 percent income tax on business, the IRS would collect a lot less money and the point inbetween is where they will get the most. I think they have probably reached this point and are beyond it already. If you put enough tax on it would completely deny incentives. In fact, things will not fly when one can't borrow money and deduct the interest.

The CHAIRMAN. Mr. Gatton, if just a handful of the businessmen who have a situation similar to yours and who understand what you have explained here would meet with their Senators from their States, I think you would see this trend change. But there are just a few of us here on this committee who have an opportunity to become acquainted with the facts that you have explained here and altogether too many who hear the presentation overlook what happened to you as a result of inflation and various other Government burdens that have been heaped onto you by laws passed by Congress. I am afraid you are going to have more to contend with. I hope that those of you who appear understand that you and others will have to speak to the other Senators who are not on this committee.

Mr. GATTON. Thank you very much.

[The prepared statement of Mr. Gatton follows:]

PREPARED STATEMENT OF C. M. GATTON, INDEPENDENT BUSINESSMAN, BRISTOL, TENN.[1]

SUMMARY

Limitations on the Deductions of Non-business Interest (Section 206 of the bill, section 163D of the code).

Implementation of this provision, as passed in the Tax Reform Act of 1975 by the U. S. House of Representatives will impede and prevent investment, eliminate the creation of jobs derived from this investment and materially curtail economic expansion. Furthermore, it is biased in favor of the Super Rich. Rather than reduce to $12,000, the current $25,000 limitation should be eliminated or at the very least, increased substantially.

Changes in the Minimum Tax for Individuals as Said Minimum Tax Pertains to Capital Gains (Section 301 of the bill, section 55-58 of the code).

My opposition to the provisions of this section is limited to the consideration of long term capital gains as a preference item. The implementation of this provision increases the maximum tax on long term capital gains to 42% (70% of one half the gain plus 14% of the other half). This is a rather severe tax since in most cases it is double taxation, i.e., the profits of a business are taxed at the corporate level and again when the stock in the business is sold at the capital gains level. The inequity of such a high capital gains tax is further magnified due to the impact of inflation when the asset is held for a period of 10–25 years.

Treatment of Prepaid Interest (Section 205 of the bill, section 461G of the code).

Under present tax law, a taxpayer may prepay up to twelve months interest provided that said prepayment does not materially distort his income. Under the tax bill passed by the 1975 House of Representatives, the cash basis taxpayer (as most individuals are) may not deduct one penny of prepaid interest. This is a harsh mandatory regulation which does not allow a taxpayer the slightest freedom or flexibility.

Dividends from an Electing Sub S Corporation—are they Investment Income? Usable to Offset Investment Interest Expense?

The present limitations on investment interest expense were passed in 1971 and became effective for 1972. The regulations for this area were to be written by the IRS. Over four years have passed and we still have no regulations covering this point. How can a business man operate in such confusion? In this light I noticed that several provisions of the Tax Reform Act of 1975 are retroactive to dates in the late summer and fall of 1975. Such retroactive dates on tax legislation are grossly unfair since most certified public accountants are not even aware of the changes and these who are aware, do not know how to advise their clients as the bill is not final.

The summary of the aforementioned provisions and the further analysis of those provisions which follow is not my sole reason for being here today. The trend in Congress over the last five to ten years if allowed to continue, seems destined to curtail individual initiative and to substantially eliminate the incentive to invest. The results of such a trend cannot help but prevent full employment and generally discourage economic activity, in the short run, and ultimately destroy our free enterprise system.

In concluding my summary remarks, I encourage you to consider the following actions:

(1) Elimination of the section on Interest Investment Expense. (Section 206 of the bill and section 163D of the code) and instead of reducing the interest investment expense deduction from $25,000 to $12,000 that you introduce an amendment to eliminate the limitation altogether or to substantially increase the limitation.

(2) Eliminate capital gains as an item of preference income under the section on the minimum tax or leave the minimum tax as proposed and pass legislation to have a stepped reduction of maximum capital gains tax rates as follows:

[1] (Appearing Not As A Representative Of Any Organized Group But On Behalf Of The Millions Of Independent Businessmen, Business Ladies, Farmers and Investors)

LONG-TERM CAPITAL GAINS

[Percent]

Investments held	Maximum tax	Minimum tax[1]	Total maximum tax
Years:			
1 to 5	35	7	42
5 to 10	25	7	32
10 to 15	20	7	27
15 to 20	15	7	22
Over 20	10	7	17

[1] 14 percent of one-half the gain.

(3) Elimination of the section on prepaid interest (Section 205 of the bill and section 461G of the code)

(4) Introduce legislation to permit dividends from Electing Sub S Corporation to be used as an offset to investment interest expense.

