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

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TAX REFORM ACT OF 1975

TUESDAY, MARCH 23, 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, Byrd, Jr., of Virginia, Curtis, Fannin, Dole, and Packwood.

The CHAIRMAN. I want to thank yesterday's witnesses for a very fine presentation. I had occasion to carefully study some of the statements last night, and I think some of the statements made by the ranching and cattle businessmen are far better than the things that have been said by many of these experts on the Hill who have never known anything about a cow except that it has something to do with milk they see on the doorstep in the morning. They want to tell us how that industry could and should be taxed.

This morning we are pleased to have with us as our first witness Mr. Julio S. Laguarta, chairman of the legislative committee of the National Association of Realtors, accompanied by Wallace R. Woodbury, chairman of the Federal Taxation Subcommittee and Gil Thurm, Staff Legislative Counsel.

STATEMENT OF JULIO S. LAGUARTA, CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS; ACCOMPANIED BY GIL THURM, STAFF LEGISLATIVE COUNSEL, AND EDWIN L. KAHN, OF ARENT, FOX, KINTNER, PLOTKIN & KAHN, SPECIAL TAX COUNSEL

Mr. LAGUARTA. Mr. Chairman, members of this distinguished committee, I am Julio S. Laguarta of Houston, Texas. I as a realtor and I appear here as the chairman of the National Association of Realtors legislative committee. I am accompanied by Mr. Gil Thurm, our staff legislative counsel and director of tax programs for our government affairs department and by Mr. Edwin L. Kahn of the law firm of Arent, Fox, Kintner, Plotkin, and Kahn, our special tax counsel.

The National Association of Realtors has the largest membership of any association in the United States concerned with all facets of the real estate industry. The association is comprised of more than 1,600 local boards of realtors located in every State of the Union, the

District of Columbia, and Puerto Rico. Combined membership of these boards is approximately 500,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums.

The health of the real estate industry is of vital importance to the national economy. A healthy real estate industry leads to a healthy economy because it stimulates employment directly, and in allied industries such as lumber, concrete, plumbing supplies, glass companies, furniture manufacturers, et cetera. In recent years, real estate investment has been beset by many adverse forces, such as the recession, a host of regulations, accelerating costs of constructing and operating real property, high interest rates and lack of mortgage funds.

In his State of the Union message on January 19, 1976, President Ford placed high priority on the recovery of the construction industry to continue our return from the depths of the recession which has plagued the Nation. Treasury Secretary William E. Simon, in his statement before this distinguished committee on March 17, 1976, acknowledged that the construction industry is one of the most depressed in the economy and he set forth the administration's proposals designed to alleviate this problem.

Basically, the administration's proposal on this issue would permit very rapid depreciation methods for the construction of new plants or expansion of existing facilities in areas where the unemployment rate exceeds 7 percent. The commercial and industrial facilities which would qualify for this very rapid depreciation include factories, warehouses, shopping centers, and office buildings.

The National Association of Realtors supports this concept and urges that residential rental properties be included in this proposal. Although there have been recent reports of recovery in the residential real estate sector, almost all of this recovery has concerned single-family homes. Investment real estate, such as multifamily residences, remains in a very depressed condition.

Unfortunately, this administration proposal is in serious conflict with the administration's continued support of an older proposal—the so-called limitation on artificial accounting losses which has been included in the House-passed tax bill, H.R. 10612. The administration's new proposal properly calls for more rapid depreciation practices than are allowed today. On the other hand, LAL would call such rapid depreciation an "artificial" loss and deny the deduction of this amount in certain cases. We respectfully submit that very rapid depreciation methods are of no benefit if deductions for that depreciation will be disallowed.

Shopping centers, warehouses, office buildings and other such commercial and industrial facilities are constructed by individuals, partnerships and corporations. Although LAL does not apply to corporations—an example of its discriminatory aspects which we will discuss later—LAL does hurt the individuals and partnerships that

are needed to fulfill the President's objectives of encouraging construction and capital formation.

This committee is continuing to consider important and worthwhile incentives such as the investment tax credit. However, incentives for the purchase of machinery and equipment will not be effective unless there are new and modern commercial and industrial facilities in which to place the machinery.

The National Association of Realtors has developed a positive program designed to stimulate real estate investment and, hence, the national economy.

One aspect of this program is the consideration of enactment of provisions which would permit a real estate entity, whether a partnership, a trust, or a corporation, to engage in devlopment with the same multiple ownership and the same tax results as have long been considered available for limited partnerships. This would be a fundamental method for continuing local, rather than absentee, ownership of real estate developments and encouraging a broader base of capital investment by small investors. We are now considering a proposal for this legislation. With your permission we will submit at an appropriate later time a discussion draft of this legislation which we consider to be administratively practical for the Government.

Another example of our positive program relates to our belief that all taxpayers should pay a fair share of tax. The National Association of Realtors believes that if it is necessary to make a change in the taxation of individuals investing in real estate, then such a change should be in the nature of a minimum alternative tax. Under this method, one would pay the greater of his regular tax or the minimum alternative tax. We are submitting with our statement a draft of a legislative proposal for such a minimum alternative tax.

We believe the proposal meets the objectives set forth by Treasury Secretary Simon in his March 17, 1976 testimony before this committee. According to Secretary Simon:

> 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.

The minimum alternative tax [MAT] proposal which we submit herewith is equitable, simple and efficient. MAT is equitable because, unlike LAL, it treats all industries in the same manner. It is simple because only one understandable MAT rule is needed. On the other hand, the House-passed tax bill, H.R. 10612, contains a separate, complex and lengthy LAL rule for separate industries. MAT is efficient because it effectively hits the target cases without the overkill and complexity of the House bill's numerous LAL rules, separate minimum tax, personal and investment interest limitations, prepaid interest rules and other such provisions.

At this point, I would like to address in more detail some of the proposals contained in H.R. 10612 and other matters under consideration by this committee.

H.R. 10612 contains several LAL sections designed to limit so-called "artificial accounting losses." In fact, when this concept was

originally introduced in 1973, it was referred to as the Limitation on Artificial "Accounting" Losses. Since then, however, the word "accounting" has been dropped from the title, perhaps giving a mistaken impression that only "artificial" losses are being limited. In the case of real estate, LAL would disallow the current deduction of interest and taxes paid during the construction period, and also accelerated depreciation in excess of straight-line depreciation.

It is a mistake to call construction period interest and taxes "artificial losses." There is nothing "artificial" about them. There is nothing "artificial" about the checks that have to be written in payment of these expenses. These expenses are true economic costs and require out-of-pocket cash outlays. It is often said, but worth repeating, that one is not allowed to pay for these expenses with "artificial checks".

At one point, the House was considering making LAL even worse, by eliminating the ability to combine—aggregate—income and losses from separate real estate properties. That is, if one property produced income, you pay tax. Yet, at the same time, if another property had a loss, a deduction would be denied. A harsh amendment to deny aggregation was defeated on the House floor. Treasury Secretary Simon's statement before this committee properly supports aggregation. That is, if an LAL rule is adopted, for real property investments, aggregation is essential.

Proposals such as LAL present a serious threat to the Nation's economy in general and to the real estate industry in particular. Furthermore, the National Association of Realtors opposes the LAL proposal because of its inherent discriminatory nature:

(1) Discriminates—all other industries are permitted to deduct interest as an expense, and this is the correct accounting and economic treatment of interest.

(2) Discriminates—LAL favors corporate investors, particularly very large publicly held corporations which invest in real estate either directly or through partnerships. LAL discriminates against individuals who invest as proprietors or through partnerships.

(3) Discriminates—economic studies indicate that LAL would materially reduce the anticipated yield on real estate investment, thereby putting pressure on rents, encouraging conversions to condominiums, and creating difficulty in attracting equity capital for new development.

(4) Discriminates—LAL is complex to administer, in substance requiring the taxpayer to maintain two sets of accounting records, a costly burden for all investors, particularly small ones.

LAL will be even more discriminatory under the Treasury's proposal set forth by Secretary Simon in his statement before this committee. For example, Treasury would exempt the oil and gas industry from LAL. Also, it would exempt sports franchises to which the House bill applies LAL. Similarly, Treasury would ease the House bill's application of LAL to farming activities.

Thus, LAL would be applied in different ways to different industries and real estate investment would receive the harshest treatment. In addition to the discriminatory aspect of this varying treatment are the numerous economic dislocations which will result from such

changes in the Internal Revenue Code. The tax incentives Congress provided in the code relate to various risk-taking investments. Most of these investments are essential to the economy. Attempts to deal with them on a one-by-one basis cause distinctions that distort the flow of risk-taking capital. Taxation cannot be as precise as the LAL approaches require, with their 100 percent disallowance of deductions in the affected industries without regard to the many varying situations.

Proponents of LAL say that it would raise revenues. This proposition is based upon the premise that all present real estate activity will remain the same after adoption of LAL. This is a faulty premise. LAL would adversely affect yields on real estate investment and hamper investor's cash-flow needs.

Attached to this statement are graphs which illustrate the adverse impact of LAL on yields from real estate investment. There is no doubt that LAL hits the highly sheltered individual. However, it also impacts on all investors regardless of tax status.

According to economist Dr. Norman B. Ture, the combined impact of several of the provisions of H.R. 10612 on real estate investment would be $6.3 billion less real estate investment; $11.2 billion less GNP; a loss of 280,000 jobs; and a loss of $2.8 billion in Federal revenues. Dr. Ture's calculations take account of the fact that as laws are changed, investments change. Investment capital will not be available for the real estate industry in the same manner as today if LAL is enacted.

It is estimated that LAL alone would reduce real estate investment by $1.7 billion, end 74,000 jobs and lose $900 million in Federal revenues.

We urge this committee to take full account of secondary and tertiary effects of proposed changes in the tax law. The adverse ripple effect of LAL on the real estate industry and national economy would be too great.

The dangers of an LAL approach are further evident by looking at some developments in Canada.

In mid-1971, Canada amended its income tax laws by enacting an LAL concept. That is, certain real estate losses—so-called capital cost allowances—could not be deducted against income from other sources.

At that time the Canadian Government recognized that these new rules would have an adverse effect on the total level of real estate activity but they were of the opinion that the difficulties would be temporary and minor. They stated that:

> Construction activities would be reduced for a period of time until rents rose sufficiently in response to a growing demand to restore the related attractiveness of real estate investment. The government probably would have to take action to offset any reduction in apartment construction during the transitional period. (Volume 6, Implications of the Proposed Tax Reform.)

In retrospect, it appears that the effects of eliminating these deductions were underestimated. In the ensuing years the Canadian real estate and construction industries encountered considerable difficulties. Construction activity decreased significantly and there were dramatic increases in the price of residential real estate. Although

much of the decline in construction can be attributed to other factors, such as high mortgage interest rates, certainly the tax change exacerbated the situation.

In the light of these distressing trends, the Canadian Government suspended some of the stringent tax rules that were enacted. In 1975 they reinstated provisions to allow deductions against personal income of losses on new residential rental properties which were started within a 1-year period. Recently, this relaxation was extended for an additional 2-year period.

The message of the Canadian experiment is clear. Disincentives in the tax law to real estate investment are markedly reflected in the downturn in real estate activity. This should not be permitted to occur in the United States. Accordingly, we urge this committee to abandon any LAL approach to tax revision.

The House-passed tax bill contains a $12,000 annual limitation on the amount of personal interest, and investment interest in excess of investment income that an individual may deduct. Personal interest includes home mortgage interest and interest on consumer loans and educational loans. Investment interest includes interest expenses related to certain net lease transactions.

The National Association of Realtors is opposed to such limitations on the deduction of interest expenses. Such a limitation on home mortgage interest deductions is a foot in the door to the possible entire elimination of home mortgage interest deductions.

We endorse the Treasury's opposition to this drastic interest limitation.

H.R. 10612 would severely restructure the existing minimum tax. By adding construction period interest and taxes to the list of tax preference items, the proposal adds to the discrimination against the real estate industry. Such expenses are not preference items—they are legitimate out-of-pocket expenses. Moreover, the complete denial of an offset for the amount of regular income taxes paid would convert the existing minimum tax into an oppressive surcharge or add-on tax.

We heartily endorse the Treasury's opposition to these proposed changes.

If some change in the present tax rules concerning investment incentives is necessary, the National Association of Realtors supports a minimum alternative tax (MAT) concept designed to ensure that all taxpayers pay a fair share of tax. In this regard, we have attached to this statement a draft of legislative language which could be used to implement such a minimum alternative tax (MAT).

In the MAT approach, one would pay the greater of his regular income tax or the MAT tax. Thus, it is a true alternative tax concept in line with the concept which Treasury Secretary Simon recommended to this committee.

Under this approach, a taxpayer would compute his or her taxable income under the regular rules. To that amount he would add any of the tax preference items. The regular income tax rates would then be applied to 50 percent of this total. The taxpayer would pay the greater of his regular income tax or this MAT tax. The simple

computation steps are as follows: (1) Taxable income plus tax preferences equals total base; (2) total base multiplied by 50 percent equals alternative income; (3) regular tax rates applied to alternative income results in minimum alternative tax (MAT). Taxpayer pays the greater of MAT or regular income tax.

Congress would determine which deductions would be called tax preferences for purposes of MAT. For example, the existing minimum tax lists nine preference items. Congress could add to or subtract from this list.

MAT is designed to replace the existing minimum tax and avoid the need for numerous and complex LAL rules, investment interest limitations, prepaid interest rules, and other such provisions. Anytime that Congress decides that a particular deduction or exclusion should be classified as a tax preference item, it could be added to this one, simple MAT formula. Thus, a new separate and complex rule would not have to be created as would be necessary with the House tax bill's LAL approach.

The effect of the MAT proposal will be to provide a more comprehensive approach to dealing with tax incentives than the several LAL proposals. It would put all incentives in one group and prevent a taxpayer from shopping for his tax incentive investment. The propasal is flexible enough so that any item deemed appropriate may be included. The LAL approaches adopted by the House fail to provide a comprehensive approach to all tax shelters, and by an entire denial of deduction represent overkill.

The MAT proposal is not only simple and equitable, but it is effective as well. MAT zeroes in at the target case—the highly sheltered individual—without the severe LAL effects on all investors regardless of tax status.

In studies undertaken by the department of economics and research of the National Association of Realtors, the MAT proposal was applied to some of the abuse cases that were presented to the House Ways and Means Committee by the staff of the Joint Committee on Internal Revenue Taxation. MAT effectively raised the tax liability of these taxpayers. The computations are submitted with this statement. In the first example, a taxpayer with income in excess of $400,000 showed a tax liability of only $1,200. In the first place, it is not certain that this tax would not be increased upon audit by the Internal Revenue Service using the present tax rules. In any event, by applying MAT in this situation, the taxpayer would be required to pay $116,930 in tax rather than $1,200 as indicated.

Thus, one simple MAT proposal can effectively curb abuse situations and eliminate the unnecessary complexity of numerous LAL rules, the existing minimum tax, personal and investment interest limitations, prepaid interest rules and other such items which would have to add hundreds of pages to the Internal Revenue Code and Regulations and be an administrative nightmare for the Internal Revenue Service and for taxpayers.

Some may say that the concept of simplifying the code is aimed entirely at the low or middle income individual and that complex rules such as LAL are appropriate. They would be incorrect in this

belief. As stated by Assistant Secretary of the Treasury Charles M. Walker, in a speech presented at a session of the American Bar Association Section on Taxation, on February 9, 1976:

For the upper income and business taxpayer the complexity, of the tax law, is much more formidable, arising in part from the sheer difficulty of defining the income from a business activity. Some would regard the complexity faced by the business enterprise or high-income taxpayer of little moment on the argument that these taxpayers can afford the services of tax experts to advise them and prepare their returns. Whatever the intrinsic merits of this view it overlooks the effect on all taxpayers of the existence of a tax system which few can understand. The feeling is increasingly widespread that those who can afford the talents of highly skilled tax advisors are able to avoid paying their fair share of taxes. When few can understand the law, confidence in general is sure to be eroded."

We urge this committee to reject LAL. If change in the tax rules concerning investment incentives is necessary, we believe such change should be made by the adoption of the Minimum Alternative Tax (MAT) approach.

As mentioned above, the National Association of Realtors is continuing to develop positive suggestions to assist in the Nation's capital formation goals. One aspect of this program is the legislative proposal for the creation of a new real estate entity. This proposal is designed to bring more certainty into the law so that the risk takers, and their investors, lenders, contractors and tenants can make and carry out necessary long-range plans.

Furthermore, a healthy real estate industry is dependent upon mortgage money being available to those who need to borrow funds. Therefore, any incentives such as deductions for savers and interest income credits should receive the close attention of this committee.

This distinguished committee is presently considering the energy tax bill, H.R. 6860. The National Association of Realtors urges this committee to give special consideration to incentives that would encourage energy conservation in residential and commercial buildings. In this regard, we support a tax credit to homeowners who purchase insulation and solar energy equipment to achieve conservation goals. Similarly, we endorse efforts to establish incentives to convert multifamily residences from single master metering to individual metering systems.

We are strongly opposed to the provision of H.R. 6860 that establishes an excise tax on business use of oil and natural gas and we urge this committee to reject this unwarranted excise tax.

As a part of its statement of policy for 1976 the National Association of Realtors calls upon Congress to refrain from any further erosion of public confidence in real estate—our Nation's most fundamental asset—by resisting attacks on private property ownership. In addition to the above discussed items, our statement of policy on Federal Taxation urges Congress to:

Eliminate discriminatory limitations on individual investment interest deductibility and any other provisions which favor "corporate" owners over individuals;

Enact capital gains provisions which recognize the effect of inflation and encourage the formation and turnover of capital;

Increase the existing capital gains exclusion to a sales price of $35,000 for the sale of a home by a taxpayer over 65 years of age;

Enact as part of the Internal Revenue Code presumptive, realistic useful lives for depreciation of real property;

Continue the rapid amortization provision for rehabilitation of low-income housing;

Allow a limited deduction for costs incurred to prevent deterioration of a personal residence; and

Exempt from Federal income tax, funds from assessments held for the administration, maintenance, and operation of condominium and other homeowner associations.

Thank you for this opportunity to present our views.

[Attachments to the preceding statement follow:]

Attachment A

MINIMUM ALTERNATIVE TAX

Sec. ——. Minimum Alternative Tax

(a) *In General.*—Part VI of subchapter A of chapter 1 (relating to minimum tax for tax preferences) is amended by inserting immediately before section 56 the following new section:

"*Sec. 55. Minimum Alternative Tax For Individuals*

"(a) *Impositionof Tax.*—In the case of a taxpayer other than a corporation, in lieu of the tax imposed by section 1 and 511, there is hereby imposed a tax (if such tax is greater than the tax imposed by such sections) determined as if the taxable income of the taxpayer is an amount equal to one-half of the taxpayer's alternative income as hereinafter defined.

"(b) *Determination of Alternative Income.*—For purposes of this section, the term "alternative income" means the sum of—

"(1) the taxable income for the taxable year,

plus

"(2) an amount equal to the sum of the items of tax preference as defined in section 57."

(b) *Amendment to Section 57.*—Section 57 (relating to items of tax preference) is amended by adding at the end thereof the following new subsection:

"(d) *Additional Items of Tax Preference.*—In the case of a taxpayer other than a corporation, there shall be included under subsection (a) as items of tax preference for taxable years beginning after December 31, 1976, the following:

"(1) (Add here new items of tax preference to be included).

"(2) (Add here new items of tax preference to be included).

(c) *Conforming Amendments.*—

(1) Section 56 (relating to imposition of the minimum tax) is amended as follows:

(A) by changing the heading to read as follows: "Sec. 56. Minimum Tax For Corporations."; and

(B) by adding at the end of section 56 the following new subsection: "(d) *Application of Section.* In the case of taxable years beginning after December 31, 1976, this section shall apply only to corporations."

(2) Section 5(a) (relating to cross references relating to tax on individuals) is amended as follows:

(A) by amending paragraph (5) to read as follows: "(5) For minimum alternative tax for individuals, see section 55."; and

(B) by adding at the end thereof the following new paragraph: "(6) For minimum tax for corporations, see section 56."

(3) Paragraph (1) of section 871(b) (relating to tax on nonresident alien individuals) is amended by inserting "section 55," after "section 1".

(4) Section 877(b) (relating to expatriation to avoid tax) is amended by inserting ", section 55," after "section 1".

(d) *Effective Date.*—The amendments made by this section shall apply to taxable years beginning after December 31, 1976.

Attachment B

Computation Using MAT Approach

February, 1976.

Case No. 1

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%)	0
Partnership profit and loss (line 2 below)	−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 (line 1 below)	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 $1,000 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.

Minimum alternative tax (MAT)

1. Taxable income per return	$7, 000
2. Add: Tax preferences	410, 000
3. Total	417, 000
4. Deduction—½ line 3	(208, 500)
5. Alternative income	208, 500
6. Tax [1]	116, 930

[1] Based on joint return tax rate; no allowance for 50 percent maximum tax on earned income.

Case No. 2

Partnership return

(Type of business: Real estate. Date of startup: Apr. 30)

Capital contributed by partners	$53, 000
Liabilities of partnership	3, 420, 000

Income	$118,000
Expenses	321,000
Interest	186,000
Depreciation	116,000
Real estate taxes	0
Management and syndication fees	0
Net loss	203,000
Net loss as a percent of capital contribution	383.0

Individual income tax return

(Occupation: Executive)

Wages and salaries	$100,000
Dividends and interest	51,000
Capital gains (100%)	0
Partnership profit and loss: Real estate (line 2 below)	−127,000
Farming income	97,000
Rental loss (line 2 below)	−13,000
Other income	4,000
Economic income	252,000
Adjusted gross income	112,000
Itemized deductions	35,000
Taxable income (line 1 below)	74,000
Income tax	30,000
Minimum tax	0
Tax credits	0
Total tax after credits	30,000
Tax as a percent of economic income	11.9

ANALYSIS

This partnership, which is building and operating a store, is highly leveraged. Partners contributed capital of $53,000 to finance assets of $3,280,000. In the first year, the partnership threw off a loss of $203,000, almost four times the investment by the partners. Deductions were for interest $186,000, amortization of the financing fee $19,000, and depreciation $116,000.

The executive who invested in this store had large salary, dividends and interest and also has sizable income from a farm. The farm income consisted of a profit on the sale of cattle and feed grain. This executive used the 50-percent maximum tax method to compute his income tax.

Minimum alternative tax (MAT)

1. Taxable income per return	$74,000
2. Add: Tax preferences	140,000
3. Total	214,000
4. Deduction—½ line 3	(107,000)
5. Alternative income	107,000
6. Tax [1]	49,520

[1] Based on joint return tax rate: no allowance for 50 percent maximum tax on earned income.

CASE No. 3

Partnership return

(Type of business: Real estate. Date: Second year of operation)

Capital contributed by partners	[1]
Liabilities of partnership	$7,716,000
Income	1,157,000
Expenses	1,300,000
Interest	609,000
Depreciation	215,000
Real estate taxes	124,000
Management and syndication fees	42,000
Ground rent	44,000
Net loss	142,000
Net loss as a percent of capital contribution	[1]

[1] Not available.

Individual income tax return

(Occupation: Executive)

Wages and salaries	150, 000
Dividends and interest	25, 000
Capital gains (100 percent) (line 2 below)	365, 000
Partnership profit and loss (various) (line 2 below)	−151, 000
Rentals (line 2 below)	−101, 000
Other income	13, 000
Economic income	632, 000
Adjusted gross income	118, 000
Itemized deductions	97, 000
Taxable income (line 1 below)	16, 000
Income tax	3, 000
Minimum tax	19, 000
Tax credits	0
Total tax after credits	22, 000
Tax as a percent of economic income	3. 5

Minimum alternative tax (MAT)

1. Taxable income per return	$16, 000
2. Add: Tax preferences:	
(a) Partnership loss	(151, 000)
(b) Rentals	(101, 000)
(c) Capital gain deduction	(182, 500)
Total tax preferences	434, 500
3. Total	450, 500
4. Deduction—½ line 3	225, 250
5. Alternative income	225, 250
6. Tax [2]	128, 655

[2] Based on joint return tax rate; no allowance for 50 percent maximum tax on earned income.

Attachment C

Economic Charts on Impact of Tax Proposals on Yields

IMPACT OF ALTERNATIVE PROPOSALS ON YIELDS FROM A SUCCESSFUL REAL ESTATE INVESTMENT

Introduction.—The National Association of Realtors®' Department of Economics and Research and its consultant, Dr. Ennis Eisen, have used a computer model to compare the potential impact of two tax proposals on the yield from a successful real estate investment.

The analysis of yield encompasses all economic gains accruing to the investor, including cash flow, amortization, capital gains, and the tax benefits of sheltering other income. The analysis pertains to a successful residential project and is bounded by a set of assumptions which characterize the investor, the property, and its financing.

Cases.—The following three cases have been considered:

1. Current Tax Law

All construction-period expenses are deducted in the year incurred, component depreciation utilized, 1969 recapture rules in effect.

2. Alternative Minimum Tax

All tax preferences are added to taxable income. Regular tax rates are applied to ½ of this amount. Taxpayer pays the minimum tax if it is larger than his regular income tax.

3. Limitation on Accounting Losses (LAL)

LAL is applied to both construction interest and taxes, and excess depreciation. Full recapture of excess depreciation.

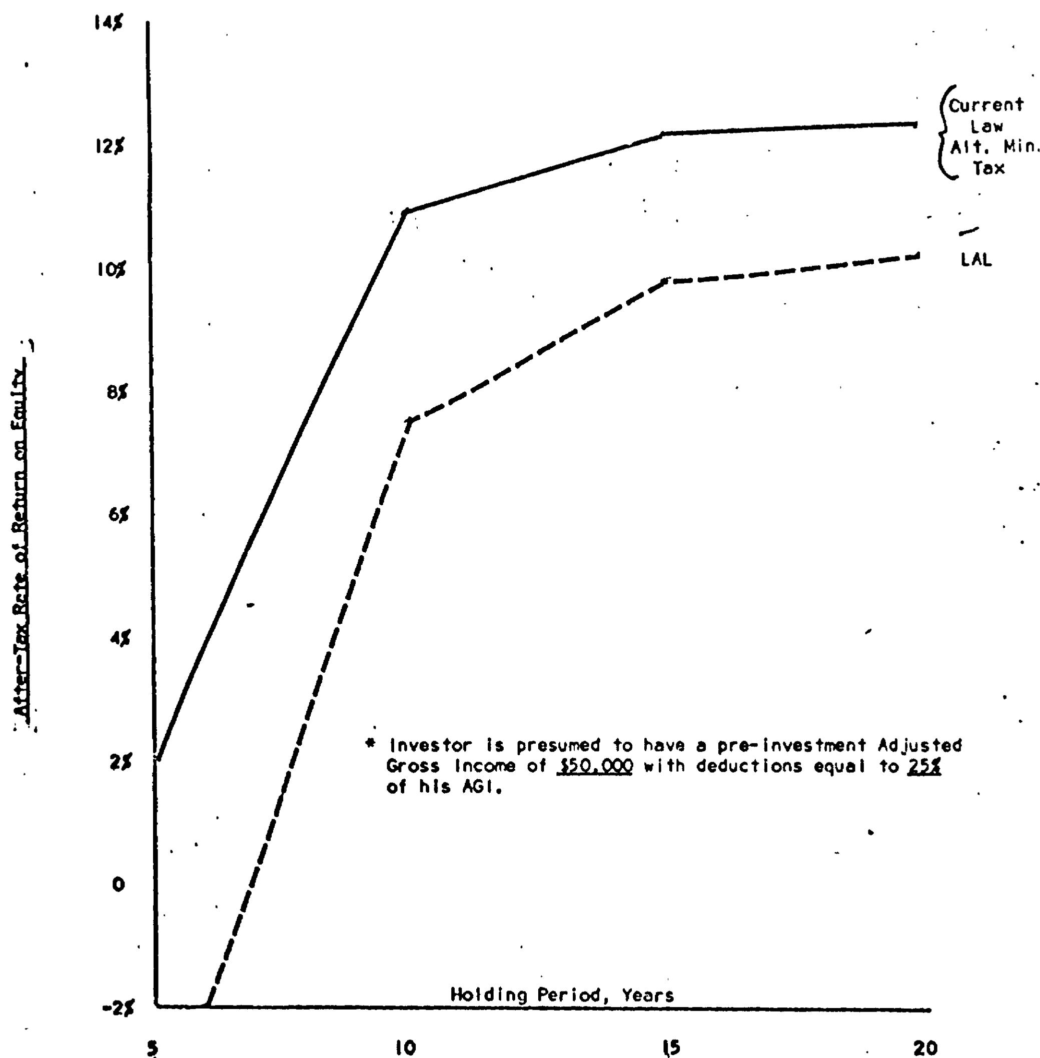
Findings.—Data from our model of a successful real estate investment are chartered on the following pages. Some of the more salient features shown by the data are:

Both the Alternative Minimum Tax and LAL substantially reduce the after-tax rate of return on a successful real estate investment for highly sheltered tax-payers.

LAL impacts heavily not only on the intended target groups of high income and highly sheltered taxpayers, but on all investors regardless of tax status.

The Alternative Minimum Tax is more selective in its impact. It bears more heavily upon the highly sheltered wealthy individual and impinges only modestly upon the broad base of middle income taxpayers who form the core of the real estate industry.

Our data show the yield for a successful real estate venture. If the project is only marginally successful, the deferred loss account created under LAL is indefinitely suspended—thus adding an extra element of risk to an already risky enterprise.



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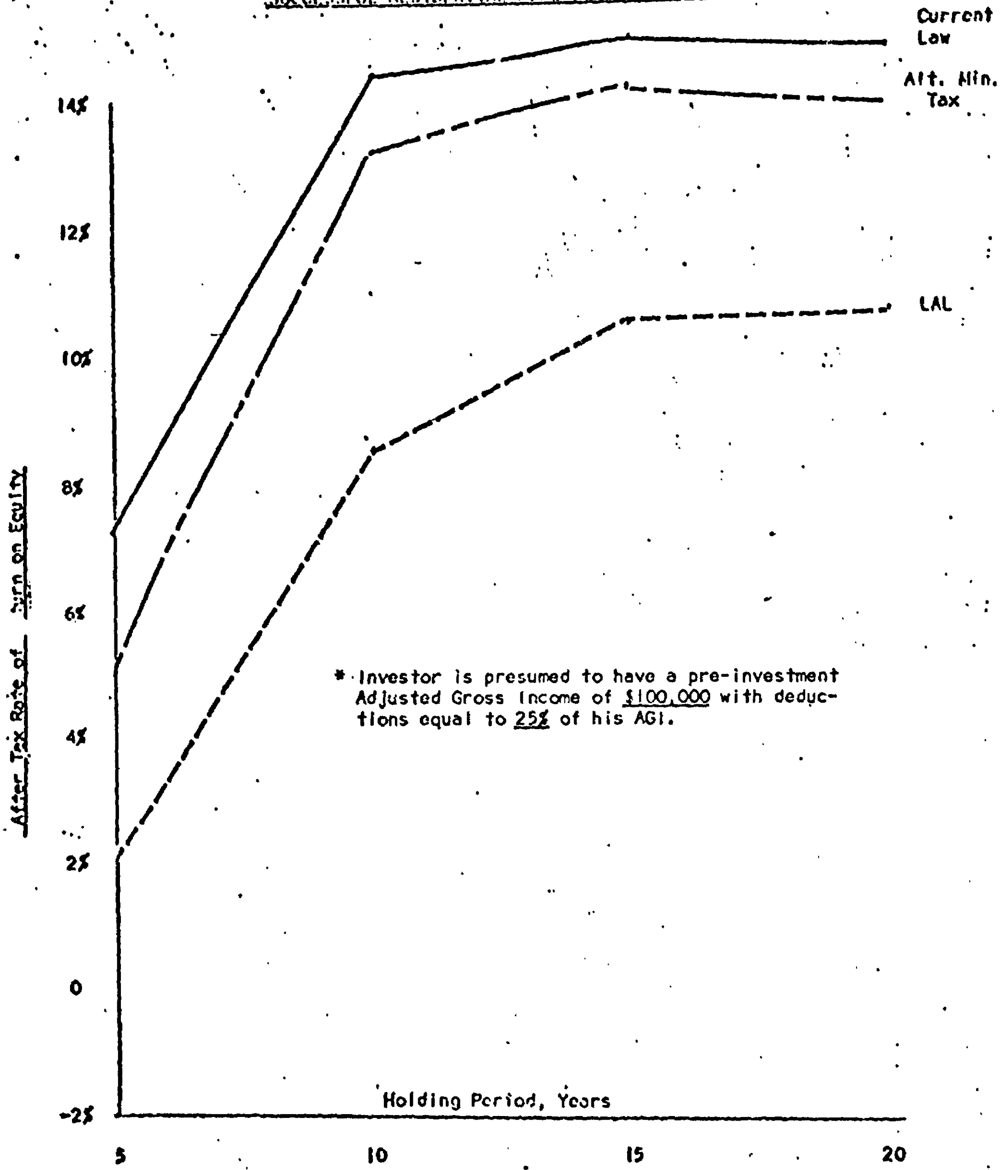
Department of Economics and Research
March 1976



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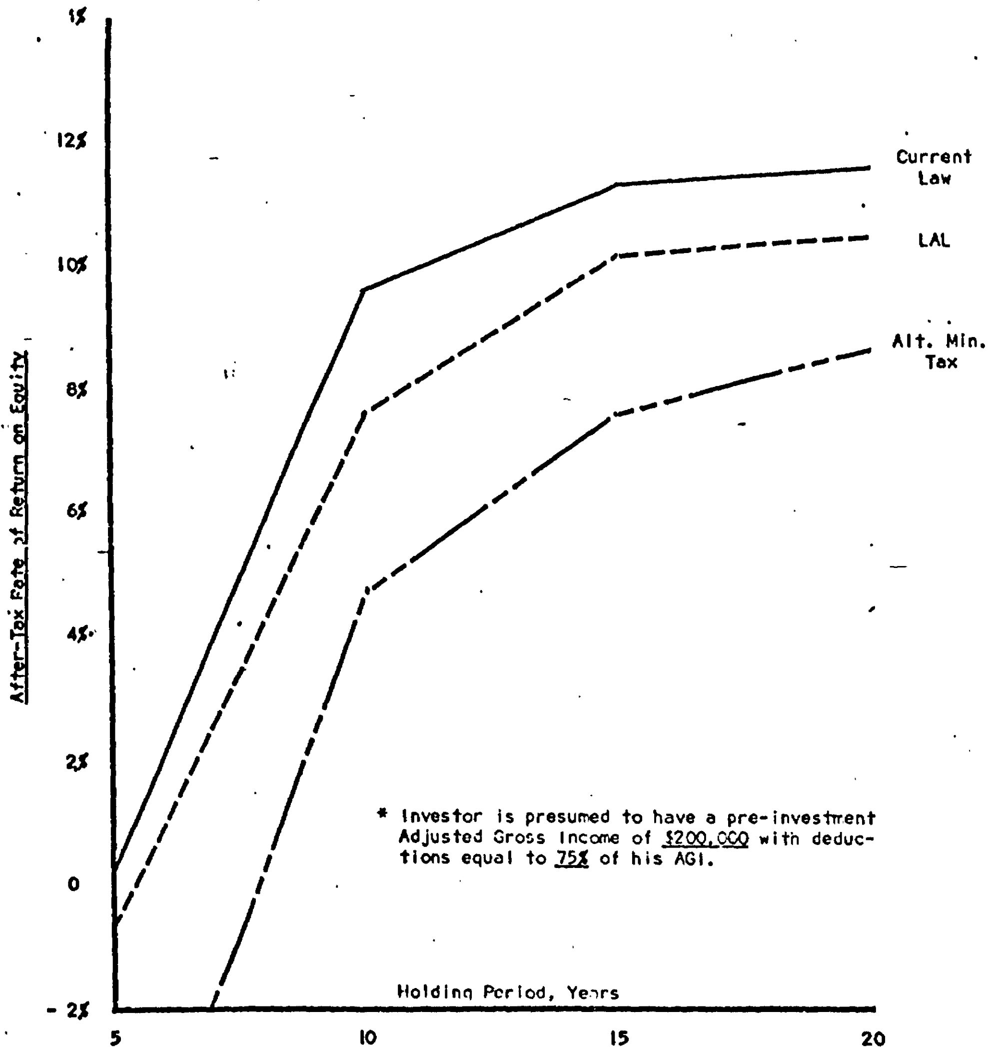

The CHAIRMAN. Senator Curtis.

Senator CURTIS. I think Senator Fannin was here first.

Senator FANNIN. Thank you, Mr. Chairman. I certainly appreciate the fine testimony you have given here this morning, Mr. Laguarta. I am very interested because of the particular situation in my State of Arizona where we have an extensive retirement industry. What would be the effect on your industry if the $12,000 interest deduction limitation provision comes to pass?

Then I will get, perhaps, to the people who are not retired, but have a second home, for instance, in our State.

Because of the cold weather, they may have a health condition where it is imperative that since they have a winter home they must go to the warmer climate. How would this position of the maximum $12,000 allowable affect your industry?

Mr. LAGUARTA. It merely states there is a maximum interest deduction of $12,000 which would include the interest expense on a home mortgage. If a modest investor desires to go out and put his capital at risk to develop real property, to develop a small apartment house or any other kind of investment in real estate, this limitation of interest would be placed on his total interest deduction over $12,000 which would include his home interest deduction.

Sentor FANNIN. I understand that, but wouldn't it be discriminatory?

Mr. LAGUARTA. Absolutely.

Senator FANNIN. I think the general assumption is that the second home is just a rich man's second home and generally speaking that is not true. So, I feel this is very important. Your testimony indicates your industry feels it is discriminated against, too, by this bill. Would you summarize your view in this area? The general bill that came from the House has quite a few items that you have spoken about, and you feel your particular industry is vitally affected. Would you want to select what is most damaging to the industry?

Mr. LAGUARTA. In particular, corporations are allowed to deduct their interest expenses in this program as proposed in H.R. 10612, yet individuals have a limitation placed on them, Senator.

Let's just take the example I was using of the corporations in our town that are engaged in real estate development. If they chose to go the route of funding their capital needs through bonds or through general corporate borrowings, these are deductible for them operating expenses. LAL would not apply to the corporations in this instance, but would apply to the individual so we think that that is certainly discriminatory against the individual as opposed to the corporation.

If you were in the same business of manufacturing a 12-unit apartment as you would be for going into the drug business, as an example, and you had to buy goods to put on the shelves of your drugstore, the interest on the loan to create that merchandise on the shelves of the druggist would still have to be paid and could be deducted if he put it in real estate, it would not be deductible. We think it directly points the finger at real estate.

Senator FANNIN. We hear so much about the cases in which people take advantage of a particular situation. Where they do have a deduction, of course, the LAL provisions in the House bill are trying to curb extensive utilization in some of these accounting losses. But now this would be eliminated, as I understand it, with the alternative tax where you take the regular tax to be paid and you take the other matters that would be included in the LAL, and you divide that by half, so the amount that is involved could not be too far out of line; is that correct?

Mr. LAGUARTA. That is correct.

Senator FANNIN. You pay the higher of the two. So if there are great areas of discrimination, you would feel that the individuals or the corporation was being given a special privilege beyond the necessity. The minimum alternative tax would take care of that; is that correct?

Mr. LAGUARTA. That is correct. We understand the concern of Congress over a few people who have tremendous incomes who pay no income tax. But the minimum alternative tax would absolutely catch everyone in that particular field and require that they pay some tax and not allow anyone to escape payment of taxes entirely.

Sentor FANNIN. Would you say it is fair to characterize the bill before us as a no growth bill? That this would be the results if you applied the different stipulations in this bill?

Mr. LAGUARTA. Absolutely.

Senator FANNIN. Who would benefit from enactment of this bill? There are all these groups that think they will benefit. There is reason for this bill including these stipulations.

Who do you feel would benefit from the bill that has come from the House?

Mr. LAGUARTA. I assume the authors feel the public is going to benefit. We disagree on that point. When there is a cloak thrown over construction and development, this discourages development, discourages the economy and there is no productivity so, therefore, there are no taxes that would come from the productivity. Our charts and graphs and studies indicate to us that there would be more tax generated by an encouragement of development rather than a discouragement of development, Senator.

Senator FANNIN. Also, we are talking about jobs in this country. Of course, jobs take capital formation and if we are going to have the jobs that will be needed in the future, in accordance with the study that has been made by Chase Economists, they will need around $4 trillion in the next 10 years, and even the industry in which I have been very much associated, the energy industry will need as much as a billion dollars. Would this bill greatly preclude the obtaining of capital formation for your industry?

Mr. LAGUARTA. Yes, sir.

Senator FANNIN. Thank you very much.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. How important is the outside investor to the real estate industry? By outside investor, I mean the person not personally engaged in construction.

Mr. LAGUARTA. We feel they are very important. The one I used in my prepared testimony, the medium-sized investor, the man who has now saved some money from his earnings, and has a desire to put this money out with an opportunity for some reward. If these poeple are discouraged from this opportunity, they are left only with the opportunity to invest in other medias.

Senator CURTIS. What will LAL do in your industry?

Mr. LAGUARTA. We believe it will depress employment and it will depress the industry, and add to the burden we have in unemployment in this country.

Senator CURTIS. Quite measurably.

Mr. LAGUARTA. Yes, sir.

Senator CURTIS. You alluded to the Canadian experience. What was that?

Mr. LAGUARTA. In our printed testimony on page 8, the Canadians in 1971 put in a program which basically related to an LAL type tax program. What happened was that the Canadian real estate and construction industries experienced considerable difficulties, and while this was not solely tied to the LAL type provisions, construction did almost stop. As a result, the rents escalated dramatically, and they say that the results of this tax law change was actually discouraging development, discouraging meeting the needs of housing in Canada, and they had to go in and make some revisions to curb this unwanted trend as far as Canada was concerned.

Senator CURTIS. Was this a Federal law in Canada or one of the provinces?

Mr. LAGUARTA. I believe it was a Federal law.

Senator CURTIS. In reference to your minimum alternative tax, how would that work in the case, say, of an individual with $100,000 ordinary income, $100,000 of interest receipts on tax-exempt bonds? How would this work out?

Mr. LAGUARTA. If I said I was a tax expert, I would be waving a false flag.

Mr. KAHN. We leave the determination of the tax preferences to Congress. If interest on municipal bonds are included as a tax preference, then the taxpayer would compute his income in the ordinary manner and assume——

Senator CURTIS. That $100,000 would be on the ordinary income?

Mr. KAHN. Less whatever deductions he is entitled to.

Let's assume it brings him to a taxable income of $75,000. He would add $100,000 to that, divide the total, $175,000 by one-half which I believe would be $87,500 and apply the regular tax rates to that figure.

Senator CURTIS. The reason I used $100,000 and I should have said instead of regular ordinary income, I meant ordinary taxable income after reductions in order to make the mathematics easy.

What tax would he be paying on his tax against the interest under our plan? Assuming the interest on tax exempt bonds is a tax preference and a man has $100,000 of ordinary taxable income and he has $100,000 of that, and $100,000 of interest from tax-exempt bonds——

Mr. KAHN. I am sorry I threw the computation off. In that case, with $100,00 taxable income, add $100,000 of the otherwise tax-exempt interest, giving a total of $200,000. Divide that in half and come out with $100,000 subject to the regular tax rate. There would be no change in his taxable position in that case, whereas his interest on tax-exempt bonds did not exceed his taxable income.

Senator CURTIS. If he had $100,000 of ordinary taxable income and $200,000 interest from tax-exempt bonds, then what would be the result?

Mr. KAHN. Then the total of $100,000 and $200,000 would be $300,000. He would pay tax on one-half of that or $150,000 so, in effect, he would be paying tax on $50,000 out of his $200,000 tax-exempt interest.

Senator CURTIS. I would have to look at the tables to see if he boosted his income into the higher brackets.

Mr. KAHN. He would have boosted it, assuming a married taxpayer, assuming somewhere—I don't have the tables in front of me—somewhere from 50 percent up.

Senator CURTIS. Mr. Chairman, if the committee will excuse me, I am due at the White House in just a few minutes.

The CHAIRMAN. I am concerned about the estimates that we will not lose revenue but will make a lot of money by confiscatory Government taxes. Maybe counterproductive would be a better word than confiscatory, even though sometimes it works out to the same thing.

In other words, I am concerned about these Government estimates that assume that the Treasury can kick a man's brains out at midnight tonight and the man will nevertheless show up for work tomorrow morning, earn the same amount of money and pay an even higher amount of taxes on that money. Those assumptions completely overlook the fact that the man will not be on the job, but will be in the hospital. In fact, the Government may be paying something directly when it is trying to save the man's life after the Government agent clobbered him the night before.

Failure to take into account the effect a tax change will have on a taxpayer leads to poor Government estimates and poor Government estimates tend to lead to bad law.

For example, the House report says that if this LAL provision is put on real estate people, it will pick up a revenue gain of $84 million in 1976, increasing gradually on up to a $289 million gain in 1980. But those estimates only assume what happens with the first stroke, as if the real estate people will not change what they do if the provision is enacted.