Mr. Chairman, Distinguished Members of the Committee, Ladies and Gentlemen:

My name is C. M. Gatton. While I am a member of numerous groups I am not here as a representative of any group but I should like to think that I represent the view of the majority of relatively small independent business men, business ladies, farmers and investors.

I am most appreciative of the opportunity to present information and ideas on a few aspects of the Tax Reform Act of 1975. The points I wish to discuss are as follows:

I. Limitations on Interest Investment Expense

(Section 206 of the bill, section 163D of the code)

Background.—Prior to 1972, there was no limitation on the deduction of investment interest expense. Excess investment interest expense prior to 1972 was considered an item of preference income. Currently, (1972 through 1975), investment interest expense is deductible up to the taxpayer's net investment income plus an exemption of $25,000. A taxpayer's investment income is defined as his income from interest, dividends, rents (net leases only apply) and royalties, his net short term capital gain from his disposition of investment property and the ordinary income recapture of depreciation. The 1975 tax bill passed by the House of Representatives reduces the exemption from $25,000 plus the taxpayer's investment income to a mere $12,000 plus investment income per year. The House passed bill also has certain other provisions that further limit what a taxpayer may consider as investment income when compared to the present tax law on this subject.

Explanation.—With the inflation of recent years and the very high interest rates of the immediate past, the $25,000 deduction should not be reduced to $12,000 but should be increased to $50,000 or even $100,000 or eliminated altogether. It is just this type of action by our people in Washington that has created most of the economic problems in our economy. A man with limited or no investment income with today's high interest rates is severely limited in making an investment. Certainly he would not make an investment where he could not deduct the interest. With such a serious cramp on individual investors, you can never expect full employment in the private sector nor anything resembling the economic growth of the past thirty years in the future of America.

If a taxpayer could deduct the interest, he might make an investment that would surely create jobs and generate other economic activity. If he cannot deduct the interest, he certainly could not make such an investment. If a taxpayer deducted $50,000 in interest, the bank or other financial institution which was the final recipient of this payment would pay tax thereon. The taxpayer could not even buy a cup of coffee with his $50,000 interest check, so why should he not be able to deduct it. All this provision does is prevent investment, eliminate the creation of jobs derived from this investment and materially curtail economic expansion.

If I may, I should like to use my own situation of a few years ago to illustrate this point. In 1958 upon receiving a degree in Finance and Banking at the Wharton Graduate School, University of Pennsylvania, I was some $12,000 in debt. Upon graduation, I accepted a job in a bank in Lexington, Kentucky. After six months in the bank, I borrowed $25,000 and opened a Volkswagen agency in Owensboro, Kentucky. Within four years I had become a member of a group that purchased control of a bank (my part was $200,000 and I borrowed the entire amount) and had purchased twenty acres of land for $76,000 at the edge of Owensboro, Kentucky. At this point, I was approximately $350,000 in debt. If the investment interest expense limitation had been in effect at this time so as to prevent me from deducting the interest, I could not have afforded to take the risk. The profit I made on the sale of the land and the bank stock combined with my profits in the Volkswagen agency permitted me to acquire a Chevrolet-Cadillac agency in Bristol, Tennessee in 1967. The personal and corporate income taxes that I have paid since 1967 have been substantial and would not have been possible if I could not have deducted the interest in the 1963–1966 period. Thus with the limitations of this provision, young businessmen in the future will be denied the opportunities which were available to me.

Furthermore, I consider the provisions of this section highly biased in favor of the *Super Rich.* To take a couple of names we are all familiar with, The Honorable Senator Edward Kennedy or Vice President Nelson Rockefeller could make an investment of let's say six million dollars to buy a bank or start a new business, borrow all the money and write off the interest expense against their other investment income. Even if I could borrow such a sum of money, I could not deduct but a very small portion of the interest expense because of my comparatively small investment income.

II. Tax on Preference Income

(Section 301 of the bill and section's 55–58 of the code)

Background.—Preference income was first defined and a minimum tax placed thereon with tax years after 1969. What are tax preferences?

(a) Capital Gains—one half of capital gains are taxed at regular tax rates. The other half is considered preference income.

(3) Accelerated Depreciation—the excess of accelerated depreciation over straight line depreciation is preference income.

(c) Depletion.[1]

(d) Fast Amortization.[1]

(e) Stock Options.[1]

(f) Financial Institutions Bad Debt Deductions.[1]

Since 1970, the tax on preference income has been a flat 10% of preference income which exceeded the following:

1. $30,000 ($15,000 if married, filing separate returns).
2. Plus regular tax for the year.
3. Carryover feature for up to seven years of unused portion in any year of the above beginning with 1970. (see paragraph 1131, Prentice Hall, 1976 Federal Tax Course).

Explanation.—The principle item of so called preference income is capital gains so I am going to limit my discussions to this one area. For many years the tax on capital gains had been to tax one half the gain at ordinary tax rates with no tax on the other half, or to use the alternative tax which limited the tax to a maximum of 25% of the gain. Commencing in approximately 1965 a phasing in process was started to limit the alternative tax to the first $50,000 of capital gain with the balance at regular tax rates where the taxpayer was in regular tax rates exceeding 50%. This process of phasing in was completed about 1970. Therefore, our current tax on capital gain is as follows:

One-half the gain is taxed at ordinary rates. However, the taxpayer may elect the alternative tax of 25% of the first $50,000. (The alternative tax may not be used if income averaging is used.) The other one-half of the gain is subject to the preference tax as outlined above regardless of whether the alternative tax method is used.

Now according to an article in the Wall Street Journal, Friday, December 5, 1975, page 23, the House has passed a bill which raises the preference tax

[1] For more detailed explanation, see paragraph 1132, *Prentice Hall,* 1976 Federal Tax Course.

to 14%, and far worse than the tax raise itself, substantially eliminates all the deductions.

1. A man starts with limited assets, forms a corporation, works for twenty years or longer to build a business. During this period he substantially increases his employment and inventories, pays Federal and State income taxes of approximately 50% of earnings (plus numerous other taxes such as but not limited to property tax, gross receipts tax, sales tax, social security tax on payroll, unemployment, excise, etc., etc.) and is otherwise a good individual and corporate citizen.

After twenty years, this man decides to sell the business to someone younger. Under the 1975 House passed tax bill, the majority of his capital gain would be taxed at an effective rate of 35% (70% of half the gain) plus an effective preference tax of 7% (14% of half the gain) or a combined tax of 42%. This after having paid over half the profit in corporate income taxes (not to mention the other taxes) is capricious, confiscatory, and grossly unfair.

It is also rather doubtful that a younger man could be fuond to buy such a business. Who would want the headaches and red tape of owning a business when 50% of the profit is paid out in current taxes and another 42% of the accumulated earnings paid in tax when the business is sold. This leaves only 29¢ out of each $1.00 profit.[2] Another way of looking at it is if the business earned ten, twenty or thirty percent return on investment before tax—the final after tax return on capital would be 2.9%, 5.8% and 8.7%. When capital cannot earn a fair rate of return net of tax then who will provide the capital for the relatively small, independent businesses[3] in America's future?

Furthermore, a younger person wishing to buy such a business would probably need to borrow 50–75 percent of the purchase price, and he would find that he could not even deduct most of the interest (see section I, Investment Interest).

How could any enterprising young man have the incentive to bet his all on his ability when the odds are rapidly becoming so stacked against him? Say he has $200,000 and wants to buy an $800,000 or $1,000,000 business, there is no way it will fly if he cannot deduct the interest, nor could he have any incentive with the preference tax on top of the corporate income tax and personal capital gains tax.

2. A man buys a tract of raw land ten years ago close to your home town for $100,000. Now, he sells the land for $200,000. Most people would agree, pretty smart. Assuming this man has other income which puts him in or near the maximum tax bracket and under the new tax on preference income as passed by the House, it works out like this:

Capital gain	$100,000
Capital gain tax	(35,000)
Do	(7,000)
Preference tax	42,000
Profit after tax	58,000

Thus, the man made $58,000 over ten years or $5,800 per year or a return of 5.8% per year or less than the rate of inflation. He ended up with less buying power than he had ten years ago. The Bureau of Labor Statistics Consumer Price Index stood at 95.4 in January, 1966. As of January, 1976 it had increased to 166.7 so the man's $158,000 was worth $92,236 in 1966 dollars or his buying power had actually decreased by $7,764. And, of course, I doubt seriously that the average piece of raw land around your home town has doubled in current dollars in the last ten years. Sure some have perhaps even tripled, but most have not doubled in value in current dollars.

3. A person buys a business in 1966 for $325,000. The business averages profit before tax of $200,000 per year and pays one-half of the profit in state and federal income tax. Now, ten years later, the business has a net worth in current 1976 dollars of $1,325,000. Sounds pretty good doesn't it? However, the taxes were paid out in cash and the net worth of the business is tied up in inflated inventories and receivables. Furthermore, if the man sold the business under the

[2] Carry this one step further and assume Federal estate taxes and State inheritance tax of 35% to 50% and you have left 14¢ to 19¢ out of each dollar profit.

[3] Definition of a relatively small business: one with profit before tax of $100,000 to $500,000 and net worth of $500,000 to $3,000,000.