Now, take a simple transaction. Let's assume a man can borrow some money and buy a piece of property for $100,000 and sell the piece of property after 10 years at a higher price. Assuming he can sell it 10 years for $200,000, after inflation is taken into account, there is no real gain. But in view of the fact, that inflation is working on the money he borrowed as well as on the property, by that time he has $100,000 in equity, even assuming he has not reduced the indebtedness, but has only paid the interest expense. Of course, the person lending the money has taken one good clobbering. He has been paying a tax for the privilege of losing money in constant terms. But if the man who has the property proceeds to sell it, at that point, under the LAL approach, as I understand it, he would pay a 42 percent tax. It would be a foolish thing to sell that property and pay $42,000 in taxes. The smart thing would be to keep the property, continue to deduct the interest expense, and find some way to use the property or hold on to it or trade it or just hang in there until he can find some way that he can do business in such a fashion that he can keep more than 60 percent of what he made. The fact that he will not sell the property simply is not taken into account in those calculations of the revenue gain.

If the man sold the property under the way the tax law used to be in earlier days, and paid a 25 percent capital gain on the inflated

$100,000 of value, you would then have bricklayers laying brick; you would have carpenters nailing boards together; you would have electricians out working on the site; you would have people manufacturing building materials; you would have transportation people transporting people from place to place; and all these people would be paying taxes on their incomes, income taxes, social security taxes, unemployment insurance taxes. The State would be picking up money. All that would be taking place if he sells the property, but not if he holds on to his property—and there is not 1 penny of that reflected in these revenue estimates.

Admittedly, some of those workers might find a job doing something else, and that ought also to be in the estimates. But an estimate is badly in error if it assumes that all those workers would find a job doing something else. The last I heard, 19 percent in the construction trades are out of work right now.

By the time they take another $1.7 billion of taxes away from the oil industry, they estimate they are not going to lose any money as a result of doing that, even though we all know that the companies that they are taking it away from after paying taxes put that much back in and borrow that much more in invest into finding new sources of energy. So a $1.7 billion net tax in addition to the $30 billion that industry is already paying means that it will reduce their energy-finding activity by $3.4 billion. The effect of that will be felt all up and down industry, including the people who make the steel, who mine the iron ore, who work in the transportation industry, even the people who dig the mud to deliver it to the spot where they are drilling. Mud is a secret ingredient—you have to have mud so the pipe will turn and so the thing will blow not out if you discover something.

If you allow the industry the incentive to produce oil or gas, you stimulate a lot of economic activity. That is something you can sell. If you eliminate their incentive to produce, you will have to find some other kind of jobs for the people who will be put out of work. The alternative jobs these people, who want to end the incentives, are talking about would be to put somebody out there trying to produce rice or soybeans which we can't sell, that we have to give away—and that results in a Government expense, too. Or they want to get them jobs in the housing industry where people are all going broke now and need a shot in the arm in the worst kind of way.

I just think that these revenue estimates must be corrected to try to see how much they really can be expected to raise when you take into account the effect they will have on people's incentives.

The way these people, who want to change the tax law, make revenue estimates is like saying the batter hit a homerun, and the only thing wrong about that was that the center fielder happened to reach up and catch the ball before it went over the fence.

If you people will look at these estimates that appear on page 19 of the House report on the Tax Reform Act, I would be curious to know how much you estimate will be gained. I would like to see how you document your estimates, and I will try to provide you the assumptions on which these revenue gains were estimated by those who prepared them. I have asked those same people to go back and

take a look at the secondary and tertiary effects of these so-called revenue-raising provisions. I believe that we are going to find a great change in the estimates when we analyze those effects in depth.

I can recall a time when one of our Senators in good conscience sat here and proposed an amendment which sounded great to give 3-for-1 Federal matching for whatever a State would spend on social services. That was estimated to cost us $40 million a year. In a few years, it was threatening to cost us $4 billion a year. No one ever bothered to assume that if you are going to give a guy $3 every time he puts up one, that guy will put up more dollars than he was putting up prior to the time we made the offer. I would be willing to sit here and trade you $5 bills for $20 bills all day as long as you can keep coming up with $20 bills.

Those kind of Government estimates lead us into difficulties. I am hoping we can get much better estimates. I have asked the Treasury to start looking at their estimates again and talking to the people in the businesses that are affected.

For example, if you have to pay a 42-percent tax on any gain from selling property, illusory though the gain may be, are you still going to sell that piece of property or are you going to hang on to it?

I see you are shaking your head. You believe that he is not going to sell the property if he has to pay 42 percent out in taxes.

Mr. LAGUARTA. No, sir.

The CHAIRMAN. The point is that if he wouldn't make that sale, and somebody in the area would like to risk his money to develop the property into a subdivision but can't buy the property, then the city just fails to grow. Isn't that correct?

Mr. LAGUARTA. That is correct. Right on.

The CHAIRMAN. These revenue estimates will not be corrected to where they ought to be until we recognize that capital accumulation does have some value and that we ought to encourage a man to try to make a little money in the hope that by doing so he will benefit himself and benefit others besides himself.

I for one do not buy this theory of some of our ivory tower friends that every dollar a man makes belongs to the Government first, and that anything he is permitted to keep is a gratuity from the Government—on the theory that the Government did not have to permit him to keep any of his earnings. It seems to me that one of these days we should begin to recognize that if a man earns something by dint of hard work, then that is his money, and it is not a tax expenditure to the extent that the Government does not tax it all away from him.

Senator Byrd?

Senator HARRY F. BYRD, JR. I yield my time to the chairman. He is doing so well.

The CHAIRMAN. If I can, I am going to get us some figures that will show what the real revenue gain from these proposals would be rather than just the first impact if you assume everything else will continue to operate as though you never changed the tax law at all. I would appreciate your giving us the best estimates you can, and I want to thank you for your suggested alternatives. We all agree that if someone makes some money, he should pay some taxes. I see you are nodding agreement at that.

Mr. LAGUARTA. That is correct, sir.

The CHAIRMAN. When people proceed to come forward with so-called tax reforms which will bring the Government to a halt, cost a fantastic number of jobs and reverse the progress of this Nation, I just think we ought to find a better name for it than to call something like that tax reform.

Senator FANNIN. I would like to comment that the figures you have given on page 6 are very impressive, quoting Dr. Norman B. Ture. Could you furnish the committee with an estimate of the effect the minimum alternative tax and interest limit would have? If you could furnish the committee with that information, we would appreciate it.

Mr. THURM. We do not have a full revenue estimate of the minimum alternative tax approach. What we have supplied the committee with is an example of the effectiveness of the proposal on various so-called "abuse" situations. We will be very happy to supply the requested information.

Senator FANNIN. Thank you.

[The following statement was subsequently received for the record:]

As we understand it, the Treasury Department is making that calculation, and it appears that the minimum alternative tax could raise about $900 million. It is interesting to note that the minimum alternative tax impacts more heavily on the so-called abuser than does a minimum add-on tax.

Senator HARRY F. BYRD, JR. I note you indicate a job loss of 74,000 jobs on page 6 as a result of LAL alone. Do you happen to have the figure for the State of Virginia?

Mr. LAGUARTA. No, sir, I don't have the figures for the State of Virginia.

[The following was subsequently received for the record:]

We have figures which illustrate that the real estate industry is important to the State of Virginia. In 1973 Virginia had 141,277 people who were employed directly in real estate and construction. This was 11 percent of the State's privately employed labor force. In addition, this basic activity probably supported an equal amount of employment in other related industries.

The considerable role that real estate and construction play in the national and State economy is in sharp contrast to the smallness of its establishments. In Virginia an estimated 13,305 firms are actively engaged in real estate or construction. The majority of these firms are small—70 percent having less than eight employees.

The CHAIRMAN. We have taken longer than we should have because of our tight schedule, but I want to say something to this group of witnesses, because there are a lot of people who are in your line of endeavor trying honestly to make a decent living and advance their communities the best they can. The probabilities are that this committee will report something that will favor the concept you have advocated, assuring a fair amount of taxes would be paid by your industry in such a fashion that the industry can do what the Nation has a right to expect of it. But if we do, we will have a difficult fight on the Senate floor maintaining that position. I regret to say that when you present your views to the Senators you have been talking to here, it is like the preachers who go to church and denounce people who don't come to church. The only people who are hearing the message are those who don't need to hear it to begin with.

Your people had better make some plans, when the fur starts flying on the Senate floor, to have some of your members come back to town and talk to some of the Senators who were not available to hear you or to hear those members of the U.S. Senate who share your views.

The few Senators you get a chance to speak to at this hearing cannot do the job all by themselves. Other people have to explain the counterproductive features of this tax proposal. I don't know anybody who can better explain it than people from the State talking to their own Senators.

I know the great daily newspapers in this town and elsewhere sometimes seem to question whether a citizen has the right to communicate with his Senator or Congressman, but the Constitution clearly provides that you have a right to petition Congress for a redress of your grievances, and it gives you that right every bit as much as it gives these big newspapers to say just the opposite of what you think.

Thank you very much.

Next we will call Ms. Cushing N. Dolbeare, executive secretary of the National Rural Housing Coalition.

STATEMENT OF MS. CUSHING DOLBEARE, EXECUTIVE SECRETARY, NATIONAL RURAL HOUSING COALITION

Ms. DOLBEARE. Thank you very much.

It is a real pleasure to be here since I have a somewhat different message from the previous witness or some of the other witnesses today.

I would like to approach this question in terms of the overall housing needs of the country. The National Rural Housing Coalition is concerned with people in rural areas. But we are very much aware that a great deal of the urban housing problem—and I am speaking now of the low income housing problem—has been caused because housing and economic development in rural areas has lagged so far behind needs. Housing and employment opportunities simply have not been provided. So, a great many people have moved to cities where they are really no better off.

The National Rural Housing Coalition is concerned with the total housing problems of people in this country who do not have adequate shelter.

Our major premise is that the housing needs of low and moderate income people in this country are urgent and compelling by any measure, although there is a wide discrepancy in the measures that are used.

For example, the Department of Housing and Urban Development in its own program review in 1973 reported there were 15 million housholds that were eligible for housing subsidies but were not receiving them.

The Joint Center for Urban Studies at Harvard and MIT, under contract with HUD, identified a need for 13 million units.

Most recently, in 1974, the Congress reaffirmed, in the Housing and Community Development Act, the 1968 goal of provision over a

decade of 6 million low and moderate income housing units. We have provided 2 million, and two-thirds of the decade has elapsed.

In contrast to this need, last year there was an overhang of some 400,000 houses that were built which builders were unable to sell. This was due to a variety of reasons: because the economy was weak; because interest rates were high; but most importantly because those units of unsold houses were built for people in the top 20 percent of the income distribution. Most of these potential consumers already had adequate houses and, therefore, were not in the market for new houses.

At 1972 rates, when we had the highest level of production of subsidized housing in the history of this country, we were building so that the private unsubsidized market would in 14 years provide a new house for every family in the country with income sufficient to afford that house, whereas it would have taken 179 years to provide housing for people at the bottom end of the income distribution, the lowest 20 percent.

In 1973 HUD shut down its subsidized programs because of runaway costs. Since 1973, the increase in tax expenditures for housing has been greater than the total expenditure now budgeted for direct subsidies for low income housing.

We have in this country, if you look at tax expenditures as one part of our housing subsidy system and direct expenditures as the other part of our housing system, a subsidy system which is terribly inefficient and dramatically skewed to favor people who really, by any economic test of need, do not need Federal subsidies.

In 1974, for example, the 1 percent of households in this country with incomes above $50,000 received 10 percent of all housing subsidies. Ninety percent of the taxpayers in that income bracket received some form of housing subsidy by making some kind of itemized tax deduction.

At the other end of the income scale, households with incomes below $3,000—the neediest group—14 percent of the population, received only 7 percent of all housing subsidies and only one household in 10 received any kind of housing subsidy, either through the tax system where mortgage payers were deducting interest payments or because they were occupying low income housing.

It seems to me, since tax subsidies and tax expenditures are three times at least as great as direct expenditures, that this committee has a significant responsibility to address the question of how our whole housing subsidy system should operate, how much should be funded through the tax system and how much should be funded in a direct manner.

I am very much aware that the capacity of the Government to deal adequately with major questions, such as housing, are limited. We don't have unlimited resources to spend on low income housing or on meeting housing needs. Therefore, it seems to me it is of critical importance to be sure that—however we spend our money, whether it is through the tax system or whether through direct subsidies—we are spending that money in a cost-effective way to meet real needs in the most efficient manner possible.

The Department of Housing and Urban Development a couple of years ago commissioned the Touche-Ross Co. to make studies of

the effectiveness of tax expenditures in housing, particularly the 167(k) deduction for 5-year amortization for rehabilitation and for some of the efforts to stimulate multifamily construction. The conclusion of those studies—and I would be glad to supply the official summaries for the record if it would be helpful—indicated these are not really at all efficient in achieving their purpose of stimulating low income construction, moderate income housing construction or rehabilitation.

Forty-five percent of our total rental housing subsidies and I am talking now of public housing and other subsidized rental housing, 45 percent of that cost, again according to HUD's figures, is in the form of the tax deductions that are made possible through the provisions of the Internal Revenue Code for excluding interest on housing authority bonds and for rapid depreciation and other expenses for the other programs.

The major point that I wish to make is that current tax law seems to be both bad tax policy in that it disproportionately benefits people with relatively high incomes. For example, people with incomes above $50,000 get one-third the benefits of excess depreciation, three-quarters of the benefits of 167(k), nine-tenths of the benefits of exclusion of interest on State and local bonds.

The tax system, therefore, seems to me to be bad tax policy in that it moves away from a progressive system. It certainly is bad housing policy. These expenditures are costly. They are uncontrollable. They benefit people who do not need assistance. The same amounts used for direct lending programs, for example, the programs of the Farmers Home Administration in rural areas, would be far less costly and would benefit far more low income people.

Therefore, I urge this committee to do two things. First, to explore how the housing problem can be addressed as a whole. One of the real fears that those of us are concerned with the problems of low income housing is that if you adopt LAL or some other form of limiting the subsidy, it may have an impact on low income housing development. So we need something else to achieve that objective, assuming that the tax provisions are really essential to achieve that objective. I am skeptical on that point because I read the 1969 hearings that this committee held, and I was particularly impressed—this was a couple of years ago when I was working on a study—with the predicted impact of the limitations on depreciation that were incorporated in the 1969 act on shopping center construction and other commercial construction and so forth. One would have thought in 1969 that we would never build another shopping center. Clearly, there are other factors at play. Clearly, it seems to me it is impossible to predict with any degree of validity what is going to happen. We have to use our best judgment. It seems to me we have to be ready to reconsider, if the impacts turn out to be other than the ones we wish for.

So, I would urge this committee not to extend 167(k), and to strengthen the provisions on LAL in the House-passed bill. An even better approach would be to eliminate within 5 years the accelerated depreciation and expensing deductions. Finally, I urge the committee to stubstitute a tax credit for the deduction of mortgage

interest and property taxes because I think people in the middle income range really need those deductions and we would have to substitute another subsidy program if we eliminated that one.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you very much. You have given us many figures. When you say the top income group gets more than 90 percent of the subsidies am I correct in concluding that it is not numbers of people you are talking about, but dollars. Isn't that right?

Ms. DOLBEARE. The 1 percent is numbers of people and 10 percent is dollars.

Senator FANNIN. The 10 percent——

Ms. DOLBEARE. It is dollars in direct tax expenditures. This is based on Treasury analysis as far as the income distribution of tax subsidies is concerned. It is based on HUD analyses as to who benefits from the direct spending programs and those are aggregate totals.

Senator FANNIN. Figures can be very misleading. As far as HUD is concerned, we do have a surplus of low income housing in many areas of the country. They cannot dispose of them. They are a burden upon the communities and we receive many complaints.

Ms. DOLBEARE. It is not a surplus of housing fit for occupancy.

Senator FANNIN. There is a question of whether or not the house is acceptable from the standpoint of what they previously were living in. There are many factors involved. I don't want to get into that, but I do feel the Farmers Home Administration has been doing an excellent service. I can cite my State of Arizona. There are many areas of Arizona that have been supplied with housing where just a few years ago they were not receiving that consideration. So I do think the Farmers Home Administration has done an excellent service, and I think we would have to analyze specifics rather than just generalities. I do think there are many areas where specifics could show we have gone forward tremendously in the last few years.

Thank you, Mr. Chairman.

The CHAIRMAN. I have been looking at your chart here. Of course, you and your group have a right to look at it this way. Under the tax law, people were permitted to deduct the interest expense which they actually paid on their homes and the Government because of this deduction failed to collect $4.7 billion in taxes. Taxpayers were permitted to deduct property taxes that they paid on their homes to government, and that deduction reduced taxes another $3.8 billion. The fact that in these and other respects they were permitted to deduct taxes which they actually paid, I, for the life of me, can't look upon as a Government handout. It seems to me that this is money that they were not permitted to keep. While your group might want to look upon their deductions as a gift from Uncle Sam, I look upon that as money the people had to pay and, therefore, it should not be taxed. We went through all of this in Louisiana when our State legislature undertook to deny a taxpayer the right to deduct the Federal income tax that he had paid to Uncle Sam on his State income tax. That proposal was so unpopular that those who voted for it suffered horrible casualties at the next election, and great numbers of them were not returned. The most popular thing

anyone can say who is running for office is that he is not going to levy taxes on taxes.

For my point of view, I cannot buy this concept that we are giving a man a handout when he was not permitted to keep the money he made. Your people can look at it that way, but I find it very difficult to buy that concept.

Ms. DOLBEARE. Would you then extend the concept to renters? What we are really saying is somebody who has an income of say $20,000 and pays $2,000 a year in rent is not able to keep that money because they are spending it for shelter on which the landlord pays the income taxes, but if they own the house and pay some of it in taxes they do deduct it.

That is an inequitable thing for people in the same classes of income, as well as being skewed, so that the higher your income, the more proportionately you benefit from this particular tax benefit.

The CHAIRMAN. I happened to lead the charge myself to enact the earned income credit to say if these people you are talking about making $3,000 or less by any peradventure of doubt paid any tax whatever, we would in effect give it back to them through a payment out of the Treasury. This 14 percent group here that you are speaking of with incomes of less than $3,000 is benefiting not only from the earned income credit—which I don't see on your chart, by the way—but they are also benefiting from about every benefit program other than the one you have mentioned here, such as the food stamps, the welfare programs, or unemployment insurance. I am not saying all unemployment benefits are handouts, but to the extent that they are paid for a full year when a person works for only 3 months, that is getting very generous. If you look at all the things we are doing for low-income people, they are not being treated as badly as you might suggest.

I would like to do more for them, especially if we could relate the benefits more to their working.

Ms. DOLBEARE. I am looking at this from my 20 years of experience in housing. It may be a narrow perspective, but it seems to me the vast majority of people in this income range have critical housing problems. The vast majority of them either do work or have worked most of their lives and are now too old to work. I am not in any way meaning to imply that you are any less concerned than I am.

The main thrust of this is, I think, that in housing we need to look at the totality of what the Federal Government is doing or is trying to do in housing. I think that a total housing program, where most of the subsidies go to people with incomes above $20,000, when clearly people with incomes below $20,000 need assistance most, needs some kind of very critical reexamination.

The CHAIRMAN. I appreciate what you have said and I hope that we can just understand that we both have a concern for these less fortunate people. I want to help them just as much as you do, but I don't think it would help them just by making invidious comparisons as though we did somebody some favor that he would not be able to demonstrate sufficient gratitude for before the good Lord calls him home.

I will put a chart in the record that I first used some time ago in arguing for the earned income credit to help these same low-income

people you are talking about. The chart shows that for those whose income is under $1,000, if you look at what they paid to the Federal and State governments as a group, it totaled 44 percent. But if you look at the transfer payments that they received from Federal and State governments, it amounted to 126 percent of that, for a net tax of minus 83 percent measured against income.

When you separate out the working poor—rather than those who are living on social security, welfare, various disability benefits, or unemployment insurance—when you look at those who are actually working, you can say those people were really entitled to a better break than they were getting, and that is what we voted for, and we try to take better care of those.

I for one want to help all these people for whom you have a laudable concern. I don't think we are going to be able to help them very much through the tax system, because they paid so little taxes—to the point where we have given them in transfer payments amounts which exceed to one what they are paying in taxes as a group.

I think that if we are to help those people, it will have to be done by the appropriations route. I don't think it helps them to suggest that a person has done something wrong because he has been permitted to deduct the expense of a tax he has paid or interest he has paid. There is nothing wrong with that fellow. He is doing his part.

Ms. DOLBEARE. I did not mean to suggest that was wrong. I suggested a tax credit rather than a deduction which would benefit mainly the people in the income range of $10,000 to $20,000.

The CHAIRMAN. I would like to insert the chart I referred to in the record at this point.

[The chart follows:]

TAXES AND TRANSFERS AS A PERCENTAGE OF INCOME, 1965

[In percent]

Income class	Taxes		Total	Transfer payments	Taxes less transfers
	Federal	State and local			
Under $2,000	19	25	44	126	[1] −83
$2,000 to $4,000	16	11	27	11	16
$4,000 to $6,000	17	10	27	5	21
$6,000 to $8,000	17	9	26	3	23
$8,000 to $10,000	18	9	27	2	25
$10,000 to $15,000	19	9	27	2	25
$15,000 and over	32	7	38	1	37
Total	22	9	31	14	24

[1] The minus sign indicates that families and individuals in this class received more from Federal, State, and local governments than they, as a group, paid to these governments in taxes.

Source: Joseph A. Pechman, "The Rich, the Poor, and the Taxes They Pay," the Public Interest, November 1969. The data are from the Economic Report of the President, 1969, p. 161.

Herman Miller, "Rich Man, Poor Man," p. 17.

The CHAIRMAN. Even though we have the forbidding name of Senate Committee on Finance, that does not mean that we are not interested in the poor. I think our record is pretty good in that respect. While my concern is not quite perhaps the same as yours, it does extend to poor people.

Thank you very much.

Senator HARRY F. BYRD, JR. You mentioned these should be credits instead of deductions. Would this be the way you would envision it,

the homeowner with say $6,000 of interest payments, instead of taking that as a deduction from total income you would use that as a credit against whatever taxes paid?

Ms. DOLBEARE. Not the total amount, but an amount up to a ceiling. I have suggested a ceiling of $200. Maybe it should be $300 or $500. You could deduct that from your tax. It would benefit people in the lower income range where the amount does not get up as high as $6,000 just as much as the person in the higher income range can afford to spend roughly $6,000 for those privileges.

Senator HARRY F. BYRD, JR. If you have a $200 ceiling on interest payments I don't see how any person could afford to build a house. If you don't permit any of that interest to be deducted, I don't see how they could buy a house.