Tax Reform bill of 1975, he would pay $415,000 in capital gains tax leaving $910,000. The Consumer Price Index stood at 95.4 in January, 1966 vs. 166.7 in January, 1976. Therefore, the January, 1976 index is 171.8 of the January, 1966 index. The man invested 1966 dollars and when you convert his 1976 net sale price of $910,000 to 1966 dollars he has $531,231 or a profit over ten years in 1966 dollars of $206,231. This comes out to an average profit per year of $20,623 and an average return on his 1966 investment of 6.3%. And this example is based on a highly successful business with a high rate of profitability.

In conclusion, unless you want to eliminate all incentive for people to invest, to struggle with the headaches of business and the market place, to take risks for some reward of gain, then the preference tax should not be changed. In fact, the gain on assets held for over ten years should be excluded from the preference tax altogether. The capital gains tax and inflation are sufficient taxes on gains when assets are held for ten years or longer.

Furthermore, elimination of the preference tax on assets held for over ten years would be less of a discouragement for people to sell such assets where substantial gain may be possible. If the total tax take becomes to rigorous, they of course, just refuse to sell, leave the asset in their estate and totally bypass the capital gain and preference tax. The revenue loss from elimination of preference tax on gain on assets held ten years or longer would be negligible.

Consider the full implication of a taxpayer buying a business for $800,000. An investment of this six would be a long range deal for most individuals. If he does well, he pays roughly 50% of the profit in State and Federal income tax. Several years later he sells out and pays 42% in Federal Capital gains and preference tax (assuming passage of the 1975 House bill). If he is not successful with the investment, either the business goes bankrupt or he sells out at a loss, he can only deduct $1,000 of ordinary income against $2,000 of the loss per year. (This is to be liberalized slightly under the 1975 House bill, see section 1401 of the bill and section 1211 of the code). Now, without question, the gambling houses in Las Vegas would like to have the governments odds on this deal. Of course, they (the gambling houses) are too smart to take such an unfair advantage because they know they would lose all their players. If the sections on preference income and investment interest expense are passed as outlined th 1975 tax bill (already passed by the House), you will eliminate the players in the future. Sure, it won't happen over night, but it is as sure to happen as two plus two makes four.

I would not be opposed, in fact would even favor retaining long term capital gains as preference income under this minimum tax section provided that tax legislation is passed that would provide for a stepped reduction in the maximum capital gains tax rate based on the length of the period the investment was held. Such a stepped reduction of maximum capital gains tax rates would encourage long term investment in smaller enterprises rather than hit and run speculation. It would make "quick-kill" speculation less attractive and would encourage the kind of long term investment that is so badly needed. At present, the capital gains system is an incentive for turn over of capital, not steady infusion. Long term growth, obviously, is more likely to occur when a business has stability and can operate without the fear that large chunks of capital can be quickly withdrawn. Such a stepped reduction in maximum capital gains rates would also serve to offset some of the impact of inflation. My recommendations for the maximum tax rates on a stepped reduction basis are as shown in the following table:

LONG TERM CAPITAL GAINS

[In percent]

Investments held	Maximum tax	Minimum tax[1]	Total maximum tax
Years:			
1 to 5	35	7	42
5 to 10	25	7	32
10 to 15	20	7	27
15 to 20	15	7	22
Over 20	10	7	17

[1] 14 percent of one-half the gain.

III. Treatment of Prepaid Interest

(Section 205 of the bill, section 461G of the code)

Under present tax law, a taxpayer may prepay up to twelve months interest provided that said prepayment does not materially distort his income. Under the tax bill passed by the 1975 House of Representatives, the cash basis taxpayer (as most individuals are) may not deduct one penny of prepaid interest. This is a harsh mandatory regulation which does not allow a taxpayer the slightest freedom or flexibility.

In most of the past ten years, I have found it possible to prepay small amounts of interest and almost without exception, I have paid more interest because I was in a higher tax bracket in the following year. I think this would generally be the case with most people as they progress through life due to inflation and becoming more productive as they grow older. Nevertheless, I would still like the opportunity to have the freedom to make my own mistakes.

IV. Dividends from an Electing Sub S Corporation—are They Investment Income? Usable to Offset Investment Interest Expense?

Just such a question as posed in the above title was asked recently by me of three CPA firms and one highly qualified tax lawyer. None of the CPA firms nor the highly qualified tax lawyer would give me an answer without doing some research. After their research, two of the CPA firms and the tax lawyer were in agreement and advised me that while regulations were not out on this precise point, (even though the interest limitation was passed by the 1971 tax bill and went into effect in 1972), they felt that Sub S dividends would qualify as an offset to interest investment expense. They based their conclusions on the definition of dividends as outlined in the tax code and on their research of the 1971 tax bill on interest investment expense. The third CPA firm disagreed, likewise, advising me that the regulations had not been written at this point by the IRS and that they felt, based on their analysis of the tax law and preference income, that the odds were less than 50–50 that when the regulations are published by the IRS that they would allow Sub S dividends to offset interest investment expense. Therefore, I asked the tax lawyer to contact the people in the Regulations Section of the IRS in Washington and see if he could get any idea as to what the IRS regulations might contain when they are published (its only been four years since this tax law was passed and no regulations yet). He came back to me and informed me that the probability is very strong that Sub S dividends will not be allowed as an offset to investment interest expense, except that investment income would probably flow through the individual. Why should Sub Chapter S dividends not be considered Investment Income the same as any other dividend, interest on a note or bond, or net rent on real estate? They sure don't qualify as salary!

Mr. Chairman and members of the Committee, I would like to thank you for the opportunity given me to express my views on these subjects.

The CHAIRMAN. Next, we will call Mr. Arthur Phelan, Jr., Chairman of the Board, Government Services Savings and Loan, Inc.

STATEMENT OF ARTHUR J. PHELAN, JR., CHAIRMAN OF THE BOARD, GOVERNMENT SERVICES SAVINGS & LOAN, INC.

LIMITATION ON NONBUSINESS INTEREST DEDUCTION

Mr. PHELAN. Mr. Chairman, my name is Arthur J. Phelan, Jr. I am chairman of the board and chief executive officer of Government Services Savings & Loan, Inc., in Bethesda, Maryland. I am testifying this morning in opposition to section 206 of H.R. 10612. Although a savings and loan such as Government Services will be affected adversely by passage of such a measure in its current form, my major purpose is to point out that a major segment of our country's private investors, small businessmen, entrepreneurs and individual landowners will be tremendously impacted by this provision. I believe most of these people have not even been made aware of this provision. They are generally not represented by trade associations or lobbying groups. Because this change has not been publicized, they have no opportunity to make their views known. I thank you very much for the opportunity to testify on section 206. I would request that my entire longer written statement be made a part of the record.

This bill (a) Will damage small banks and other small businesses while increasing concentration and borrowing power of large national companies. It will damage the hard-working middle and upper-middle class investor, while having little impact on the already wealthy professional investor.

(b) It will not produce the revenues expected, but rather will cause a slowdown in economic activity in many industries including housing. Many segments of the housing industry will atrophy as investors reduce or eliminate their commitments.

(c) It will substantially reduce funds available for starting small private companies which need to retain their capital. Any company which cannot show immediate profits will be shunned by investors. Technology companies will suffer extremely.

(d) It will cause a massive forced sale of perhaps billions of dollars of low yielding assets now held with short term borrowed funds. Investors will continue to expect traditional rates of returns. If their costs are increased they will move to exploitation opportunities where they can recover these costs more quickly from subsequent users.

(e) It will have an inflationary impact. As carrying costs are increased, they will be passed through to home buyers and consumers. Investors will continue to expect traditional rates of return. If their costs are increased they will move to exploitation opportunities where they can recover these costs more quickly from subsequent users.

The major assumption in this section is that $12,000 is a lot of interest to deduct. Let us recognize that, in all tax laws, once a fixed figure like this number is legislated it tends to have a very long life because it becomes very difficult for Congress to raise the level of an exclusion to reflect inflation.

The Government's unceasing need for more income has prevented the indexation of many fixed dollar figures in tax law. For example, at one time the $3,000 annual exclusion for gift tax was a considerable sum. Today it is 6 weeks' work for a New York City policeman. Since the government is in position to control the inflation rate, any such fixed figure really builds in tax rate increases without legislation.

Let us examine the $12,000 for this year. The average man who is capable of even a moderate-sized house in suburban Fairfax County will ned a $70,000 mortgage. At today's rates this will cost him $6,300 per year in interest. If he borrowed for his down payment or household improvements this might add another $1,000 in interest. His car loan could add another $700. Thus, we see he is up to $8,000 of interest deductions before he has spent anything on investments with borrowed money.

In very high cost areas, such as Alaska or Hawaii, a modest townhouse currently sells for about $120,000. Presuming a purchaser finances $100,000 at the current 9.5-percent interest, his total interest cost on his house alone will be almost $10,000. This would leave him only $2,000 to $2,500 to deduct for investment interest not offset by income.

Assume, for example, a $4,000 residual for investment. If our man borrows at a typical 10-percent rate, he will be limited to a $40,000 total investment in assets which do not pay current income. Any investment he makes yielding less than 10 percent will require him to personally pay interest as part of the carrying cost. In addition, as the cost of housing rises, and when interest rates rise, the amount available for such other investments will necessarily decrease.