Ms.. DOLBEARE. This is why we have to look at the problem as a whole. In rural areas, such people who need Farmers Home financing with interest credits. Many of them are being forced to buy mobile homes because the FmHA credit is not available. To make it possible for them to afford to purchase, it seems to me you need a direct lending mechanism with some kind of subsidy. I agree with you that people can't afford to pay interest rates of 6, 9, 10, 12 percent, but I think we need a direct approach rather than an indirect approach.

Senator HARRY F. BYRD, JR. Thank you very much.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. I have no questions.

The CHAIRMAN. Senator Dole.

Senator DOLE. I have no questions.

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. I have no questions.

[The prepared statement of Ms. Dolbeare follows:]

STATEMENT OF CUSHING N. DOLBEARE, EXECUTIVE SECRETARY, NATIONAL RURAL HOUSING COALITION

TAX SHELTERS AND TAX SUBSIDIES IN HOUSING

My name is Cushing Niles Dolbeare. I reside at 517 Westview Street, Philadelphia, Pa. I am a consultant in housing policies and programs. In that capacity, I was the author of a study of tax shelters for subsidized, limited dividend housing for the Rural Housing Alliance, "Federal Tax Rip-offs: Housing Subsidies for the Rich," published in 1972. I also chaired a special task force on taxation and the distribution of wealth and income in the U.S. of the American Friends Service Committee and the Friends Committee on National Legislation. I appear today as Executive Secretary of the National Rural Housing Coalition, a public interest organization concerned with the urgent housing needs of people who reside in small towns and rural areas.

Tax expenditures for housing dwarf direct federal expenditures

In 1949, Congress adopted the goal of achieving "as soon as feasible . . . a decent home and a suitable living environment for every American family." Major emphasis then, and since, has been placed on providing subsidies and incentives for private builders and investors to achieve this goal. The direct subsidies have been provided through programs of the Department of Housing and Urban Development and, in rural areas, through the Farmers Home Administration (FMHA) of the Department of Agriculture. The incentives have largely been provided through the tax system, through four major mechanisms: accelerated depreciation of rental housing, exclusion from income of interest on bonds used to finance public housing and state-financed housing; exemption of martgage interest on owner-occupied housing and exemption of local property taxes on owner-occupied housing. Added to this list of continuing incentives should be the one-time tax credit of $2000 for purchase of new homes. These,

and a number of lesser incentives, will total an estimated $13 billion this fiscal year. Both the magnitude and the rate of increase of tax expenditures for housing dwarf the direct housing subsidy programs of HUD and FMHA which total less than $4 billion.

Tax expenditures for housing will total almost $14 billion in Fiscal 1977, based on OMB and Treasury estimates:

HOUSING-RELATED TAX EXPENDITURES, 1977

[In millions]

	Individual	Corporate	Total
Deductibility of mortgage interest on owner-occupied homes	$4,710		$4,710
Deductibility of property taxes on owner-occupied homes	3,825		3,825
Financial institutions, excess bad debt reserves		570	570
Exclusion of interest on state and local debt (30 percent of total tax expenditure)	417	945	1,362
Tax credit for purchase of new home, as amended by Public Law 94-45	100		100
Depreciation of rental housing in excess of straight line	455	125	580
Expensing of construction period interest and taxes	570	1,065	1,635
Deferral of capital gain on home sales	890		890
Housing rehabilitation: 5-year amortization	40	25	65
Exclusion of capital gain on home sales if over 65	50		50
Total	11,057	2,730	13,787

Source: Table F-1, Special Analyses: Budget for Fiscal Year 1977.

The Budget for FY 1977 shows that tax expenditures for mortgage interest and property tax deductions are an estimated $8.5 billion, and direct housing subsidies are $4.3 billion.

The total housing subsidy system is perverse and regressive because of the impact of tax expenditures

Tables 1 and 2, attached to this statement, are an effort, necessarily crude because adequate data are not available, to analyze the impact and equity of major housing subsidy programs for this fiscal year. While the data are less than ideal, the methodology used tends to understate the regressive nature of our total housing subsidy system.

The results, wholly due to the impact of tax subsidies, are shocking:

The top 1% of the income distribution—people with incomes above $50,000—gets more than 10% of all housing subsidies. At least 90% of all families and individuals with incomes at this level receive housing subsidies through the tax system.

Only 7% of all housing subsidies go the 14% of the population with incomes below $3,000—although they have the most desperate housing needs. Less than one household in ten in this income range receives any housing subsidy, either directly or through the tax system.

The lower half of the income distribution gets only one quarter of all housing subsidies.

One basic reason for the inequity and perversity of the total housing subsidy system is that tax subsidies (credits, income exclusions, or deductions) may be claimed by all who qualify. In contrast, HUD estimated in 1973 that over 15 million households had incomes low enough to qualify for subsidized housing, but such housing was not available. Moreover, tax subsidies continue indefinitely, whereas direct subsidies have been curtailed by both Congress and the Administration.

Last year the Treasury Department, at the request of Senator Mondale, estimated the distribution of tax expenditures by income class. These figures, for 1974, appear in the June 2, 1975 Congressional Record at pages S9173–77. Table 3, showing housing-related tax expenditures in 1974, is drawn from this source. Briefly, it shows that housing-related tax expenditures totalled $9.7 billion, or 16.6% of all tax expenditures $58.2 billion).

Housing-related tax expenditures benefit low and moderate income people even less than over-all tax expenditures. The 1974 figures show that 16.6% of all tax expenditures went to taxpayers with incomes below $10,000, but this income group received only 6.9% of the housing-related expenditures.

Selected housing-related tax expenditures are particularly perverse. People with incomes above $50,000 received more than one-third of the benefits of excess

depreciation, more than three quarters of the benefits of rapid rehab amortization and almost nine-tenths of the benefits of exclusion of interest on state and local bonds.

Middle-income taxpayers were major beneficiaries of the deductions for mortgage interest and property taxes. People with incomes of $10,000–20,000 received 41.5% of the mortgage interest expenditures and 33.3 percent of the property tax expenditures. If these deductions are repealed, some substitute subsidy program will have to be invented, or many middle-income home owners will either be forced to move or the increase in their total housing costs would force them to curtail other expenditures.

Substitution of a tax credit of not more than $200 for the current tax deduction would keep the level of tax subsidy to this income group relatively constant, but it would lower the total cost of tax subsidies and make their distribution more equitable.

ESTIMATED IMPACT OF SUBSTITUTING A TAX CREDIT OF NOT MORE THAN $200 FOR TAX DEDUCTION OF MORTGAGE INTEREST AND PROPERTY TAXES

Income class	1973 expenditures		Equivalent tax credit of up to $200	
	Dollars in millions	Percent distribution	Dollars in millions	Percent distribution
Under $3,000	$2.6	0.03	$16.1	0.3
$3,000 to $5,000	31.2	0.4	98.0	1.9
$5,000 to $7,000	130.6	1.6	269.2	5.3
$7,000 to $10,000	538.8	6.8	800.0	15.8
$10,000 to $15,000	1,307.9	16.5	1,472.0	29.1
$15,000 to $20,000	1,675.3	21.1	1,137.6	22.5
$20,000 to $50,000	3,274.3	41.2	1,138.0	22.5
$50,000 to $100,000	982.8	8.7	95.8	1.9
Over $100,000	289.0	3.6	23.6	0.5
Total	$7,943.6	100.0	$5,050.3	99.9

Substituting a tax credit for tax deduction of mortgage interest and property taxes would be a step toward greater equity. But, as this illustration shows, such a tax credit would lead to expenditures double those for direct subsidies for low and moderate income housing—for an income group with far less critical housing needs. Yet efforts to increase housing subsidies for low income people have found little Congressional support because of their cost. Substitution of direct subsidies, at the level needed to achieve our national housing goal, for the indirect subsidies of the tax system would be more straightforward and would require more careful analysis of the true level of housing needs and the true costs of meeting them.

The hidden costs of other housing-related tax expenditures

The cost of excess depresiation, above straight-line, for rental housing is estimated this year at $550 million.

In contrast, HUD's 1976 budget request estimated outlays for rental housing subsidies (other than low-rent public housing) at $465 million. To put it another way, only 46% of federal expenditures for rental housing are accounted for by HUD payments; the remainder is a tax expenditure. One-third of this tax expenditure goes to people with incomes above $50,000.

OMB's tax expenditure estimates for 1976 show a total of $4.8 billion as the cost of excluding interest on state and local debt. In 1973, HUD estimated that 36 percent of the total subsidy cost of low-rent public housing was accounted for by exclusion of interest on the bonds financing public housing projects. If this relationship still holds, the 1976 figure is approximately $1.4 billion. This compares with $1.7 billion in direct payments by the federal government to local housing authorities. In other words, 45% of the direct and indirect federal cost of public housing is in the form of tax expenditures, and almost 90% of this subsidy goes to taxpayers with adjusted gross incomes over $50,000. For each dollar of public housing subsidy to a low income person, a rich taxpayer gets a deduction of 90¢.

There is a tax subsidy of $95 million this year for 5-year amortization of rehabilitation costs of moderate income rental housing. In 1974, this expenditure amounted to $50 million, and 76% went to people with incomes above $50,000. In contrast, Congress annually attaches a rider to the Agriculture Appropriation

Act effectively prohibiting implementation of a Farmers Home Administration program to make rehabilitation grants to low income rural-home owners.

Current Tax Law is Both Bad Tax Policy and Bad Housing Policy

There are cheaper and better substitutes available for all of the major housing-related tax expenditures. Credits or direct subsidies could accomplish the social purpose of the mortgage interest and property tax deductions.

Direct lending by the federal government would clearly be a surer and less costly way of providing financing for rental housing than is the tax incentive of excess depreciation. Legislation is pending to provide this step and for direct lending to finance low rent public housing as well. Programs, though inadequately funded, are already enacted to provide for housing rehabilitation.

We urge that tax legislation and expenditures be given the same careful scrutiny, on an annual or bienial basis, that is given to substantive housing legislation and appropriations. Specifically, we urge that the Finance Committee strengthen the legislation dealing with real estate tax shelters and limitations on artificaial losses adopted by the House, and that you give serious consideration to proposals, such as that introduced by Senator Hathaway, to substitute tax credits for mortgage interest and property tax deductions.

TABLE 1.—APPROXIMATE DISTRIBUTION OF FEDERAL HOUSING SUBSIDIES BY INCOME CLASS, 1973

Income class	Families and individuals	Tax subsidy recipients	LMI [1] subsidy recipients	Total recipients	Subsidy recipients as percent of total families and individuals
Under $3,000	$10,297,000	$112,000	$642,000	$754,000	6.7
$3,000 to $5,000	8,385,000	490,000	474,000	964,000	11.5
$5,000 to $7,000	7,523,000	1,436,000	428,000	1,864,000	24.8
$7,000 to $10,000	10,688,000	4,000,000	227,000	4,227,000	39.5
$10,000 to $15,000	15,955,000	7,360,000	25,000	7,385,000	46.3
$15,000 to $20,000	9,838,000	5,688,000		5,688,000	57.8
$20,000 to $50,000	10,023,000	5,690,000		5,690,000	56.8
Over $50,000	606,000	597,000		597,000	98.5
Total	73,313,000	25,326,000	1,796,000	27,122,000	37.0

Note.—This approximation comes from a variety of sources, not strictly compatible with each other. The number of families and individuals is the total shown in "Money Income in 1973 of Families and Persons in the U.S.", Current Population Reports; Income distribution of tax subsidy recipients from table in appendix to 1974 National Housing Goals Report; Income of low and moderate income housing subsidy recipients from information in HUD's Housing in the Seventies. The point is clear and incontestable: the majority of housing subsidy recipients have incomes above $10,000 and, roughly speaking, the higher one's income, the more likely one is to receive a subsidy.

[1] LMI = low and moderate income.

TABLE 2.—ESTIMATED AMOUNT OF FEDERAL HOUSING SUBSIDY, BY INCOME CLASS, FISCAL 1976

Income class	Tax subsidy (millions)	LMI [1] subsidy (millions)	Total subsidy: dollars in millions	Total subsidy: Percent	Income distribution (percent)
Under $3,000	$3.7	$928.2	$931.9	6.7	14.0
$3,000 to $5,000	44.6	686.4	731.0	5.2	11.4
$5,000 to $7,000	186.8	618.8	805.6	5.8	10.3
$7,000 to $10,000	770.5	327.6	1,098.1	7.9	14.6
$10,000 to $15,000	1,870.3	36.4	1,906.7	13.7	21.8
$15,000 to $20,000	2,395.7		2,395.7	17.2	13.4
$20,000 to $50,000	4,682.2		4,682.2	33.5	13.7
Over $50,000	1,405.4		1,405.4	10.1	.8
Total	11,359.3	2,600.0	13,957.3	100.1	100.0

[1] LMI = low and moderate income.

Note.—This table rests on some unreliable assumptions, and is illustrative only. The tax subsidy assumes that the distribution of tax subsidies in 1976, by income class, is the same as in 1973, although the amounts are larger by 43 percent (the increase from 1973–76). The housing subsidy assumes that the $2.6 billion in low and moderate income housing subsidies is distributed proportionate to the number of households served by subsidy programs in 1973—again, unreliable, but no better data are available. Finally, the income distribution is assumed to be that of families and individuals in 1973, for lack of better data. Nonetheless, the major conclusion—that the lower half of the income distribution gets only a quarter of total housing subsidies—is not far off the mark. Nor is the conclusion that the top 1 percent get 10 percent of subsidies.

TABLE 3.—1974 HOUSING-RELATED TAX EXPENDITURES, BY ADJUSTED GROSS INCOME CLASS

Adjusted income class	Taxable returns	Total tax expenditures	Mortgage interest	Property taxes	Excess depreciation	Interest exclusion [1]	Rehab amortization	Total housing	Housing as percent of total [2]
				Dollars in millions					
Under $3,000	4,057	$1,085		$1	$2		$2	$5	0.5
$3,000 to $5,000	7,579	1,738	$13	24	6			43	2.5
$5,000 to $7,000	8,273	2,357	52	66	10			128	5.4
$7,000 to $10,000	11,428	4,403	265	221	21	$0.3		507	11.5
Subtotal	31,337	9,583	330	312	39	.3	2	683	7.1
$10,000 to $15,000	15,952	8,875	886	583	42	1.2	2	1,514	17.0
$15,000 to $20,000	9,856	8,881	1,133	771	38	6.6	2	1,951	22.0
Subtotal	25,808	17,756	2,019	1,354	80	7.8	4	3,465	19.5
$20,000 to $50,000	9,006	17,414	2,078	1,774	128	29.4	6	4,015	23.0
$50,000 to $100,000	665	6,116	348	407	80	116.7	14	966	15.8
Over $100,000	160	7,306	95	213	48	163.8	24	544	7.4
Subototal	825	13,422	443	620	128	280.5	38	1,510	11.2
Total	66,966	58,175	4,870	4,060	375	318.0	50	9,673	16.6
				In percent					
Uhder $3,000	6.1	1.9		0.02	0.5		4	0.05	
$3,000 to $5,000	11.3	3.0	0.3	.6	1.6			.4	
$5,000 to $7,000	12.4	4.1	1.1	1.6	2.7			1.3	
$7,000 to $10,000	17.1	7.6	5.4	5.4	5.6	0.09		5.2	
Total	46.9	16.6	6.8	7.7	10.4	.09	4	6.9	
$10,000 to $15,000	23.8	15.3	18.2	14.3	11.2	.4	4	15.7	
$15,000 to $20,000	14.7	15.3	23.3	19.0	10.1	2.1	4	20.2	
Total	38.5	30.6	41 5	33.3	21.3	2.5	8	35.9	
$20,000 to $50,000	13.4	29.9	42.7	43.7	34.1	9.2	12	41.5	
$50,000 to $100,000	1.0	10.5	7.1	10.0	21.3	36.7	28	10.0	
Over $100,000	.2	12.6	2.0	5.2	12.8	51.5	48	5.6	
Total	1.2	23.1	9.1	15.2	34.1	88.2	76	15.6	

[1] 30 percent of total for all tax exempt bonds. [2] Percent of total tax expenditures.

Source: U.S. Treasury tables prepared for Senator Walter Mondale, CR June 2, 1975, pp. S9173-77.

The CHAIRMAN. Next we will call Mr. Don Lawrence, president, National Apartment Association accompanied by John C. Williamson, general counsel.

STATEMENT OF DON LAWRENCE, PRESIDENT, NATIONAL APARTMENT ASSOCIATION; ACCOMPANIED BY JOHN C. WILLIAMSON, GENERAL COUNSEL

Mr. LAWRENCE. Mr. Chairman, members of the committee, I appreciate this opportunity today to testify on behalf of the National Apartment Association in regard to certain pending tax reform provisions which affect the apartment industry.

Before going into the specific changes we are proposing, I would like to comment on the widespread fiction emanating from some congressional sources and in the Nation's press that the real estate section of the tax reform bill had been whittled down to a pile of sawdust as one feature writer described the situation recently in a local newspaper. Actually, there are provisions in the bill which, if enacted, could have a serious impact on the apartment industry which is truly a depressed industry. Indeed, there is ample justification for this committee to reject for the time being any tax reform provision which constitutes a disincentive to investment in an apartment project.

Nevertheless, I will address myself to some specific provisions and convey our thoughts as to whether they should be retained in the bill.

While we cannot deny that there is some merit in the limitations on artificial accounting losses (LAL) as approved by the House, there are more compelling reasons to strike it from the bill. These reasons are: (1) the present depressed state of the rental housing industry; and (2) the decision of the Treasury Department, as expressed in testimony before this committee on March 17, that even the modest version of LAL in the House bill should not apply to the oil and gas industries.

We have nothing against the oil and gas industries, but LAL's principal, if not sole, claim to validity rests on its even application to all sectors of the economy involving investments that may generate so-called artificial accounting losses.

I might add we disagree that the deduction of construction interest, for example, is an artificial accounting loss.

If some industries are exempt from LAL and others are partially exempt, then the remaining victims, such as real estate, suffer an erosion of their relative position in the private investment market. When one realizes that real estate is already a residual receiver of funds in the capital markets, as evidenced by its current depressed state, the application of LAL to real estate, under the circumstances outlined by the Treasury, stands out as a gross act of discrimination.

It certainly cannot be justified as part of a tax bill which is hailed as an instrument for restoring fairness and integrity to our tax system.

A further example of the Treasury's discriminatory approach to rental housing is set forth in its job-creating tax incentive proposal

for rapid depreciation for business in areas where the unemployment rate exceeds 7 percent. The Treasury excludes rental housing because of stimulants administered by the Department of Housing and Urban Development. These stimulants represent subsidies whose effectiveness in reviving the multifamily industry is questionable and whose cost to the taxpayers is astronomical. Our industry is not asking for this tax incentive although the unemployment rate in the building trades presents a compelling argument for its application to the construction of rental housing. Nevertheless, the exclusion of rental housing from the Treasury's plan makes it imperative that present tax laws are not converted into disincentives for the construction of needed housing.

I want to emphasize that our position against LAL does not mean that we believe that everything is perfect in our tax system and its application to our industry. We must concede that the so-called tax shelter as it operates in our business does, in fact, result in situations where taxpayers with substantial economic income pay little and sometimes no Federal taxes.

The remedy is in a revised and equitable minimum tax, or in a minimum taxable income (MTI) as proposed by the Treasury in its March 17 testimony or as advanced by several of our allied groups before the House Ways and Means Committee. Because we have not had sufficient opportunity to study the Treasury's MTI, we ask permission to file a supplemental statement in the near future on this proposal.

THE MINIMUM TAX

While we recommend an abandonment of LAL along with the harsh minimum tax approved by the House, and the substitution of a minimum taxable income, we would like to discuss some inequitable aspects of the minimum tax as set forth in H.R. 10612.

The House bill would crank into the minimum tax formula the elements of LAL which are referred because of the need to construct more rental housing during the next few years.

If excess depreciation and construction period interest and taxes are offset against unrelated income because of the deferred effective dates, they become items of tax preference, and are subject to the 14-percent surcharge.

We believe this double play is inequitable and should be stricken from the bill. The ingredients which make up LAL should not be considered as items of preference under the minimum tax formula. We agree with the Treasury that this action is conceptually unsound, and we concur in HUD's and the Treasury's belief that this double play can have an adverse effect on real estate development. We reiterate our opposition to LAL and recite this inequity as additional evidence of a discriminatory approach to real estate in this tax reform bill.

We also recommend two additional changes in the minimum tax formula, should this be the method adopted by the committee, to assure that all high income individuals assume a fair share of the tax burden. First, we believe that the taxpayer should be able to subtract Federal income taxes paid from the sum of preferential items. The minimum tax was designed to make certain that everyone

paid some taxes. Denying the right to subtract taxes paid converts the minimum tax into an added tax or surcharge.

We also recommend that the nonrecognized portion of capital gains be eliminated as a preferential item subject to the minimum tax. Capital gains is taxed with rates as high as 35 percent. The minimum tax had its genesis in a desire to make certain that people with substantial incomes paid some taxes. Therefore, including capital gains, which is already taxed as a preferential item, makes it evident that the purpose is to indirectly increase the capital gains rate. We respectfully submit that this does violence to the basic purpose of the minimum tax; and capital gains should therefore be eliminated as a preferential item.

We strongly endorse the Treasury's recommendation of a sliding scale approach for the taxation of capital gains and losses. Under this proposal capital assets held for more than 1 year and less than 5 would result in half of the gain taxable at the normal rate. For property held more than 5 years and less than 25, the percentage of gain taxable at the normal rate would be reduced by 1 percent per month, so that property held 25 years or more would result in 30 percent of the gain taxable at the normal rate.

RECAPTURE OF EXCESS DEPRECIATION

The House-approved tax reform bill provides for total recapture as ordinary income of depreciation deductions, in excess of straight line, taken on property after December 31, 1975, regardless of the date the property was constructed or acquired. This would introduce a retroactive feature in the tax code. We strongly recommend that the total recapture of excess depreciation begin with respect to property acquired or constructed after December 31, 1975. In the interest of fairness, taxpayers should not be subject to a change in the rules in effect when they acquired the property.

REHABILITATION OF RENTAL HOUSING

We support Section 102 of H.R. 10612, which would extend the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing. The bill increases the amount of rehabilitation expenditures, that can be taken into account per dwelling unit for purposes of the special 5-year depreciation, from $15,000 to $20,000. Because of the timelag in planning major rehabilitation, we recommend that this provision be extended for 5 years instead of 2 as provided in the bill. Also, because the rehabilitation of our existing rental housing inventory looms as a vital element in the renewal of our cities and in stopping the ominous trend toward abandonment, we urge that consideration be given to extending this special depreciation provision to all rental housing.

In view of the per unit dollar limitation, including the deductions in LAL, or as preferential income in an MTI in lieu of LAL, and the recapture provisions of existing law, the benefits from such a provision far outweigh the temporary advantage that may accrue to the taxpayer. Certainly, it would provide an incentive for the preservation of our existing rental housing inventory, a goal of pronounced increasing national significance.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. I don't believe we have ever begun to consider how much revenue we are losing in the Government and even worse, how much income we are losing the American people by tax laws that discourage the kind of men who know how to make business succeed from fully employing their talents. When one gets a taxable approach in a 50-percent tax bracket, from that point on, a man spends more time trying to find some way of keeping what he made then he does employing his extensive talents to find out how to put these many people who want to be put to work and using these people to produce more income for the benefit of all concerned.

I hope we can depart from the concept that has been all too well expressed around here from time to time that the taxation system should work on the theory that you should only permit a man to keep after taxes that which the tax planners think he would require for his daily existence for food, clothing, shelter and a minimal amount of recreation.

Now, at a lower rate on very successful people, we can generate a great deal more revenue because they do just a great deal more. You only have to look at the boxing industry to see what happened when we put a 50-percent limitation on earned income instead of a champion putting his crown on the line once a year, he put his crown on the line anywhere from 3 to 4 times a year. So, at a 50-percent rate, you would make 3 to 4 times as much revenue as you would on a 70 percent rate on the same individual. I would like to hope those people are not in business entirely for the purpose of making revenue for the Government.

We have hardly scratched our potential to raise revenue from other sources. We don't have a value added tax here in this country. We have very few excise taxes other than those on gasoline. There are many other ways which would not be nearly as counterproductive as these wartime tax rates on individual incomes.

A proposal had been made—I have been reading some of the statements before they have been made by the witnesses and will be made for us by the Association for the Bar of New York City. I would suggest that your people obtain a copy of it and look at it. It may be available before they appear here. I think those people have made one of the most useful suggestions I have seen yet as to ways we could undertake to see that no one escapes paying a fair share of taxes and at the same time you would not destroy the incentive of the business people to devote their talents fully to the benefit of society as well as themselves. When you have had a chance to study that, I would like to know what your reaction is.

Mr. LAWRENCE. I will let you know, sir.

The CHAIRMAN. Senator Byrd.

Senator HARRY F. BYRD, JR. No questions.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. You made a reference to the Treasury discrimination and said you had a housing development stimulant. What was that?

Mr. WILLIAMSON. The current stimulant that we have now in the market is the $3 billion made available under the Brooke-Cranston

bill to buy 7½ percent mortgages. Since 1946, at least for 30 years, the Congress has tried to develop some mechanism to stimulate the multifamily housing industry and to help low- and moderate-income people obtain decent shelter. It has been a very difficult task. The trail is strewn with the wreckage of these programs. The costs were astronomical and the programs abandoned.

Senator PACKWOOD. Treasury said you had trade offs and you don't need LAL and some of the other incentives you need to extend to the business.

Mr. WILLIAMSON. We are not concerned so much about the tax laws; but the tax laws which have disincentives such as LAL if it were applied to some industries and not others.

Senator PACKWOOD. That is nothing much more than a credit allocation. We would be saying the gas or oil industry is more depressed so therefore we would give it to them.

Mr. WILLIAMSON. Yes, it is a form of credit allocation.

Senator PACKWOOD. Does your association represent those who construct apartment houses or just manage them?

Mr. WILLIAMSON. Both.

Senator PACKWOOD. I would have to do it by region. There are areas in the United States today where there is a dramatic shortage and there are some areas where there is not a shortage. There are still very few which are limited everyday but there are still some giveaway programs to rent apartments.

Basically and overall today, there is a shortage of apartments in the United States. The vacancy rates are dropping rapidly.

Senator PACKWOOD. But you say it varies substantially.

Mr. LAWRENCE. From city to city.

Senator PACKWOOD. Why should't we adopt the approach we would give LAL where we need to construct apartments but not other areas?

Mr. LAWRENCE. I feel in time we will not have the problem. The vacancy rate in all cities will be gone. I think within the next 8 to 9 months the cities now that have a vacancy rate, these apartments are going to be rented.

Mr. WILLIAMSON. For example, in Dallas-Fort Worth, the FHA or GNMA is not making available any of this 7½ percent money because there is an overbuilt situation in Dallas-Fort Worth but in 1 year that could be converted into a shortage.

Senator PACKWOOD. And the trend is down in the vacancy rate?

Mr. WILLIAMSON. The vacancy rates—there is a sharp drop in them and I think various shortages will be manifesting themselves in the next 12 months.

Mr. LAWRENCE. In the Los Angeles rate we have a vacancy of 1 to 2 percent.

Senator PACKWOOD. You are telling me with the trend down and this pressure coming on that apartments will still not be built without LAL?

Mr. WILLIAMSON. I think we are saying that LAL would have a delayed impact, a various delayed impact because there is a delayed effective date in the bill. But, yes, LAL would act as a disincentive to investment in real estate.

Senator PACKWOOD. You are saying without the deduction even though the market is going to be pressuring you and even though there are shortages, without the artificial losses, these apartments are not going to be built?

Mr. WILLIAMSON. The deduction of construction period in interest and taxes is not an artificial loss. That is a substantial deduction that if LAL were approved with the disallowance of the deduction on construction interest that this would be a disincentive. There would be less risk capital going into the apartment industry.

Senator PACKWOOD. If there is such a shortage and it is going to be so tight, then you have a natural LAL situation?

Mr. WILLIAMSON. The interest rates are high. Rents have not increased to keep up with increased costs. There is inadequate profitability. It is just a very risky business with a return not enough to encourage capital from going in.

Senator PACKWOOD. Why not? You are only faced with rent control in how many cities in this country?

Mr. WILLIAMSON. It is not that. The money is not there. The rents would have to be increased 20 to 30 to 40 percent to make it profitable.

Mr. WILLIAMSON. Yes. The costs of operating apartments are substantial and every time you increase the rent to increase costs, there is generally more and more pressure for rent control. You have it in some State or other in about 8 States and you never know when it will assert itself. Philadelphia rejected rent control last year but I think they have a new city council this year and will probably approve it. So, this is a very serious deterrent to people investing in apartment projects.

The FNMA has been developing a mortgage purchase program of conventional multifamily mortgages. I think they have already decided they would not buy a mortgage in any area that has rent control. So, it is a self-defeating proposition and a deterrent along with other factors. This is just one more deterrent.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Dole.

Senator DOLE. I have just two questions.

What extent do apartment builders depend on outside equity financing?

Mr. LAWRENCE. The estimated $20 billion, it would be probably $2 billion according to the Treasury figures.

Mr. WILLIAMSON. Treasury made a study of the impact of LAL and those are the figures that they gave us based upon 1974 construction of rental housing. It would affect about $2 billion out of $20 billion because corporations would not be involved, and you are only talking about the equity that is invested and the fact that a relatively small percentage would have no real estate related income. But it is substantial. It is about $2 billion out of $20 billion according to the Treasury.

Senator DOLE. What do you see as the impact on LAL because of the availability of such financing?

Mr. WILLIAMSON. We have done a lot of agonizing with the Treasury since it first broached the subject in 1973. I think the at-

tempt in the House of Representatives to have project by project LAL would be disastrous. The House modified it.

When you want to exempt certain industries or partially introduce other industries, you introduce a new note into LAL which would make it disastrous for real estate because it would impair real estate's relative position in the investment market.

Senator DOLE. You mentioned the sliding scale capital gains rate. How would that assist your industry?

Mr. WILLIAMSON. It would reduce the capital gains rate for property held for a long period of time. I think the Treasury proposal is a sound one. After the property is held for 5 years, for each year of the holding period, the amount of the gain taxable under the taxpayer's normal rate would be reduced 1 percent per month. I think it would act to unlock a lot of properties that were held for a long period because it would reduce the capital gains rates. I think it would be a meritorious proposal to gear the rates to the holding period.

Senator DOLE. What do you see as the purpose of the minimum tax?

Mr. WILLIAMSON. The minimum tax is to assure that everybody paid a fair share of the tax burden. I think it is a laudable purpose.

Senator DOLE. As I understand, you will file a statement in response to the administration's proposal?

Mr. WILLIAMSON. We would like to file one not just on the administration's MTI but also the proposal mentioned in the testimony of the National Association of Realtors.

The CHAIRMAN. Thank you very much for a very fine statement.

The next witness, Mr. John Hart, is still testifying before another committee on the House side. We will give him his chance to testify later on.

We will move on now to Mr. Wallace R. Woodbury, chairman, Tax Subcommittee, International Council of Shopping Centers. We are pleased to have you, Mr. Woodbury.

STATEMENT OF WALLACE R. WOODBURY, CHAIRMAN, TAX SUBCOMMITTEE OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. WOODBURY. Thank you, Mr. Chairman. I have with me Mr. Edward C. Maeder of the law firm of Winston & Strawn, our legislative counsel. I am a mortgage broker and a savings and loan executive although my primary activity is shopping center development.

We appreciate the opportunity to testify. We have an extensive written statement that we would like included in the record.

The CHAIRMAN. We will print your full statement in the record and then if you can excite us with what you say, we will go home and read all of your statement.

Mr. WOODBURY. The shopping center business is a capital intensive, high-risk business. We have very long lead times in developing shopping centers. A typical lead time is 1½ to 2 years for a neighborhood center, and anywhere from 3 to 7 years for a regional center. It is almost never less than 3 years before a developer gets started on a center.

We have many uncontrollable conditions present during the predevelopment stage where great sums of money are spent for predevelopment costs. We have the problem at all stages of development of applications for necessary permits being rejected because of governmental regulations. We are obligated to undertake with our own money expensive studies in the environmental area and elsewhere as a result of the many changes in environmental and land use laws the past few years. These governmental changes have greatly increased the front-end costs of developing shopping centers.

We have attached to our written testimony tables which show statistics on shopping center development which we believe will be helpful to the committee. The first table shows the development delays in 1976 caused by additional governmental red tape and other factors.

Next we show the increase in front-end expenditures, percentage wise, and in total cost that shopping center development has experienced in the last 5 years.

We include a study showing the reduction in construction by our members that would result from a measure which required them to capitalize construction interest expenses. The LAL provision would result in the capitalization of these expenses since that is the only real way out for those who would be affected by LAL. This study demonstrates that at least 26 percent of projected shopping center developments would be aborted because of the LAL provision.

We also have a table showing the slowdown in shopping center construction during recent years, and one showing the loan versus cost ratio that demonstrates the increasing amount of equity required to build shopping centers during the period from 1970 to 1974.

Also included is a table showing the net return per square foot on equity investment after debt service and before taxes which demonstrates the decline in internal capital generation in the shopping center industry.

We think this information will be helpful in explaining our present problems with a seriously deteriorating market for shopping centers.

To couple the House-passed tax proposals with the existing depressed economic situation in the shopping center industry would have a cumulative economic effect that would be catastrophic to our industry. As our survey shows, many shopping center projects would be aborted as a result of the House provisions.

The equity requirements for shopping center development would be dramatically increased. This would be far more of a problem for smaller entrepreneurs who currently have a difficult time in competing for capital with other types of investments and with corporations, institutions, and wealthier individual entrepreneurs. If the tax laws are changed as the House suggests, the smaller developers will be at an even greater disadvantage competing with these groups which are not affected by the LAL rules and the investment interest rule that is part of the current law.

We believe that the Treasury revenue estimates are invalid. I won't spend a lot of time on these estimates because the chairman has already elaborated on that subject.

However, we have attached to our testimony the analysis by Dr. Ture, which evaluates the direct effects on employment, investment,

and revenues as a result of the application of three major provisions of the House tax bill—LAL, the changes in the minimum tax, and the changes in the interest rules. This study shows a net revenue loss of $2.3 billion a year to the Federal Government instead of the $1.5 billion positive gain indicated by the Treasury figures.

The slowdown in development activity resulting from these three provisions would have a substantial adverse effect on employment. Dr. Ture's analysis shows that there would be about 221,000 fewer jobs in the real estate industry as the result of the application of these three provisions. The tax on the traditional deductibility of interest during the construction period is unwarranted. If interest is some sort of a tax shelter that should be attacked, it should be attacked across the board without the singling out of a particular industry. Construction period interest and taxes are real cash costs. There is nothing artificial about them.

As a premise, I think it is erroneous to single out construction preferences. They are a business interest expense of someone trying to develop shopping centers. They add nothing of intrinsic value to the property.

It is interesting to note that the LAL rules applied to real estate affect only individuals and not corporations. In fact, LAL would only apply to smaller individual entrepreneurs since wealthier individuals would not be affected because they could borrow money on other assets and take a deduction for the interest paid for that money since it would not be construction interest. Also, I cannot compete with a corporation that builds the same project as I do and can deduct its interest. Since as an individual, I cannot deduct the interest paid. My equity requirements would be increased 50 percent as a result of LAL, and I could not compete with corporations, institutions, and wealthier individuals.

The investment limitation provision that is in the law and which is made worse by the addition by the House of a $12,000 limitation is discriminatory against me as a smaller entrepreneur and as an individual. As is the case with LAL, this provision does not apply to corporations. The institutions and the very wealthy can avoid this provision in the same way they can avoid the application of LAL. They have enough other rental income property to shelter their interest expenses so they have no excess investment interest. This provision hurts the little man.

Both the LAL rule and the investment interest rule affect the smaller entrepreneur and not the corporations or the wealthy. This results in discrimination in the ability to attract capital generally and within the real estate industry.

With the high risks involved in the shopping center industry, it would be unconscionable not to permit aggregation. We feel the Treasury's most recent testimony recognized the need for aggregation and accepted our arguments for aggregation.

We could not be in the shopping center development business and take the high risks that exist during the early years of a project if we could not aggregate all our real estate-related income against our front-end expenses, that is, if we could not use the income from one

project to offset what we lose on a losing project. Many of our projects don't reach culmination although we have made major expenditures of money. Many of those which we do finish either do not result in a net profitable situation because they are never leased up enough to make them profitable, or they are not leased up for many years.

Our industry is in a depressed condition. We don't think any legislation should be enacted at this time which would increase the impact of taxation on this depressed industry and cause less construction and more unemployment.

We believe that if you want to tax more people, and if it is the individual who should be subjected to this change, the alternative minimum tax route that the chairman has discussed is by far the sensible way to go. It would not impact those people already paying a substantial tax, and it would make everybody pay a fair share of taxes We have included in our testimony the discussion of a measure that takes this route.

The CHAIRMAN. I am going to see that the best talent we have available to us will study these cost analysis prepared by Dr. Ture whom you employed because in your judgment he has fine credentials as an economist and has a profound understanding of our tax system and in my judgment has those credentials. This should be studied. We-ought to check it and cross-check it and we should also look at the secondary and tertiary effects. If these figures you have can be supported, then I find that this House measure insofar as the real estate industry is concerned to be an absolutely incredible proposal. Here is an industry where everybody in it has been going broke. We hope things will turn around and they will start making money for a change but here is a proposal just in case someone does make a little money somewhere along the line they want to be sure they take them anywhere from 50 to 75 percent and to be sure he does not have any incentive to go into-this industry.

You are saying without looking at the secondary and tertiary effect on your revenue alone the cost would be 280,000 and that is not looking at the fact that the carpenter loses a job and he has less money to spend down at the grocery store. He does not have the funds to go buy himself a boat to go fishing or enjoy it for recreational purposes or to go down to the bowling alley so those people have to cut back on their unemployment. That is just looking at what you can see for starters, a loss of $2.8 billion.

I just hope that we do not get ourselves into this counterproductive type thing where nothing more than intellectual arrogance that we think we know better what somebody should pay than somebody else would know, that we are going to tax this country into a first-class depression, bankrupt our Nation in the quest for tax uniformity.

It seems to me some things might be more important. I don't know of anything more important than putting 100 million Americans to work honestly and productively for the benefit of society and for the benefit of themselves and hoping that in doing so they will all pay a fair amount of taxes to the Government. If in the quest of

seeing it on a given dollar of income where it is real income or merely illusory income, we are going to try to build a monument to someone stealing which would put this country in a deep depression, and have literally millions of able-bodied American men who want nothing more than a chance to make an honest living among the ranges of the unemployed tax eater rather than taxpayers. I hope we are just not that foolish.

You can be sure we will study this very carefully. I hope that you will heed my advice and just because you happen to testify before four Senators who can understand what you are saying, don't assume by that that 100 Senators get the message. You may have to repeat this and people in your line of endeavor may have to take this statement and the evidence that can be used in support of it and see that those who did not attend the hearing, as well as those who are not on the committee, those who have benefitted from some of these novel tax expenditures that are being developed on some of these other committees are aware of these other problems as well.

Mr. WOODBURY. I have noticed statements by Senators in opposition to our position, and we include in our written testimony the statement of President Kennedy in one of his tax messages, when he was faced with a similar economic condition: "The chief problem confronting our economy in 1963 is its unrealized potential—slow growth, underinvestment, unused capacity and persistent unemployment." Although he proposed reform in some important areas of tax law, the Congress, at his urging, enacted a tax incentive—the investment credit—to stimulate the economy. And it worked.

Also, Senator Robert Kennedy, on the introduction of his housing bill (*The Urban Housing Development Act of 1967*, *Cong. Record* 18822–40 July 13, 1967), devoted most of his statement discussing the need for tax subsidies to get private capital to do the job of building low-income housing, because it was impossible to do it on a direct subsidy basis.

The CHAIRMAN. Thank you very much. These matters should be studied.

I was the manager of the bill that emerged from the speech that President John Kennedy made, when he contended that by reducing the wartime tax rates and by providing an investment tax credit, we could get the economy going again. He concluded it would cause the Government to have more revenues, not less revenues, if you did those things.

I think that when we repealed the investment tax credit, the disaster that it caused to the economy and Government revenues indicated the impact of that type of stimulus, which one might call a tax expenditure. Permitting a businessman to keep a fair amount of the earnings he makes brings in more revenue to the Government—certainly in the long run, and often in the short run. We have to give adequate incentive for businessmen to make an investment and take a chance. Senator Byrd.

Senator HARRY F. BYRD, JR. No questions.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. I have no questions.

Senator DOLE. You are talking to four of the members of this committee. We understand the problems in the House. We hope we can change those in November.

The CHAIRMAN. I hope that you can change a few people before November.

Senator DOLE. Do you mean a special election?

The CHAIRMAN. No, I honestly believe that when people are confronted with facts, especially when they hear them more times than one, it begins to get to them. I think everybody wants to do the right thing that is good for the country. If they have failed to do so, it was because they were poorly advised or they did not get proper encouragement.

Senator DOLE. I want to say very seriously there is that school of thought in the Congress—and I don't suggest it is bipartisan in any sense, and they may be perfectly and properly motivated but, at the same time, I think the Chairman spelled out some very difficult problems—if we are going to tax everyone who makes a profit, and that is what that seems to mean to some members, and there should be no profit making in this country, they are going to see to it, if they can, that it not be done—I have not read your entire statement —I can hardly lift it—that we have some minimum tax.

Mr. WOODBURY. We think now is not the time to hit the real estate industry at all, but if you feel there are some unfair situations with people escaping taxes, an alternative minimum taxable income provision would be the right approach. The House bill's revision of the minimum tax with the addition to the base of construction period expenses not disallowed under LAL, the increase in the rate to 14 percent, and the elimination of all exemptions, including the tax you are already paying, is ludicrous. I will buy municipal bonds myself and spend more time with my wife.

Senator DOLE. Wouldn't it be more serious at one stage on the House side? Weren't there some last-minute changes that gave you 2 years to go broke?

Mr. WOODBURY. They made it a little worse on the floor by eliminating the exemption for half of your taxes. In addition, they have a $20,000 exemption which disappears when you have $40,000 in tax preference items. This provision requires the payment of additional taxes with no basis for adjustment. Accelerated depreciation is one of the preference items, and it is seldom recapturable under the recapture rules. However, this provision allows for the payment of taxes through recapture. If they don't catch you under LAL, they catch you under the minimum tax.

The CHAIRMAN. I don't believe you could find as many as 70 Senators who would vote to do the type of thing you are testifying to that we find in the House bill if they heard the testimony I am hearing before this committee.

We are all very busy and very few Senators are going to find time to read all that is in these hearings. People like yourself are going to have to do something to get Senators to fully inform themselves of what is going on. I know how it was when I was a junior member of the Finance Committee, I was busy somewhere else. The Senate is in session right now. Theoretically, Senators should all be

over on the Senate floor. Then you go to the Senate floor—if you are a businessman and you are hoping at that time the chairman or some member of the committee will explain the problem you have, only 5 Senators are there. The only chance a businessman has is to get a list of all the Senators who did not hear his statement and did not hear the debate on the floor and head down the hall tapping on doors to see if he can get somebody to at least hear about the mistake they are getting ready to make.

In view of the fact that he is not a constituent from their State, they don't have time to bother with him. The only answer to that is to get a delegation from that Senator's State to tap on his door. Most Senators have enough political wisdom to listen to their own constituents.

Senator DOLE. He may be out in his own State.

The CHAIRMAN. Then catch him there.

The point is that assuming what you say here is basically correct, and I believe it is, people like you can't depend on just a few of us who hear your testimony before the committee getting through to all of our colleagues. There used to be a time when you could, but I regret to say you are going to have to do more to save yourself than was the case in earlier years. In earlier years, there was a time when a committee like this one would hear a presentation and if you could prove that what someone was trying to do to you was very bad and counterproductive, you could pretty well count on the Senate going along with the committee. But that is not the case any more. We find people who feel their judgment is so far superior to everyone else's that their judgment should be followed, people who shout "tax reform" and "tax expenditures" and that type of thing. Sometimes it is very hard to overcome that in the Senate, just as it is the House.

Thank you very much for your presentation.

[The prepared statement of Mr. Woodbury follows. Oral testimony continues on p. 541.]

STATEMENT OF WALLACE R. WOODBURY, FOR THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

SUMMARY OF COMMENTS

The adoption of the LAL, minimum tax and interest deduction limitation provisions of the House Bill would clearly result in a substantial reduction in real estate development including new shopping centers. This would have a ripple effect across the economy that would produce substantial unemployment in the construction industry and other related professions and businesses.

The consequences of this slowdown would be higher rents and consumer prices, a substantial outflow of investment capital from the real estate market, and a reduction in the availability of consumer marketplaces. Thus, the reduction in real estate development would reduce the demand for manufactured goods and severely diminish the effectiveness of the current and proposed investment credit incentives.