I am sure the committee is aware that there are very few small retain investments available in the country which yield 10 percent. Land virtually never does. Stock in small, fledgling, entrepreneurial companies does not and should not. Indeed, any entrepreneurial company in its early years is unable to pay dividends at such a high rate without damaging the business.

I strongly urge the committees to ask themselves how many hundreds of millions of dollars of venture capital in this country would dry up if all investors were limited to $40,000 units. The entrepreneur class in any society is not large. However, it is precisely this class of investors which create new jobs and new products and new industries, and have done so over the history of this country.

There is a philosophy prevalent in our land that growth is undesirable and that the United States has all of the products and real estate development that it needs, and that the solution to all of our problems is to stop building. These attitudes are deeply embodied in this bill, but they are not consistent with reality in the day-to-day world, where capital will always tend to move to the wealthiest people. By this section the people who are the small-time, leveraged investors will be decimated while the large investors of the Rockefeller and Whitney class will not be affected because of their vast wealth and the networks of corporations which they are able to fund.

The incredible diversity and broadening of wealth in this country since World War II came about because of the commitments of hundreds of thousands of attorneys, accountants and proprietary businessmen who have had a strong urge to make an extra $100,000 to $200,000 through speculative investments. These are the unnoted heroes of American capitalism. They are not known beyond a small circle in their community. In many cases they have helped to improve community standards by providing new jobs, new industries, new buildings, and a sense of growth and progress. Many members of this committee may know some of them only as successful supporters.

Certainly, very few of their peers and elected representatives will be familiar with the details of their personal financial transactions. However, it is the aggregate efforts of these hundreds of thousands of people who have helped spread the wealth in this country beyond Wall Street and the big corporations which have so many natural advantages. Many times they were taking substantial financial risks and losses, often losing all of their personal funds and digging into their pockets to pay back bank loans as well.

From the point of view of draftsmanship, fairness and enforceability I think it is important to note the following inadequacies of this provision as presently drafted:

(A) For a provision with such far-reaching impact, I feel many questions in this section are left unanswered or for the IRS to come up with its usual convoluted answers. The House Ways and Means Committee Report does not deal specifically enough with the intent of the section. The definitions contained in section 206 do not give enough detail to enable anyone to even assess the impact on his personal investment portfolio.

For example, the term "business interest" is defined as "interest on indebtedness to purchase or carry a trade or business property held for use in a trade or business." Who will determine what is to be considered allowable in this category? What guidelines have been drafted which will give guidance to investors as to whether their interest is considered business interest, or personal or investment interest? Is one limited on interest on money borrowed to purchase stock in a company where an individual is employed? If so, what guidelines will rule the extent to which an individual has to be directly involved in working for a company before he is allowed this type of deduction? Will a man who borrows $200,000 to purchase 100 percent of the stock of a small company for which he works be treated the same as a man who works for General Motors and borrows $200,000 to purchase stock in that company?

Will a man who owns major blocks of stock in several unrelated companies, and serves as an active officer or director of all of them, be required to declare only one as his principal trade or business and not take any deductions on indebtedness incurred for investments in the other companies? Suppose the same man divested himself of interests in companies in unrelated industries and reinvested the same money in companies which were all in the same industry, would he then be permitted to treat all interest as business interest? If this is so, then the section is a clear incentive to conglomeration and concentration of assets.

These are only a few of the questions which will arise as a result of the vague definitions in this section. If a provision of this type is to be passed, I think you can see that these types of questions should be anticipated and clear guidelines established prior to its enactment.

(B) In addition to the problems relating directly to the lack of sufficiently clear definitions, there are no procedural guidelines for handling the many inequities which will exist if the section is passed as is. For example, in financing the purchase of stock or the buyout of a company, lenders will frequently use a series of short-term notes rather than locking themselves into a long-term commitment.

It is often understood between the borrower and his lender that the notes, which may be due every 90 days, or on demand, will ordinarily be renewed at the end of each period or continued indefinitely. However, the way this provision is written any person who previously used such financing, but had not obtained a longer term written commitment before September 11, 1975, will appear unable to take his deductions once this section is enacted. Equally affected would be an investor who had planned to curtail short-term borrowing by refinancing his property with long-term mortgages, even though his debt level did not rise after September 11. Thus, he became an unwitting victim of the high interest rate policies of the last 3 years. There are many other examples which could be cited where such inequities have not been dealt with in either the bill or the committee report.

(C) If section 206 is enacted, I think the committee should understand that it will cause a vast restructuring of many personal investment portfolios. Many investors will undoubtedly have to sell out some or all of their assets, and they should be given an adequate amount of time to do so. They must totally revise a portfolio which was designed under laws which held it perfectly acceptable to deduct interest. This will take time and research in order to avoid mistakes, particularly since most such investors are not even now aware of this section, and there are many unanswered questions as to its intent.

If people are going to be forced to shrink the size of their portfolios to take into account the overnight doubling of carrying costs, they must be given adequate time. The country must avoid the dumping of huge amounts of illiquid assets on the market at one time. Nowhere in the House Committee Report is this problem addressed. Nowhere is there any concept of who would use after tax dollars to buy these low yielding assets without substantial losses to the sellers.

To illustrate the impact which this section might have on an individual investor let us examine a specific case. Imagine a man whose mortgage and other personal interest comes to $12,000. He also has borrowed $200,000 at 10 percent to invest in a land development project from which he can expect no return for the current year. His total deduction for this year would be limited to $12,000, or less than half of the $32,000 he would now be permitted. Or if he had invested the same $200,000 in a new company paying dividends of 2 percent on his total investment, his after tax cost would be increased by almost $16,000 or 50 percent. How many active investors are ready for such a shock?

In addition, this section will be detrimental to elderly people who own farms or other large tracts of undeveloped land, and to the small building companies that need this land.

The current tax laws are so structured as to encourage the purchase of land through deferred purchase money mortgages. Under the almost universal method by which land is transferred from the agricultural user to the investor intermediary, a down payment of 29 percent is the maximum cash paid. This number arises directly from provision of the IRS code. Thereafter, installments are characteristically made for 5 to 10 years. This has the effect of giving the seller a spreading of his income and makes it possible for the investor to afford more of a commitment than an all-cash purchase.

Naturally this debt will carry an interest charge. Under the provisions of this section, the effective cost of this interest would, for most investors, be doubled over a 5- to 10-year period. The inescapable conclusion is that investors will have to reduce the size of their commitment by the difference.

The Treasury may believe that people will simply pay taxes on their income and then pay the same amount for land as they would have before, but this will not happen. The difference in dollars will not shift from the investor to the Treasury, but rather will shift from the seller to the Treasury. In many cases the sellers will be older people, retired farmers, legatees of old inheritances, and others who would suffer greater consequences from the transaction than the new investor. When people are old and must sell their assets to prepare for their declining years, this type of real estate transaction is far less voluntary than it is for the investor class. The purchaser of land is free to buy or not buy as he sees fit. In many cases the seller is not so free.

And, further, if the investor receives more for his land at resale, it should be borne in mind that the Treasury will recover higher taxes. Concurrently, if the original seller receives less, the Treasury will recover less in taxes. In effect, I am saying that there will be no net gain in revenue for the Treasury and a net loss to the people whose assets are depreciated.

A good example of tax legislation which was expected to produce revenues, but in practice only reduced investments and had a major negative impact on the economy, is the bill which limited the investment tax credit.

To illustrate that revenues will not be affected and that land values and housing will be adversely affected, let me present an example from my own experience as a lender. The creation of subdivision housing from large tracts of land begins many years in advance with the formation of a syndicate of investors to purchase the land. These investors may be lawyers, accountants, business executives or others, who are not directly involved in the building or development business. In many cases, these investors may borrow the money which they invest in the land purchase. They will, of course, have to pay interest on the borrowed money, but cannot expect any return from their investment until the land is sold. Often the investors maintain their investment until the houses are built, which could be sevral years, and only receive a significant return once the individual houses are completed and sold, provided the builder does not suffer bankruptcy first. This type of syndicated investment warehouses the land and frees up the capital of the builder/developer who actually constructs a project.

It also aids the bank or savings and loan which provides the construction funds, because there is extra working capital in the project which the builder does not have to pay cash interest on. In this case, there are other investors with an interest in the project, so that in the event of problems the lender does not have to bear the entire burden. However, the syndicate investors have to be provided with an incentive to make this type of investment, which is sometimes lucrative, but which is also very risky.

Interest deductions have traditionally been a major incentive, along with the profits to be gained from the successful and timely completion of such a project. If the individual investor's carrying costs are doubled, as suggested under this bill, either this type of supplementary financing, which is very necessary to relatively small, and often undercapitalized builders, will disappear, or the extra cost will necessarily be passed through to those who ultimately purchase the finished houses.

Therefore, one of the long-reaching effects of this provision could be that many small builders, who in many cases produce quality houses but do not have available the large amounts of capital of nationally rated firms will be forced to reduce their business. Even if such builders could find adequate direct financing to build, the carrying costs would in many cases still put them out of business. You all know that high interest costs are a major reason why so many small building firms have gone out of business in recent years, and are also a major contributor to the ever-increasing costs of new homes.