Norman B. Ture, Inc., economic consultants, studied the economic and tax revenue effects of the adoption of the House Bill's LAL, minimum tax and interest deduction limitation provisions and determined that their adoption would result in a loss in the real estate industry of $5 billion in investment, 8.8 billion in GNP, and 221,000 jobs. The net effect on federal revenues would be a loss of $2.2 billion.

In addition, the adoption of these House passed provisions would discriminate against, and effectively eliminate, investment in shopping centers by smaller,

noncorporate entrepreneurs. This would force the shopping center industry and other income property development into the hands of large corporations to which LAL does not apply and institutional and extremely wealthy investors who build for cash without borrowed money.

The chairman and others have suggested an alternative minimum taxable income approach in lieu of the House adopted provisions. ICSC finds this approach far more reasonable than that taken by the House. We suggest that such a proposal should include the following:

Under the minimum taxable income proposal, the taxable income of an individual having tax preferences would be determined as the greater of:

(1) The taxable income determined in accordance with existing tax law, or

(2) Fifty percent (50%) of the sum of taxable income (or net loss) determined in accordance with (1) plus all tax preferences (those of the current year plus carryovers less a deduction for tax preferences disallowed in prior years).

(3) The excess, if any, of the individual's income determined in accordance with (2) over the income determined in accordance with (1) (representing currently disallowed tax preferences) would be carried over as a deduction in subsequent years.

All tax preference items should be grouped for this purpose. Thus, all present law tax preference items plus other tax preferences currently escaping taxation would be added to the taxpayer's taxable income.

This proposal is an alternative to the minimum tax and the investment interest limitation provisions of present law and the several LAL approaches being considered. The approach will substitute for existing tax provisions a more intensive approach, much simpler to administer than the existing provisions and the LAL approaches agreed to by the House.

The President in his State of the Union Message proposed a short-term program to encourage new development by permitting certain properties to accelerate depreciation by adopting a shorter useful life (H.R. 11854).

We applaud the recognition that incentives are needed to encourage development in the current difficult economic climate, and such recognition underscores the inadvisability of new tax provisions that would discourage development and would discriminate heavily against smaller entrepreneurs.

However, it is difficult to evaluate whether the Administration proposal would be useful because of the uncertainty as to the additional tax impact of new tax provisions which might more than offset any advantages, and the very short qualifying term which is substantially less than the front-end time necessary to place and program major projects such as shopping centers.

Until these questions are answered it is difficult to take a definitive position in regard to the President's proposal.

STATEMENT

I. Introduction

Mr. Chairman and Members of the Committee:

My name is Wallace R. Woodbury. I am a Salt Lake City, Utah, based real estate broker, mortgage broker, attorney, and a non-corporate developer and operator of shopping centers.

I am a Trustee of the International Council of Shopping Centers and I appear today on behalf of its members. The ICSC is a business association of more than 5,000 members. About 60-percent of its members develop and/or own shopping centers. About 15 percent are retailers, who operate stores within shopping centers. Most of the developer-owner members own from two to four shopping centers each, and collectively have been responsible for most of the estimated 16,000 shopping centers in the United States. In addition, members include professionals who service shopping centers, and other individuals and business firms involved directly or indirectly in the financing, development, ownership, or operation of shopping centers.

New shopping center construction has traditionally involved investment of over $6.6 billion per year for building, stores, fixtures, and equipment. It is estimated that shopping centers provide regular employment for more than 5,000,000 sales and store personnel and that hundreds of thousands more are engaged in the construction end of the business. The rippling effect on employment in related professions and businesses, among them law, architecture, engineering, display, advertising, maintenance and cleaning, and the manufacture of goods used in construction of and goods sold in the centers, is considerable.

Shopping centers have a significant influence on the total economy. It is estimated that, after adjusting for such non-shopping-center-type retail activities as sales of automobiles, gasoline, lumber and building materials, and fuels, shopping centers account for 44 to 48 percent of the remaining retail sales in the United States.

During the 1976-1980 time period, assuming a 1980 U.S. population equal to 222.8 million people and a real per capita disposable personal income equal to $5,298 (in 1974 dollars), there will be a need for an increase in the gross amount of shopping center retail space equal to 369.6 million square feet to satisfy consumer needs for retail goods and services.

It is my intention to talk about what some of the proposals before you would do, if enacted, to the economy as a whole and to the shopping center industry.

II. Construction Period Expenses

The impact of the proposed changes in the tax laws on the shopping center industry can best be understood if it is understood that new shopping center development is a high risk, capital intensive, and very complex business.

The development of a shopping center, from the time of its conception to final completion and opening, is a very lengthy process. The gestation period may run from one and one-half years to two years in the case of a neighborhood center, and from three years to seven years and sometimes longer, in the case of a larger center.

The development of a shopping center is also a highly complex task, requiring the expertise of people in such disciplines as law, engineering, city planning, economics, finance, retailing, leasing, environmental protection, and architecture.

Finally, the development of a shopping center, even before the construction phase, entails the expenditure of large sums of money for "front-end" costs with negligible chance of recovery if the project is not ultimately completed and successful. This front-end money is spent for many purposes, including the following:

(1) *Governmental approvals.*—In today's economy and social setting, the increasingly burdensome requirements for zoning, land use, and environmental regulatory agency approval from local, regional, state and federal authorities depends on the outcome of a series of studies the developer undertakes at his own expense and risk. Often governmental approvals are conditioned on extensive expenditures for environmental and land use purposes. A representative list of such studies has been developed by ICSC and it represents a massive commitment of time and resources by a developer.[1]

(2) *Financing requirements.*—A developer must show through extensive studies that there is a strong market need for the shopping center, that there exists, from high credit major tenants, a legally binding commitment to operate on the site, and that the project's proforma statement indicates economic feasibility. Having achieved these assurances, a developer's access to mortgage funds is further contingent upon achievement of viable leases with adequate credit at pre-projected rental rates.

(3) *Leasing.*—To generate major tenant(s) interest in the site, the developer must have extensive research studies and physical layout studies prepared. He must also forecast the center's fixed and operating expenses in order to determine the required minimum rent prices for the rentable space, and he must then lease enough of the retail space for sufficient terms of years at sufficiently high rental rates to secure a long-term mortgage loan.

(4) *Securing the site.*—The developer must tie up the land on an option or by some other means in order to provide time to gain necessary governmental approvals and to generate tenant interest in the site and insure that he can "deliver" the site on the closing of the deal.

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[1] *Site evaluation* in terms of soil erosion and subsoil conditions and the availability of municipal services and public utilities, to insure that the project is buildable and will not represent an undue burden to the local community.

Engineering studies to determine the need for on-site water runoff rentention and sanitary sewer and storm drainage systems.

Environmental studies to determine how the shopping center should be designed so as not to violate local, state and/or federal ambient air, noise, and water quality standards and to insure the protection of the area's other natural resources, including the public's need for open-space.

Economic and market studies to determine the shopping center's impact on the fiscal structure of the local municipality, the area's employment base, and the region's existing centers of retail activity.

Architectural and landscaping studies to provide for general aesthetic appeal, pedestrian safety, and the prevention of blighting influences.

Planning studies to insure that the shopping center conforms to applicable subdivision, zoning, and building ordinances, as well as the region's comprehensive land use plan.

A shopping center project faces a myriad of risks during the predevelopment and construction periods. These include, weather, labor availability and strikes, unexpected site conditions, zoning and title problems, uncontrollable cost increases, breakdowns in the delivery of supplies, and delays or failure to get governmental approval. In addition, the developer may face new competitive retail facilities in the market, and financial failures or delays in the opening of committed tenants.

ICSC has gathered information which shows that the degree and extent of unexpected delays among ICSC developer members whose shopping centers are scheduled for opening in 1976 is substantial.[2]

The financial risks in the life of a shopping center are greatest during the pre-development and construction stages. Income from the project is zero during this period and substantial cash expenditures for property taxes, interest and other carrying charges continue without let-up. Failure to achieve full occupancy at projected rental rates may cause years of operating losses. The exposure and individual liabilities involved run into millions of dollars. At the extreme, these risks and costs can send a developer into bankruptcy.

"Front-end" cash expenditures are absorbing an increasing share of the total cost of shopping center projects.[3] For instance, construction period interest and financing costs were seven percent of the total cost (including land acquisition) for regional centers opened in 1974, and only 3.2 percent for regional centers opened during the 1968–1970 time period.[4]

The cash outlays for capital items such as environmental and other governmental permits, market and traffic surveys, and other overhead and development costs went from an estimated 2.1 percent of total capital cost to an estimated 6.7 percent, during the same time period.[5]

[2] See the following table:

FREQUENCY AND DURATION OF DELAY IN CENTERS SCHEDULED FOR 1976 OPENING

Size of center (GLA range)	Percent of centers delayed			
	Less than 6 mos	6 mos to 1 yr	1 to 2 yrs	Over 2 yrs
Under 100,000 ft²	4.2	14.3	4.2	1.2
100,000-300,000 ft²	4.3	14.0	4.3	1.1
Over 300,000 ft²	9.5	2.4	4.8	

Source: ICSC Research Department, based on a sample of 394 shopping centers.

[3] See the following table:

SELECTED "FRONT-END" EXPENDITURES AS PERCENT OF TOTAL CAPITAL COST FOR CENTERS OPENED IN 1974 AND DURING THE 1968-1970 TIME PERIOD (FOR CENTERS THAT CAPITALIZE THESE COSTS)

[Median percent]

Type of center (opening time period)	Interest and financing [1]	Other overhead and development charges [2]
Regional:		
1974	7.0	6.7
1968–70	3.2	2.1
Community:		
1974	4.5	4.0
1968–70	2.3	1.1
Neighborhood:		
1974	5.3	2.4
1968–70	5.0	(³)

[1] Includes interest during construction, loan fees, loan settlement costs, appraisal costs, and legal fees.
[2] Includes market and traffic surveys, zoning fees, outside accounting and auditing fees, real estate taxes, other taxes, insurance, advertising, other administrative costs. Deductible items under present law represent only a small portion of this category.
[3] Not available.

[4] Id.

[5] Id.

Source: Dollars and Cents of Shopping Centers, 1972, 1975, The Urban Land Institute (Washington, D.C.) pp. 282-283 (1975), and p. 190/6 (1972).

Burdensome environmental, land use, and OHSA regulations and other governmental requirements have substantially increased preconstruction period failures (there is no recovery of expended front-end funds) and the preconstruction period costs of completed centers. These increases thereby have substantially increased equity requirements for new shopping centers.

III. Deduction of Construction Period Expenses

A. Present Law

The present law permits the full deduction against current income of interest and property taxes incurred in connection with carrying real estate and constructing improvements thereon.

The present law also permits a taxpayer the election of capitalized interest and taxes paid during construction of a project, and the annual election to capitalize interest and taxes in regard to non-productive "investment" property. If such expenses are capitalized they become part of the cost of the property in determining depreciation deductions.

The present alternatives therefore permit either "up-front" deductions or deferred deductions; but either way in regard to construction period interest and taxes the taxpayer is entitled to the deduction and the only difference is timing.

One of the most important consequences of such deductions is to reduce equity capital requirements and to ease the financing of real estate development; that is, the actual equity investment required to develop real estate is lessened to the extent of the income taxes recouped by being able to deduct construction period interest and taxes. This, of course, encourages investment in real estate development and is a method for generating capital for the financing of such development.

B. Proposed Changes

There are various proposals for changing the current treatment of interest and taxes for development real estate and they all, in one way or another, and in varying degrees, either eliminate or penalize "up-front" deductions.

For example, the House Bill includes a limitation on the deductibility of so called "artificial accounting losses" (LAL) and would provide that for noncorporate taxpayers the interest and taxes attributable to the construction period, along with certain other deductions, cannot be taken as a current tax deduction except against current real estate related income. This effectively disallows the deduction unless there is otherwise taxable real estate income.

The adoption of LAL without "aggregation" (the aggregating of all real estate related income and expenses), as suggested by some, would result in the elimination of individual taxpayers from the development business.

C. Discriminatory Nature of LAL

The adoption of LAL would be discriminatory.

Construction period costs are real costs of investment and should be deductible just as similar expenses are deductible in other businesses. All interest payments, except on tax free bonds, have traditionally been deductible by all taxpayers.

Under the proposed law, interest during the construction period is treated as an artificial loss. Unlike accelerated depreciation beyond straight line, however, interest costs are a real loss—an actual cash loss.

The adoption of LAL without aggregation of income and expenses would be unconscionable and amount to confiscatory taxation. In no other area of business is investment treated in this fashion. How can a taxpayer be expected to share with the government his gains and not his losses? General Motors doesn't; a dealer in commodities doesn't. All corporations do, in fact, aggregate.

Without aggregation, a shopping center developer could actually find himself in the position of having two shopping centers: one very successful on which he pays heavy taxes, another on which he is actually losing cash (not "artificial deductions") but for which he can take no deductions. A noncorporate taxpayer could not afford to take this risk.

The adoption of LAL without aggregation would force the shopping center industry into the hands of large corporations to which LAL does not apply and institutional and extremely wealthy investors who build for cash without borrowed money. The small individual entrepreneur would be forced out of business and concentration in the indutry would be substantially increased.

D. Economic Impact of LAL on the Shopping Center Industry

The adoption of LAL will result in a slowdown in the development of shopping centers, and a significant increase in unemployment.

Limitations on the deductibility of construction period expenses would affect a large majority of the new shopping center projects being undertaken by ICSC members as indicated by a recent survey[6] (even though such tax provisions will apply only to noncorporate taxpayers), and the impact of such limitation on the development and operation of shopping centers would be serious.

The severity of this impact is indicated by a survey of ICSC members by Touche-Ross and Company[7] in which the reponse to the question, "what would be the effect on your company if federal tax legislation required all costs during the construction period to be capitalized?" was as follows:

	Percent distribution
1. Require higher rents	33.1
2. Continue to require the same return on equity	15.3
3. Accept slightly lower rate of return	4.8
4. Experience reduction in outside investiment funds	12.1
5. Experience reduction in development	26.6
6. Experience no effect at all	5.6
7. Other-unspecified	2.4
Total	99.9

The indicated results of such changes i nthe tax law—the higher rents, lower rates of return, reductions in investment funds and the reductions in the number of shopping centers developed—would serve to further depress an industry that is already suffering a downturn[8] with resultant adverse effects on employment.

The ultimate consequence would be to deny to a significant portion of our population much needed outlets for retail goods and services in the future.

Limitation on the deductibility of construction period expenses would increase significantly the equity required during the construction period. This is because the main source of equity capital in the shopping center industr yis cash flow generated by successful centers. In the shopping center industry, construction period deductions shelter the cash flow from successful centers and produce equity capital for development.

Without these deductions I estimate a 150 percent increase in the typical equity required for a noncorporate taxpayer to develop a center. A corporate competitor could justify identical rental rates without the increased equity investment.

Clearly without existing tax incentives, it would be difficult for a noncorporate equity investor in a shopping center project to earn a competitive rate of return, especially after taking all alternative risks into consideration.

Without expectancy of a minimum return commensurate to risk, nobody invests capital. We would be better served to liquidate our taxable assets and convert them into tax-free bonds—the ultimate loophole—rather than take the chance of having to absorb cash losses.

Reduced investment will cause a considerable slowdown in shopping center unemployment. The consequence of this will be a lower degree of market competition, higher tenant rents, and, in the short run, lower retail store profit margins (increasing the probability of tenant bankruptcies). In the longer run, higher tenant rents are likely to be passed on to the consumer in the firm of higher prices for retail goods and services.

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[6] A survey of 214 ICSC developer members having 793 shopping centers in operation and 339 shopping centers under development as of June 3, 1974. Prepared by Howard Kalkstein, ICSC Research Department, March, 1974.

[7] The Touche-Ross and Company's *Depreciable Life Study*, prepared for the ICSC, April 6, 1973.

[8] An F. W. Dodge Survey presenting annual data on shopping center construction (GLA) for the period 1970 to 1974 indicates the following:

Shopping center GLA construction:	*Percentage change*[1]
1971 compared to 1970	+15.9
1972 compared to 1971	+32.3
1973 compared to 1972	+8.4
1974 compared to 1973	−21.6
1975 relative to 1974[2]	−41.0

[1] F. W. Dodge.
[2] ICSC Research Department.

E. Capital Shortage

The reduction in the source of equity capital generated within the shopping center industry caused by LAL will occur at a time when the future development capital needs of the shopping center industry, and those of the non-residential development sector in general, cannot be fully met by today's primary market financial institutions (the commercial banks, life insurance companies, mutual savings banks, savings and loan associations, mortgage companies and mortgage investment trusts). An analysis conducted by the ICSC Research Department on the relationship between the 1970-1974 quarterly flow of construction loans (current dollar value of originations) for nonresidential properties[9] and the current dollar value of non-residential construction put-in-place[10] demonstrates that the dollar value of construction loans from these institutional sources of capital have been substantially less than the capital requirements of the private non-residential development community.[11] These statistics also demonstrate the continuing need for substantial equity capital in order to undertake new non-residential construction.

In addition, recent evidence[12] suggests that the internal liquidity of many new U.S. shopping center projects has deteriorated substantially when compared to

[9] *The Supply of Mortgage Credit 1970–1974*, U.S. Department of HUD (Washington, D. C.) October 1975; p. 110, Table 5-9.

[10] Construction Reports C30–745, U.S. Department of Commerce (Washington, D. C.) pp. 20-24, Table 3.

[11] See the following table:

DOLLAR VALUE (CURRENT) OF CONSTRUCTION LOAN ORIGINATIONS FOR NONRESIDENTIAL PROPERTIES AS A PERCENT OF THE DOLLAR VALUE (CURRENT) OF NONRESIDENTIAL PRIVATE NEW CONSTRUCTION PUT IN PLACE: 1970–74.

Year	Column 1, all buildings	Column 1 less industrial buildings	Column 1 less industrial and miscellaneous buildings[1]
1970	34.6	49.8	64.2
1971	42.9	56.6	72.1
1972	44.1	54.7	69.4
1973	50.6	65.4	81.6
1974	46.7	63.7	79.0

[1] Includes hospitals and institutions.

Note: The data in this table is for illustrative purposes only, to show that the developer cannot be expected to rely completely on primary institutional sources of capital during the development and construction stages for non-residential properties. Arnold H. Diamohd of the U.S. Department of Housing and Urban Development has raised similar issues with respect to residential properties. The Supply of Mortgage Credit 1970–1974, U.S. Department of HUD, pp. 123–132. Source: Ibid., ICSC Research Department.

[12] See the following table:

FUNDS AFTER DEBT SERVICE AND BEFORE INCOME TAXES (NEW CASH FLOW) FOR U.S. SHOPPING CENTERS, CLASSIFIED BY AGE AND TYPE: 1974 (DATA REPRESENT MEDIAN VALUES AND ARE IN TERMS OF CURRENT DOLLARS PER SQUARE FOOT OF GLA)

Type of center	Period center opened	Funds after debt service	Current period as percent of prior period
Regional[1]	1971–73(15)	$1.36	−15.0
	1968–70(25)	1.60	−10.1
	1965–67(16)	1.78	
Community[2]	1971–73(22)	.36	−16.3
	1968–70(13)	.43	−27.1
	1965–67(20)	.59	
Neighborhood[3]	1971–73(20)	.47	−32.9
	1968–70(21)	.70	−29.3
	1965–67(24)	.99	

Note: Data in parenthesis equal number in sample.

[1] Median total retail space equal to 546,500 square feet, with the lower and upper deciles equal to 308,935 and 840,654 square feet, respectively.

[2] Median total retail space equal to 153,500 square feet, with the lower and upper deciles equal to 79,500 and 271,000 square feet, respectively.

[3] Median total retail space equal to 52,000 square feet, with the lower and upper deciles equal to 24,300 and 101,000 square feet respectively.

Source: The Urban Land Institute, 1975 edition of Dollars and Cents of Shopping Centers, Section D, Fund After Debt Service; ICSC Research Department.

the older projects which have lower building costs, better financing arrangements, lower interest rates, lower land prices, and increasing overage rental income.

If the trend implicit in this evidence continues (and we strongly believe that it will), the shopping center developer could not rely on the internal cash flow from the more recent projects to provide for an increasing need of equity capital for future projects even if the current tax incentives are retained. Without them, of course, his capital problems will be even worse.

Thus, the capital shortage discussed before this Committee and elsewhere has begun to arrive for shopping centers.

F. The Impact of LAL on the Real Estate Industry in General

LAL would discourage investment in real estate, reducing the level in the number of people employed in real estate and the GNP originating in the real estate sector. Contrary to Treasury estimate, LAL (once implemented) would produce a negative change in federal tax revenues.

This conclusion has been reached after careful study by the economic staff of Norman B. Ture, Inc., Economic Consultants.[13] Specifically, Dr. Ture has concluded that real estate investment would fall by an estimated $1.7 billion and employment by an estimated 74,000 people. Associated changes in federal tax revenues are estimated at minus 0.9 billion.

IV. Minimum Tax

A. Present law

The current tax on preference items is now 10% of aggregate preferences to the extent they exceed income tax actually paid for the year in question (including a carryover adjustment from previous years) plus a $30,000 exemption.

B. Proposed Change

The House Bill would increase the rate to 14%, eliminate the offset for normal tax liability to be paid, and reduce the exemption to $20,000 subject to a further reduction on a dollar-for-dollar basis to the extent preferences exceed $20,000. This substantially eliminates all exemptions.

The House Bill would add to the "preference items" construction period expenses not disallowed under LAL. More than 92% of the revenues from the present "tax preference" provision have related to capital gains and accelerated depreciation beyond straight line.

C. Comment

The present minimum tax is defective in several respects:

First, as Secretary Simon said in testimony before this Committee: "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."

Second, it involves only a few of the tax preferences available under the present law thus discriminating against real estate and stock transactions and ownership. By broadening the base through adding allowable construction period expenses as a preference the law becomes even more discriminatory against real estate.

Third, it results in double and triple taxation because of no basis adjustment and therefore becomes a penalty tax.

D. Impact of the Proposed Changes of the Real Estate Industry

The tax impact model developed by Norman D. Ture, Inc., shows that the minimum tax provisions of H.R. 10612 alone would, if implemented, have a drastic effect on the Nation's real estate industry. It is estimated that investment would drop precipitously by $2.8 billion and real estate employment would decrease by about 125,000 people. Associated changes in federal tax revenues would be minus $1.2 billion.

V. Limitation on Investment Interest Deductions on Non-Corporate Taxpayers

A. Present law

The present law provides that a taxpayer who itemizes his deductions may deduct all interest paid or accrued within the taxable year on his indebtedness.

[13] See Appendix I.

A limitation is imposed on the deduction of interest on investment indebtedness. Under this provision, the deduction for such interest is limited to $25,000 per year, plus the taxpayer's net investment income and his long-term capital gain, plus one-half of any interest in excess of these amounts. Any remaining amount may be carried over to future years.

B. Comment

This proposal was enacted in 1969 to get at the wealthy. In fact, it has utterly failed to achieve that purpose for the following reasons:

(1) The Treasury has found it difficult to administer.

(2) The wealthy are able to offset investment interest against income from other real estate investments although the smaller entrepreneur lacks that capacity.

(3) It discriminates in favor of corporations and institutional investors as to whom the rule is not applicable.

(4) It unfairly deprives some individual entrepreneurs of long-term capital gains treatment to which all others would be entitled.

The net effect of the present rule is to make it difficult for the smaller individual entrepreneur to compete in business with the wealthy, the corporate, and the institutional entrepreneurs.

VI. Limitation on Non-Business Interet Deductions

A. Proposal

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 carry forward and be deductible in future years to the extent of related investment income in those years.

B. Comment

The House Bill would make the already discriminatory and onerous investment interest limitations even worse by adding non-business interest (such as home mortgage interest) and greatly reducing the maximum allowable deduction in aggregate under both rules to a maximum of only $12,000 per year. Such a limitation would substantially eliminate any possibility of many smaller entrepreneurs developing real estate, while having minimum adverse effect on the wealthy, the corporate, and the institutional investor.

C. Impact on the Real Estate Industry

The economic staff of Norman B. Ture, Inc. has analyzed the likely impact of the "interest deduction limitation" provision of H.R. 10612 on the real estate industry. Their studies show that investment in real estate would decline by an estimated $0.4 billion and real estate employment would fall by an estimated 17,000 people as a result of the application of this provision. Associated changes in federal tax revenues are estimated at minus $0.2 billion.

VII. The Minimum Taxable Income Proposal—an Alternative to LAL, the Minimum Tax and Limitations on Interest Deductions

The Chairman and others have suggested an alternative minimum income proposal. ICSC and a number of other real estate industry trade associations find this approach far more reasonable than the approach taken by the House. In line with this approach we wish to suggest that such a proposal should include the folowing:

A. Proposal

Under the minimum taxable income proposal, the taxable income of an individual having tax preferences would be determined as the greater of:

(1) The taxable income determined in accordance with existing tax law, or

(2) Fifty percent (50%) of the sum of taxable income (or net loss) determined in accordance with (1) plus all tax preferences (those of the current year plus carryovers less a deduction for tax preferences disallowed in prior years).

(3) The excess, if any, of the individual's income determined in accordance with (2) over the income determined in accordance with (1) (representing

currently disallowed tax preferences) would be carried over as a deduction in subsequent years.

All tax preference items should be grouped for this purpose. Thus, all present law tax preference items plus other tax preferences currently escaping taxation would be added to the taxpayer's taxable income.

B. Discussion

This proposal is an alternative to the minimum tax and the personal and investment interest limitation provisions of present law and several LAL approaches being considered. The approach will substitute for existing tax provisions a more intensive approach, much simpler to administer than the existing provisions and the LAL approaches agreed to by the House.

(1) Insure that all individuals engaged in business and investment pursuits for which Congress has provided tax incentives will pay tax on some portion of their income.

(2) Attack the problem directly by controlling the relationship between the amount of tax preferences and their effect on taxable income. It is simpler, more clearly effective, and less susceptible to avoidance than the House proposals.

(3) The minimum taxable income proposal would treat all shelters in one group and prevent a taxpayer from shopping for his "tax shelter" investment. The proposal is flexible enough so that any item deemed appropriate may be included.

(4) Enable capital to continue flowing to those areas in the economy for which tax incentives have been provded by Congress without discriminatorily singling our real estate tax incentives as would be the case under the LAL and minimum tax proposals agreed to by the House.

(5) Provide fairness through the carry foward of diallowed tax preferences to minimize double taxation without involving complex basis adjustments.

(6) Still discriminate against noncorporate taxpayers.

VIII. Accelerated Depreciation for Construction of Plants and Equipment in High Unemployment Areas

The President in his State of the Union Message proposed a short-term program to encourage new development by permitting certain properties to accelerate depreciation by adopting a shorter useful life (H.R. 11854).

We applaud the recognition that incentives are needed to encourage development in the current difficult economic climate. Especially in light of the inceasing burden imposed on development by expensive and time consuming environmental, OSHA, and land use regulations.

Such recognition underscores the inadvisability of new tax provisions that would discourage development and would discriminate heavily against smaller entrepreneurs.

However, it is difficult to evaluate whether the Administration proposal would be useful because of the uncertainty as to:

(1) The additional tax impact of new provisions such as the House minimum tax, investment interest and LAL provisions which might more than offset any advantages, and

(2) The very short qualifying term which is substantially less than the front-end time necessary to place and program major projects such as shopping centers.

Until these questions are answered it is difficult to take a definitive position in regard to the President's proposal.

IX. Conclusion

The adoption of the House Bill would clearly result in a substantial reduction in real estate development including new shopping centers. This would have a ripple effect across the economy that would produce substantial unemployment in the construction industry and other related professions and businesses.

The consequences of this slowdown would be higher rents and consumer prices, a substantial outflow of investment capital from the real estate market, and a reduction in the availability of consumer marketplaces. Thus, the reduction in real estate development would reduce the demand for manufactured goods and diminish the effectiveness of the current and proposed investment credit incentives.

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Norman B. Ture, Inc., economic consultants, studied the ecoonmic and tax revenue effects of the adoption of the House Bill's LAL, minimum tax and interest deduction limitation provisions and determined that their adoption would result in a loss in the real estate industry of $5 billion in investment, $8.8 billion in GNP, and 221,000 jobs. The net effect on federal revenues would be a loss of $2.2 billion.

In addition, the adoption of these House passed provisions would discriminate against, and effectively eliminate, investment in shopping centers by smaller, noncorporate entrepreneurs. This would force the shopping center industry and other income property development into the hands of large corporations to which LAL does not apply and institutional and extremely wealthy investors who build for cash without borrowed money.

It is interesting to note that when faced with a somewhat comparable situation, President Kennedy in his two tax messages to Congress mentioned "tax reform" but put his main emphasis on tax incentives to stimulate economic growth. He said at that time: "The chief problem confronting our economy in 1963 is its unrealized potential—slow growth, under-investment, unused capacity and persistent unemployment." [18]

In response, Congress adopted the business investment credit—which did have a stimulative and beneficial effect on employment and the economy.

It is encouraging to see the Congress and the Adminitration taking the same approach today with regard to the investment credit, but it is disturbing to see an opposite approach regarding investment in the real estate industry, which, if enacted, would more than negate the advangtages sought through the investment credit.

Appendix I

Economic Effects of Tax Changes Affecting Real Estate Investment—The Real Estate Tax Impact Model (Developed by Norman B. Ture, Inc., for The National Realty Committee, Inc.

SUMMARY

H.R. 10612

The Tax Reform Act of 1975, passed by the House of Representatives on December 4, 1975, would have the following economic and tax revenue effects:

EFFECTS OF TAX REFORM ACT OF 1975

[Dollar amounts in billions]

Tax change	Change in real estate: Investment	Change in real estate: Gross National Product	Change in real estate: Employment (in thousands)	Change in Federal revenues
1. Reduction of preference exemptions plus increase in minimum tax rate	−$2.8	−$5.0	−125	−$1.2
2. Full recapture on residential property	−1.3	−2.4	−59	−.6
3. LAL	−1.7	−3.0	−74	−.9
4. Interest deduction limitation	−.4	−.7	−17	−.2
5. Combined effects	−6.3	−11.2	−280	−2.8

Note.—Items may not add to combined effects due to rounding.

To estimate the economic effects of tax changes affecting real estate, it is necessary first to describe, in quantitative terms, the response of real estate investors and developers. To do so, we have developed an economic model which expresses the amount of real estate investment in relation to the cost of capital invested in real property. This cost of capital is affected by various tax provisions which are represented in the investment equation. Specifying changes in one or more of these provisions permits estimation of the change in the amount of investment. This change in investment affects employment and GNP originating in the real estate sector; the magnitude of

[18] *Congressional Record*, 962 (January 24, 1963.)

these effects are estimated by reference to relationships among real estate investment, GNP, and employment derived from the National Income Accounts. Based on these estimates of the economic effects in the industry, changes in Federal tax revenues are estimated on the basis of the effective marginal rates of the principal Federal taxes as derived from the National Income Accounts.

Tax changes aimed at curbing tax "loopholes" or "preferences" allegedly enjoyed by persons investing in real estate increase the cost of investment and lower the return on investment in real estate. Investors will react to such changes by trying to raise rents and by reducing their real estate investments. Since the proposed tax changes do not increase the demand for real property services, buyers of these services are not willing to pay higher rents for any given amount of real property services. The tax changes, therefore, result in reduced investment in real estate projects. However, as the supply of real property declines relative to the amount in the absence of the tax change, the rent per unit rises. Adjustment to the tax change is complete when the amount of real property supplied at some rental rate is equal to the amount demanded at that rent.

This reduction in real estate investment may occur almost immediately, if investors cancel some or all of their projects, or over a number of years, if owners reduce their maintenance budgets and undertake a smaller volume of new projects than otherwise. The model estimates the change in the stock of real property when adjustment is complete, but does not attempt to distribute that change over time.

The economic characteristics of individuals investing in real property and the types of properties in which such investments are made are highly diverse. Representation in the model of all possible combinations of investors and property clearly is impractical. This model, however, uses 18 classes of taxpayers investing in real estate and three classes of property holdings; these are assumed to represent the bulk of owners who would be affected by the proposed tax changes and most of the property which would be involved. The taxpayer classes comprise five levels of taxable income, three average amounts of investment, and three levels of preferenc income.[1] The three property classes are residential, commercial, and industrial. In order to analyze the impact of the interest deduction limitation, principally affecting shopping center, investors in such properties are explicitly included among the 18 classes.[2] In addition, specific assumptions are made regarding construction and holding periods, financing, and discount rate for each investor (with assumptions for shopping centers noted where different):

It is assumed that financing consists of a mortgage amortized over 25 years (30 years for shopping centers) at 9 percent interest, starting at the end of construction. A constant payment schedule with declining interest and increasing amortization appears to be more in line with actual practice than other loan repayment patterns. An initial equity of 20 percent is specified (15 percent for shopping centers).

A 9 percent discount rate is used.[3]

The preopening and construction period is assumed to be 2 years.

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[1] The taxpayer-investor classes were derived on the basis of data in the Internal Revenue Service's *Statistics of Income—1972, Individual Income Tax Returns*.

[2] The interest deduction limitation restricts the amount of investment interest a taxpayer may claim to investment income plus the excess, if any, of $12,000 per year less the taxpayer's personal interest. Net leases, a common arrangement for shopping centers, are considered investment for this purpose. It is estimated that 9% of nonresidential property would be affected by this provision based on unpublished data from the Treasury Department and from the F. W. Dodge division of McGraw-Hill, Inc. Not all shopping center investors would be affected, since some have sufficient investment income and some do not have net leases as defined by the tax code.

[3] The discount rate is the factor which equates the value of a future sum to its value in the present. Since the dollar to be received a year hence is regarded as less valuable than a dollar received today, while a dollar of outlay a year hence is less dear than the same dollar outlay today, virtually all contractual arrangements which extend through time involve the process of discounting future values to the present. The discount rate appropriately used by any investor with respect to any given project reflects both the rate of return he might expect to earn on an alternative investment and any difference he perceives in the riskiness of the project under consideration compared with that of the alternatives available to him. The 9 percent discount used in the model applies to the after-tax cash flow. A discount rate applied to pretax cash flow would be higher depending on the investor's tax bracket.

It is assumed that the developer expects to hold the property for 10 years after its completion before selling it.

Deductible preopening costs are taken as 10 percent of total investment.

Land costs are assumed to be equal to 20 percent of total cost (10 percent for shopping centers).

The useful life of the property is taken to be 33 years (27 years for shopping centers).

To simplify computation, it is assumed that rental income net of operating expenses (but before deducting interest and depreciation) and the investor's taxable income from other sources remain constant over the life of the property.[4]

Finally, it is assumed that the investor sells his property after 10 years for an amount equal to the present value of the after-tax cash flow he would receive if he continued to hold the property.[5]

Of course, investors are not identical in terms of desired holding period, discount rate, or any other variable specified above. There appears to be no reason, however, to expect large or systematic differences from one category of investor to another with respect to these variables. Nor is there empirical evidence on the correct value or distribution of values for these variables. Therefore, one value, selected after investigation of the economic litrature and discussion with government and industry sources, is used for each variable for all taxable income and property size classes.

These variables are assembled in a set of investment equations, one for each investor-taxpayer class, for which a computer program has been developed. The program calculates the net income per dollar of project cost needed annually by each investor class to undertake a residential or nonresidential project, under existing tax provisions. A proposed change in the tax law is analyzed to determine how it would affect any one or more of the terms in the investment equations. These changes are then fed into the computer to determine the change in required net income. Weighted average changes for residential and nonresidential property are computed separately, using as weights the share of all property estimated to be held by each investor class. The computer prints these weighted average changes for each tax alternative.

The percentage changes are then multiplied by the existing stocks of residential and nonresidential property to yield estimates of the impact on real estate investment. Estimates of existing stocks of these properties were obtained from the Commerce Department's Bureau of Economic Analysis (BEA).

The change in Gross National Product originating in real estate is about 1.77 times the change in investment, based on data in Real Estate in the U.S. Economy, a report prepared by Norman B. Ture, Inc. for the National Realty Committee. The same source shows that approximately 44,500 jobs are lost for each $1 billion reduction in real estate investment.

That volume also shows that labor and net capital income total about 70% of real estate GNP. The marginal tax rate on each of those shares is approximately 33%, or .33 × .7 = 23.1% of GNP according to IRS and BEA figures. In addition, indirect business taxes amount to about 1.9% of GNP. Net changes in Federal tax revenues, therefore, total approximately 25% of the change in real estate GNP, or 44% of the change in investment.

As passed by the House of Representatives, the Tax Reform Act of 1975 contains four provisions of particular concern to real estate investors. These are: 1) Changes in the minimum tax. The exemption from preference items would be lowered from $30,000 plus income tax due to a maximum of $20.000 with a further decrease of $1 for every $1 by which preferences exceed $20,000, with no exclusion of ordinary income tax. Thus, the exemption would disappear altogether for taxpayers with $40,000 or more in preferences. In addition, the list of preferences would be expanded and the minimum tax rate raised from 10 to 14 percent. 2) Recapture of the excess of accelerated depreciation over

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[4] For shopping centers, income is assumed to equal one-third of its eventual level in the first year following construction, two-thirds in the second year, and 100 percent thereafter. No evidence as to the most realistic time pattern of these variables is available. This assumption could be relaxed without significantly affecting the results.

[5] Clearly, he would not willingly sell for less, since he would then be better off by retaining the property. It is assumed that market conditions prevent him from receiving more than this minimum price.

straight-line would apply fully to residential property, as it now does to non-residential, instead of declining 1-percent per month for each month over 100 months that a property is held. 3) Limitation on artificial losses (LAL). Property owners would no longer be able to deduct preopening interest and taxes or the excess of accelerated over straight-line depreciation unless they have sufficent real estate income to cover these expenses. Any amount not deducted must be carried forward in a "deferred deduction account" until real estate income rises sufficiently. 4) Interest deduction limitations. Instead of the present virtually unlimited deduction for interest paid, taxpayers would be restricted to a total of $12,000 per year in personal interest, and investment interest equalling investment income plus the excess if any, of $12,000 over personal interest.

The CHAIRMAN. Next we will hear from Mr. George Brady with the Ad Hoc Coalition for Low and Moderate Income.

STATEMENT OF SIDNEY FREIDBERG, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, THE NATIONAL HOUSING PARTNERSHIP AND MEMBER OF THE EXECUTIVE COMMITTEE, AD HOC COALITION FOR LOW AND MODERATE INCOME HOUSING

Mr. FREIDBERG. Mr. Chairman, Mr. Brady, the president of our company, is attending a business meeting in the great city of New Orleans. I apologize for his absence.

The CHAIRMAN. Don't apologize if he is in New Orleans.

Mr. FREIDBERG. I also apologize for the absence of our chairman, George DeFranceaux, who is out of the country.

I ask your indulgence in permitting The National Housing Partnership to be represented by an understudy. With your permission, I will read a digest of my statement which will not take more than about 8 minutes, and I am told that the other gentlemen who represent organizations whose views do not conflict with ours will confine their remarks to 3½ minutes each.

I am appearing in my capacities as executive vice president and general counsel of The National Housing Partnership and as a member of the executive committee of the Ad Hoc Coalition for Low- and Moderate-Income Housing. My purpose is to explain why private enterprise will be unable to continue to provide housing for low- and moderate-income families if some of the provisions contained in H.R. 10612 are enacted into law.

Matters more specifically affecting the State housing programs and rehabilitated low income housing will be dealt with by Mr. Hance and Mr. Dukess, who will follow me. In support of my statement, and those of Mr. Hance and Mr. Dukess, I request permission to submit for the record a technical memorandum prepared by the Ad Hoc Coalition providing further analysis and explanation of points to be covered by all three speakers.

It is the public policy of the United States, reflected in the Housing and Urban Development Act of 1968 and the Tax Reform Act of 1969, and reaffirmed in 1974 by the addition of section 8 to the United States Housing Act of 1937, to encourage and support the construction by the private sector of multi-family housing for low- and moderate-income families, as well as elderly and handicapped individuals.

The production of such housing rests upon the ability to obtain major capital backing. A portion of this capital comes from conventional mortgages, from HUD-insured loans and from bonds issued by State housing finance agencies. But in all cases, somewhere between 10 and 20 percent of each project must be financed by equity money. This is private capital, which comes from private investors.

The choices available to people willing to risk their private capital today are enormous. Why should they invest in highly risky, socially troublesome low and moderate income housing with little hope of achieving a limited cash return when they can invest in high-grade corporate or Government bonds, yielding high rates of interest, or tax exempt municipal bonds with very attractive yields? There must be a reward commensurate with the risk. Presently, the only reward is tax shelter, provided by the deduction of interest and real estate taxes during construction, as well as after completion, and by accelerated depreciation and other items with which the committee is familar.

I cannot emphasize too strongly that the tax shelter for low and moderate income housing is not a loophole—an accidental flaw in the fabric of the tax law—but a deliberate, considered—and, we believe, wise—public policy decision by the Congress.

Mr. Chairman, we respectfully submit that there will be no significant production of low and moderate income housing in the future unless equity capital can be obtained from private investors, and we further submit that this equity capital can only be obtained if the rate of return produced by tax shelter benefits is preserved. Until the Congress legislates an alternative means for providing this equity capital, the present tax incentives must be unchanged, or the housing will be unbuilt.

The Department of Housing and Urban Development stated in a memorandum by Secretary Carla Hills to the House Ways and Means Committee:

> The fact is that builders will not build subsidized projects unless they are able to sell the projects to investors. And the fact is that investors will not purchase subsidized apartment projects unless their investment produces the substantial tax advantages available under current law.

Contrary to the belief of some, the housing program has made substantial and effective progress toward the national goal of a decent home in a suitable living environment for every American.

One way to illustrate the achievements of the 1968 program is to use the experiences of my company, The National Housing Partnership. It is a private organization, created by Congress under title IX of the Housing and Urban Development Act of 1968 to perform a public purpose—to encourage the widest possible participation by private enterprise in the provision of housing for low and moderate income families.

In response to Congress' appeal for private involvement, 270 large industrial corporations, banks, insurance companies and labor unions invested over $42 million in The National Housing Partnership. They invested their money as an act of faith, in reliance on specific tax advantages provided by the Tax Reform Act of 1969 and existing sections of the Internal Revenue Code.

Since it began operations in mid-1970, NHP has participated with local partners in 173 low and moderate income housing projects in 33 States that will provide decent homes for 27,405 American families at a total cost of $560,241,000, of which $44,759,000 is equity capital invested by the private sector in exchange for the promise of tax benefits.

One of the primary characteristics of low and moderate income housing projects is little or no cash distribution, because of economic reality and statutory restrictions. This can be illustrated by the experience of NHP. To December 31, 1975, we have advanced, on behalf of ourself and certain of our partners, $1,257,169 to pay operating deficits. This is in addition to deficits funded by some of our local partners. On the other side of the ledger, our share of cash distributed by profitable projects was only $203,860. Since NHP's operations have produced a net cash deficit rather than a cash profit, it is obvious that the only return to our investors is in the form of tax benefits.

Let me now turn specifically to the provisions in H.R. 10612 with which we take issue.

MINIMUM TAX

H.R. 10612 makes several dramatic changes in the current minimum tax provisions. The Bill provides for a "vanishing" exemption, eliminates the deduction for regular taxes paid in computing the minimum tax, adds construction period interest and taxes—not subject to LAL—as a tax preference, and increases the tax rate from 10 percent to 14 percent. In our judgment, it is not an overstatement to say that these changes, taken together, will virtually eliminate private investment from the construction of low and moderate income housing.

The drastic ramifications of the minimum tax provision in the House bill can best be illustrated by a typical NHP housing project where an investor in the 50-percent bracket, with $20,000 of other tax preferences, purchases an interest for $117,000. Under present law, the minimum tax is not applicable; if H.R. 10612 is enacted, this investor would pay, over a 20-year period, nearly $50,000 in minimum taxes. Under present law, his tax savings will equal his investment after 6 years; under the House bill, his tax savings would not reach this level until the 11 year. Under present law, this investor, at the end of 20 years, will receive in tax savings an amount equal to his initial investment plus 67.5 percent. Under the House bill, this 67.5 percent figure would be reduced to 25 percent. Our experience has shown that the present law is workable; the House bill, we fear, is not. Greater detail is shown in the technical memorandum which we are submitting.

Consequently, we urge your committee to exempt all tax preference items generated by low and moderate income housing from the minimum tax provisions of H.R. 10612; limitation on artificial losses—section 101 of the bill.

The Ways and Means Committee recognized the necessity of tax incentives for private investment in low and moderate income housing by exempting from the limitation on artificial losses projects which receive a subsidy commitment under section 8 of the U.S.

Housing Act—or comparable provisions of State or local law—before January 1, 1979, and where the construction begins before January 1, 1981.

We would much prefer an outright exemption of low and moderate income housing from LAL until Congress adopts some alternative housing program. However, 5 years is the absolute minimum period that is feasible because it will take at least that long to adopt, test and implement a replacement program.

The 5-year exemption contained in H.R. 10612 is deficient in that it requires a section 8 subsidy commitment from HUD—or a state or local agency—by the end of 1978. As a practical matter, construction of most projects commences within a matter of weeks after such a commitment is received. Therefore, the requirement that there be a commitment by January 1, 1979 has the practical effect of shortening the exemption to just over 3 years and in our judgment serves no meaningful purpose.