Both of these problems, which affect the whole nature of our national housing market, would be exacerbated by this provision, and the net result would probably be that many small building companies would fold, and the job of providing housing would fall increasingly to a few major national companies who are so large that they already have natural advantages.

This bill represents such a fundamental restructuring of the theory of risk investment in the United States that it is far too important to be included as a minor matter in a 661-page tax reform bill. Such a major change in the theory of entrepreneurship deserves public attention of its own, with widespread notice to taxpayers who will be affected. This is particularly necessary, since they do not now have a trade association to speak for them. I strongly urge the committee to require the Treasury to send a notice of this proposal to every taxpayer deducting more than $12,000 of interest, warning them of their intentions so that Congress can be adequately informed of the inequities that would occur.

The CHAIRMAN. Thank you very much for your statement, Mr. Phelan.

When the Treasury estimated the revenue gain from this provision, did the Treasury contact people in your industry to seek their advice on these various and sundry things that would happen as you have indicated here?

Mr. PHELAN. I have not heard of that from the U.S. Savings and Loan League, but I find incredible in the House report the suggestion of $31 million with a rising rate to $310 million. In our company alone, which is only one of 5,000-some savings and loans, I would guess the builder customers we have and the investment syndicates that support in vacuum probably themselves are taking deductions of half a million dollars. So, out of one little center of operation, the amount of interest deduction is 1½ percent of what they are claiming they can recover.

I think the numbers are not only inaccurate, but reversed.

The CHAIRMAN. I wish your people would make an effort in the brief time remaining to us to make a survey enough at least to give you a sample of what you think people would do if this were the case. I have seen so many of these things done that fail to take into account the logical consequence of what people are suggesting.

For example, you heard me tell my pet story of an actual case of this workingman, single, who works up until he gets into a demoralizing tax bracket and at that point he quits, gets himself laid off, draws unemployment insurance money and he goes fishing. He will do some useful work around the house which the tax collector has not found a way to tax just yet and he will enjoy himself around the local taverns and simply lead the leisure life until the next tax year.

When one says that tax on earned income ought to be increased from 50–70 percent, all they want to do is make sure that fellow lays off perhaps a month earlier and starts drawing his unemployment insurance money a little sooner.

Revenue estimates just don't take into account the counterproductive things that result from a proposal. We find all sorts of bad laws. I don't have the slightest doubt when we repealed the investment tax credit we cost the Government about $3 billion that year or maybe more, not to mention what we did to the economy by the uncertainty of businessmen not knowing whether they do get the investment tax credit or don't get it.

I would believe if this matter is studied and they take into account the things that should be considered, they would have to estimate that the Government would lose money from it.

Mr. PHELAN. I think there is a danger here in that this provision treats paying interest the same way the IRS views expenses, lunches, and racehorse racing. It is treated as if it is fun to pay interest. I think anyone who has high interst rates does not enjoy paying large amounts of interest. It is wrong to say that it is so much fun to do it, and there is so much assured reward. One of the major weaknesses is the assumption that somehow everybody who borrows money and deducts interest will have a capital gain. Many people in land speculation have lost a hell of a lot of money and wound up paying back not only the interest but the principal.

If you buy land and you have a loss, you still have to pay back the bank.

The CHAIRMAN. As the previous witness pointed out, if you look at the capital you started out with and the way it appreciates, compared to the cost of living, it is very unfair to suggest that that man has made money, especially when the interest did little more to offset the depreciation in the valuation of his capital—if it did that much.

Mr. PHELAN. When people were paying 12 percent interest a few years ago, they certainly were not assured an increase in the value of their assets. In many cases, their assets went down substantially.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. I don't have any questions, but I am impressed by your testimony and as has been suggested by our Chairman, if you could gather illustrations and points that you make and supporting data, that should be very helpful.

Mr. PHELAN. One thing I think the Committee should think about, in talking with most businessmen, they assume many wise people up here know practically everything there is to know and can't find it easy to believe that something that makes so little sense to them could go through.

They tend to be reluctant to write and bother their representatives with what appears to be a personal grievance. Under the system we have for trade representation, trade associations, people tend to believe that the real laws should be stopped at the pass. But with wideranging legislation, it is difficult to get people to believe they can do anything. Each man says, "I am one guy. What the hell, they are not going to listen to me," and there is a reluctance to set it down except to write some general thing about the Constitution, Americanism and that sort of thing.

That makes it difficult for you to really get the cross-section of problems that are raised, but I will pass that message on.

The CHAIRMAN. Thank you very much for the fine presentation you have made here.

We will resume hearing at 10:00 o'clock tomorrow morning.

[Whereupon, at 12:15 p.m. the hearing was adjourned, to reconvene at 10:00 a.m., Tuesday, March 23, 1976.]

O