We urge the committee to delete the requirement that there be a subsidy commitment by January 1, 1979, if the committee decides to retain the 5-year exemption rather than provide a permanent exemption, depreciation recapture—section 201 of the bill.

H.R. 10612 also changes the depreciation recapture rules with respect to low and moderate income housing. Instead of the present 10-year period, a project must be held at least 16⅔ years before there will be no recapture of accelerated depreciation. This new longer period would apply to depreciation taken after December 31, 1975 even though the project was constructed and sold to investors prior to that date.

We do not object to increasing the depreciation recapture period for low and moderate income housing, but we believe it is unfair to change the rules retroactively for projects already in existence. Not only is it unfair, it will cause future investors to question whether they can rely on current tax laws when investing in risky low and moderate income housing.

Accordingly, we urge the committee to make the new depreciation recapture rules applicable only to low and moderate housing which is built in the future.

The various amendments to H.R. 10612 which we have suggested are consistent with the position of the Administration as set forth in Secretary Hills' letter of October 10, 1975 to Congressman Ullman, Chairman of the House Ways and Means Committee, a copy of which is annexed to the technical memorandum. In discussions with representatives of the Treasury Department and HUD, we have been assured that the Administration's position has not changed.

Mr. Chairman, we believe that our suggested changes to H.R. 10612 are essential to the continuation of construction of low and moderate income housing by private investors. To eliminate those tax advantages now would amount to a breach of faith with many low- and moderate-income families who are still waiting for the decent homes promised them by Congress long ago. There may be a better program than tax incentives which can be developed in the future, but today there is no alternative. Thank you.

With your permission, I would also like to submit a technical memorandum which has been prepared jointly by the three of us. I would be prepared to answer questions now or later.

The CHAIRMAN. I would like to ask your people to take a look at the estimate in the House report of the revenue gain that they are going to make by repealing a provision that is there for the purpose of encouraging people like yourselves to build homes for the benefit of low income people. See if you can help advise us of the jobs that will be lost and the revenue the Government will lose by discontinuing this program. I do not have any doubt that you are right when you say that this program, if taxed the way this House bill recommends, is at an end.

I would like to know if we can get an adequate analysis to take into account what nobody ever tried to consider—how much revenue we lose when the carpenter and the others who would have been working on the house are out of work. It is a cinch they are not going to be working in the shopping center, because those people will be laying off workers also. From what we are hearing, I don't believe they will be working building housing for the homebuilder market, because those people are going to have to cut back also.

We need a careful analysis of what we will lose and how much we will have to pay in welfare benefits for your part of it. The people working today to build homes for low-income people will no longer be in the work force.

Mr. FREIDBERG. I would like to ask Mr. Dukess, Chairman of the National Housing Rehabilitation Association to comment on that.

STATEMENT OF A. CARLETON DUKESS, CHAIRMAN, NATIONAL HOUSING REHABILITATION ASSOCIATION, WASHINGTON, D.C.

Mr. DUKESS. Mr. Chairman, my association, the National Housing Rehabilitation Association, has been working for some years now in conjunction with and under the leadership in this instance of the National Realty Committee whose witness will testify next. We have worked intimately and carefully with the True economic model, and we have studied that issue, and we devoted tremendous amounts of time in bringing input from all over the Nation to Dr. Ture and his organization.

I understand Mr. Walsh, who is the next witness, has that information in summary form or can deliver it to the committee.

I commend the thoughtfulness of the Chairman of the Committee. That is really one of the gut issues we are talking about under the guise of tax reform.

The CHAIRMAN. Your industry is one we put in business with tax advantages. I believe George Romney was heading the drive at the time we first passed these provisions in the tax law to encourage the people you represent to divert their activities from other lines of activity to put their money into this kind of effort to try to provide rehabilitated housing at the lowest possible cost to the poor. Is that not right?

Mr. DUKESS. That is correct.

The CHAIRMAN. If we repeal the provisions we put in there which George DeFrance mentioned—and we in Louisiana have a claim on him—obviously investors won't continue in that line of endeavor. They will find something else to do with their money. When they do, all the jobs you have been able to create for people providing decent low-income housing for the poor will no longer be there. Meanwhile, when there is less housing on the market, housing being more scarce, that tends to cause rents to move up, does it not?

Mr. DUKESS. It certainly does.

I would like to point out, Mr. Chairman, that you are absolutely correct in what you said. This was an industry created, indeed, by this committee, Secretary Romney, the House of Representatives, and the Administration.

We are not here now seeking to prevent the destruction of this industry. That has virtually happened, sir. The law to which you refer, section 167(k) notwithstanding unanimous support of the Senate and the House, Treasury and HUD, expired on December 31, and we do not have that law any longer. I do not want to go out of order, but that is the basic point. We are not threatened. We have been killed already, and we are here asking to be ressurected.

The CHAIRMAN. I was under the assumption that this House bill would try to kill whatever remaining signs of life might be around somewhere.

Mr. DUKESS. That is a reasonable assumption. Ninety-nine out of a hundred is not a bad average, and that is where you would be put.

In this rehabilitation for families of low and moderate income, the Ways and Means Committee and the full House did vote its extension and, indeed, its improvement. They failed to act on an extension of the legislation which did expire on December 31, 1975, so that we have an industry now that is in total disarray. I am now speaking about the immediate need for special legislation rather than under this omnibus legislation in order to get that provision of the law extended at this time.

The CHAIRMAN. This is one of the amendments we tried to put on one of the bills and apparently some senators felt that might be a handout to vested interests of some sort and, therefore, we were not able to pass it. We will see what we can do about it on this bill or some other bill.

Mr. DUKESS. Or some other bill which I would hope would come faster. We are in total disarray at this point, Mr. Chairman. We have unanimous support for enactment of this bill from the Treasury, from the White House, from HUD, and, we are led to believe, from this committee and the Ways and Means Committee in the House. We don't know who is against it, but, in the meantime, we are dying for lack of it.

Mr. FREIDBERG. We understand the Joint Committee has some figures on low and middle income housing.

Mr. DUKESS. In view of he fact that my big mouth has already gotten me into the proceedings, there are a few other points I would like to make before turning the mike over to Mr. Hance.

As I believe I have already stated, I am president of the National Housing Rehabilitation Association. Although we have prepared a

statement, I will not repeat it at this point. However, there are a few points I would like to make.

The reason why there is apparently unanimity of support for extension and improvement of section 167(k) is that there has come to be virtually unanimous realization that within our cities—I don't mean just our major cities of 5 million or 3 million population but all of our cities throughout the Nation from coast to coast—there is, in addition to housing inventory an extraordinary investment in what we in the industry refer to as the infrastructure—the streets, the sewers, the schools, the hospitals, and so on—and the failure to take the housing that feeds off of that infrastructure and return it to a decent, sanitary, safe shelter is, indeed, a tremendous failure and a tremendous waste of national assets.

Secretary Hills is pushing very hard for preservation of the Nation's existing housing inventory or its restoration or rehabilitation, or call it what you will.

In perhaps an extraordinary dramatic signing ceremony that took place just 4 weeks ago, the eight major international and national construction trade unions joined with Secretary Usery and Secretary Hills and my association in signing a national statement of labor principles and policies which provide for three things: (1) A reduced rate for all union construction trade workers working on housing rehabilitation for families of low and moderate income; (2) A limitation on profit of the developer-builders who are engaged in that industry; and (3) A redefinition of workrules that are more appropriate to construction in the rehabilitation trades than in the new construction trades.

We have the section 8 of the Housing Act of 1974 produced by this Congress. HUD is pushing very hard for rehab. HUD has informed us through Secretary Hills that they have an extraordinary high degree of requests in the community development programs from municipalities throughout the Nation to increase tremendously the rehabilitation component of the housing effort within those municipalities. Everything is in place.

Fortuitously, everything got into place and only because of the difficulties to which you referred, Mr. Chairman, there is a missing essential element, section 167(k) did die on December 31.

We have taken the liberty of providing to the committee the technical memorandum to which Mr. Freidberg made reference and a piece of draft legislation which would extend and slightly modify section 167(k) in a manner that we are informed the Joint Committee staff favors, that HUD and the Treasury are in favor of, and we need it desperately, Mr. Chairman and members of the committee, in terms of immediate legislation at the earliest convenience. We now have a significant number of jobs throughout the Nation that are in jeopardy that could be going into construction, but the developers are unwilling or unable to put them into construction in the absence of this legislation.

Thank you, sir.

[The prepared statement of Mr. Dukess with attachments follows. Oral testimony continues on p. 565.]

Statement of A. Carleton Dukess on Behalf of The National Housing Rehabilitation Association

SUMMARY

1. Rehabilitation of Low and Moderate Income Housing owes its success to Section 167(k).

2. Extend Section 167(k), which has expired, now, by separate legislation. Extension should be for at least five years.

3. Amend Section 167(k), as does H. R. 10612, to increase maximum expenditure per dwelling unit from $15,000 to $20.000.

4. Amend 167(k) to permit use of Section 8 income limits to define low and moderate income families.

5. Amend 167(k) to clarify, as Treasury Regulations state, that it applies on a "per dwelling unit" basis.

6. Extend benefits of 167(k) to expenditures incurred pursuant to "binding contracts" in effect on new expiration date rather than, as at present, paid or accrued by such date.

STATEMENT

Mr. Chairman and Members of the Committee: My name is A. Carleton Dukess. I submit this statement in my capacities as President of the National Housing Rehabilitation Association and as a member of the Executive Committee of the Ad Hoc Coalition for Low and Moderate Income Housing. I am accompanied today by the Association's Counsel, Bruce S. Lane, Esq. of Lane and Edson, P. C., Washington, D.C.

In view of the limited time available to me, I will not repeat the points made by Mr. Freidberg and Mr. Hance, but I would like to indicate that the National Housing Rehabilitation Association subscribed to the positions set forth by them, and to the Technical Memorandum submitted by the Ad Hoc Coalition in support of our collective testimony. Beyond that I will address my remarks primarly to the rehabilitation of housing for low and moderate income families.

The National Housing Rehabilitation Association is an organization composed of persons and organizations active in the business of rehabilitating housing for low and moderate income families. Members of the Association include developers, builders, contractors, management firms, suppliers and associates professionals. The members of the Association include some of the most active organizations in the field of government assisted rehabilitation, and account for a significant portion of the multi-family rehabilitation projects undertaken with HUD or state assistance. Attached to the Technical Memorandum is a list of our members.

In my private capacity I am Executive Vice President of Continental Wingate Company which, I believe, is the nation's oldest and largest producer and operator of subsidized, rehabilitated housing.

There is a pressing need for the rehabilitation—preservation, restoration, call it what you will—of our nation's older housing inventory. I believe that the importance of this process to stabilizing and upgrading neighborhoods and preserving cities is so obvious (especially when viewed in light of the obstacles being put in the path of a new development) and so well known to the Committee that I will not dwell on it at length.

Essential to that objective has been Section 167(k), which was added to the Internal Revenue Code by the Tax Reform Act of 1969. This is the so-called five year write off of rehabilitation expenditures for housing of families of low and moderate income. As you know, when Section 167(k) was enacted in 1969, it was for a trial period of five years—later extended to six years. At the end of 1975, Section 167(k) expired and, despite repeated efforts, which we know had the support of this Committee and its Chairman, we have been unable to obtain even a stop-gap extension. This has created a severe break in the rehabilitation pipeline—which is not a process easily turned on and off—and there is a need for emergency action to repair that break.

Section 167(k) fills a programmatic void without which there can be no meaningful production or operation of this type of housing. Because of the complexities involved in working with old structures located in inner cities and the limitations imposed by the rent paying ability of low and moderate

income tenants, rehabilitation of low and moderate income housing cannot work without some external basis for developer and builder profit. Equity syndication in conjunction with Section 167(k) is ideally suited to provide a profit source and encourage the business community to enter the field. Despite suspension of the Section 236 program in January, 1973 and the depression in the economy in general and the housing industry in particular, 80,000 units of low and moderate income rehabilitated housing were produced with government assistance in the United States from 1969 through 1974, as contrasted with only 15,300 such units in all prior years.

The new emphasis on the Section 8 Leased Housing Program, often utilized in cooperation with state housing finance agencies, and the new Community Development block grant program administered by local agencies, each have a substantial rehabilitation component which has sparked renewed interest in rehabilitation. Neither program will be successful without the inclusion of significant amounts of rehabilitation, and that rehabilitation will be accomplished only with the extensive use of Section 167(k).

Therefore, we call on you to act immediately—not as part of H. R. 10612, but by amendment to separate pending legislation which can expect to be enacted at a very early date—to extend Section 167(k) for at least five years, until January 1, 1981, a period of time sufficient to encourage developers and builders to reply on it and to gear up their production.

Section 167(k) should also be amended to bring it into line with legislative and other changes which have occurred since the time that it was enacted.

Such amendments would be:

1. In recognition of inflation, to modify the ceiling amount that may be taken into account per dwelling unit from the present $15,000 to $20,000. The need for that change was recognized by the House and is contained in H. R. 10612.

2. In view of the enactment and implementation of the Section 8 Leased Housing Program, which complates both low income and non-low income housing within a single building, to codify the present Treasury Department interpretation that the write off applies on a "per dwelling unit" basis;

3. In view of the enactment of the Housing and Community Development Act of 1974, amend Section 167(k) to authorize the Secretary to set income limits consistent with those established for the Section 8 Leased Housing Program;

4. Amend Section 167(k) to make it clear that rehabilitation expenditures incurred pursuant to a binding contract entered into prior to January 1, 1981, and rehabilitation expenditures incurred with respect to low income rental housing the rehabilitation of which has begun prior to January 1, 1981, will be deemed incurred prior to January 1, 1981. This will avoid premature shut-downs and will enable the production pipeline to continue as we near 1980 and 1981.

Extension of 167(k) has been supported by Dr. Laurence Woodworth and is supported by the Administration, which also, we understand, has no objection to any of the other amendments which I have suggested.

As part of the Technical Memorandum being submitted to you, there is attached a draft of a bill that would accomplish all of the foregoing and a further technical explanation of that bill. We know that you and the staff will give this careful consideration.

Of course, it goes almost without saying that insofar as these matters are not—or cannot—be dealt with by separate legislation, they should be included in H. R. 10612.

Thank you.

Technical Memorandum in Support of Recommendations with Respect to H. R. 10612 As It Affects Low and Moderate Income Housing

I. Background

On December 4, 1975, the House of Representatives passed and sent to the Senate for consideration the proposed Tax Reform Act of 1975, H. R. 10612. A key element of that bill is the LAL concept—Limitation on Artificial Losses.

The basic idea of LAL, insofar as real estate is concerned, is that losses generated by depreciation in excess of straight-line depreciation plus real estate taxes and interest during the construction period ("LAL Losses") are only currently deductible to the extent of income derived from the same class of property. In the case of real estate, the House voted to define the class so as to permit LAL Losses to be deductible to the extent of any income derived from any real estate (determined by consolidating rental income and sale income from both residential and commercial properties). Deductions in excess of such income would be placed in a "deferred account" and would be deductible against future income from any real estate (again, not just from the specific project) and against any gain resulting from the sale or other disposition of the project.

A. Exemption for Certain Low-Income Housing

The definition of low-income housing set forth in H. R. 10612 is as follows:

"(A) property with respect to which a mortgage is insured under Section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws, and with respect to which the owner is subject to the restrictions of Section 1039(b)(1)(B),[1] or

(B) dwelling units held or to be held (pursuant to commitments) for occupancy by families or individuals eligible to receive subsidies under Section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower income families.

In the case of a building (or the portion of a building devoted to dwelling units), if 85 percent or more of the dwelling units are described in subparagraph (B), such building (or portion thereof) shall be treated as low-income housing." [See proposed Code Section 470(a)(4), p. 27 of the Bill.]

Low-income housing which falls within the above definition and the construction of which begins before January 1, 1981 would be permanently exempt from LAL (that is, the present tax law regarding deduction of losses would continue to apply to it indefinitely) if it meets the following additional test: "before January 1, 1979, there is a subsidy commitment to support new construction or substantial rehabilitation under Section 8 of the United States Housing Act of 1937, as amended (or under the provisions of State or local law authorizing similar levels of subsidy for lower income families) and such commitment was made before the beginning of the construction or rehabilitation of such property, . . ." [See proposed Code Section 470(c)(3),p. 31 of the Bill.]

In other words, for low and moderate income housing to benefit from the exemption agreed to by the Committee such housing must meet three requirements: (i) it must qualify as low-income housing; (ii) prior to construction and prior to January 1, 1979 there must be a Section 8 subsidy commitment (or the state or local equivalent); and (iii) construction must begin before January 1, 1981.

B. Application of LAL to Other Real Estate

LAL will not apply at all to any real estate project construction of which began on or before December 31, 1975. Such projects would be "grandfathered" and the present tax law regarding deduction of losses will continue to apply to them indefinitely.

With respect to projects construction of which begins after December 31, 1975, the following rules would apply:

(a) *Commercial Property.*—LAL will apply in full (without any phase-in) if construction begins after December 31, 1975.

(b) *Residential Rental Property Other than Certain Low-Income Housing.*—Any residential real property (other than the low-income housing qualifying as described above) the construction of which has begun before January 1, 1978, will be exempt from LAL ("grandfathered") if, in addition: "before January 1, 1977, (i) the taxpayer has acquired the site (or has a binding option to acquire the site), and (ii) there is a firm commitment for the

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[1] The restrictions described in Section 1039(b)(1)(B) of the Internal Revenue Code relate to restrictions on the owner's return on investment and limitations on rental charges to tenants.

permanent financing of the property which (except for clause under which the borrower may be relieved from this commitment if he does not receive the rezoning for which he has applied before January 1, 1977) is binding on both the lender and the borrower, . . ." [See proposed Code Section 470(c)(2), p. 30 of the Bill.]

C. Recapture of Depreciation of Real Property

H. R. 10612 proposes to recapture at ordinary income tax rates all depreciation in excess of straight-line depreciation incurred with respect to any residential real property after December 31, 1975 to the extent of any gain involved when the property is sold. (Commercial property is already subject to full recapture under present law.) Excess depreciation claimed before December 31, 1975 will continue to be subject to the present recapture rules.

(a) *Exception for Low-Income Housing.*—With respect to low-income housing, the House voted to adopt for all excess depreciation claimed on and after January 1, 1976 the rule which presently exists for non-government assisted residential housing, that is, a 1% reduction in recapture after the property is held beyond 100 months, with no recapture after the property is held for 16 years, 8 months. This recapture rule will apply to all excess depreciation generated by low-income housing on and after January 1, 1976, even though such housing was under construction or in existence prior to that date.

(b) *New "Foreclosure" Rule.*—With respect to all real estate, the House also voted that in the event of a mortgage foreclosure, sale, or the equivalent, the disposition of the property will be deemed to have occurred as of the date that foreclosure proceedings are commenced rather than the date on which foreclosure is concluded. This was done at HUD's request to prevent taxpayers from dragging out the foreclosure procedure in order to avoid recapture.

D. Section 167(k)—Rehabilitation Expenditures

The House voted to continue Section 167(k) for an additional two years so that it will apply to rehabilitation expenditures incurred before January 1, 1978. In addition, it voted to amend the Section to increase the maximum amount of rehabilitation expenditures per dwelling unit that may be written off to $20,000 (from $15,000), but it did not change the minimum amount, which presently is $3,000. The new limit applies to expenditures incurred after December 31, 1975. The bill makes it clear that the accelerated depreciation permitted by Section 167(k) will not be subject to LAL.

E. Minimum Tax on Tax Preference Items

The House voted to increase and expand the minimum tax on tax preference items.

Under present law, a taxpayer is subject, in addition to his ordinary income tax, to an additional tax equal to 10% of the amount by which his aggregate tax preferences in any one year exceeds a "floor" equal to the sum of (i) $30,000 (for married taxpayers filing joint returns), plus (ii) the amount of his income tax for such year, plus (iii) the tax imposed for the seven preceeding years (but not taxable years prior to 1970) which was not previously used to reduce preference income.

H. R. 10612 would increase the rate of the minimum tax as of January 1, 1976 from 10 to 14% and would decrease the $30,000 exemption to a $20,000 exemption which would be reduced to zero when preference income exceeds $40,000. In addition, it would eliminate entirely any deduction for regular taxes paid either in the current year or in any past year.

Presently, insofar as real estate is concerned, the "tax preference items" are accelerated depreciation and capital gains. H.R. 10612 creates, as of January 1, 1976, several additional categories of tax preference items, among which are interest and taxes generated during the construction period of real estate projects to the extent that such interest and/or taxes is not placed in an LAL deferred account.

II. DISCUSSION

Congress made a conscious decision in enacting the Housing and Urban Development Act of 1968 to use the federal tax laws in partnership with

direct housing subsidies to induce private developers to produce more residential rental housing for all Americans and particularly for families of low and moderate incomes.

That decision, which essentially adopted the recommendation of the President's Committee on Urban Housing (the Kaiser Committee), was followed by the enactment of provisions of the Tax Reform Act of 1969 favoring the construction of residential rental property, particularly low- and moderate-income housing, and reducing the tax benefits favoring the construction of other types of real estate. The most notable provisions added by the Tax Reform Act of 1969 were the enactment of Section 167(j), which continues to permit double declining balance and sum of the years-digits depreciation of new residential property, but proscribes the use of such rapid depreciation with respect to non-residential real estate; the enactment of Section 167(k), which permits a sixty-month write-off of rehabilitation expenditures for low- and moderate-income rental housing; the enactment of Section 1250(a)(1)(C), which in effect permits low and moderate income housing projects to be sold at capital gains rates after they have been owned for ten years and other residential rental property to be sold at capital gains rates after sixteen years eight months, while removing that privilege from non-residential real estate; and the enactment of Section 1039, which permits the deferral of gain on qualified sales of certain low- and moderate-income housing projects, including Section 236 projects.

These tax incentives, working in concert with the various housing subsidies provided in 1968 and earlier housing acts, dramatically increased the number of quality housing units for low- and moderate-income families. It led to the creation of The National Housing Partnership and other entities, large and small, which in combination have produced many hundreds of thousands of low- and moderate-income housing units that would not otherwise have been produced. For example, in 1971, there were 430,000 federally subsidized housing starts, approximately twenty percent of the 2,000,000 U. S. housing starts for that year, excluding mobile homes. The National Housing Partnership alone has participated in the organization of 173 low and moderate income housing partnerships in 33 states—which will provide shelter and decent homes for more than 27,000 American families. Many other developers are involved in the type of activity as NHP, producing many thousands of homes for low and moderate-income families. There is no other incentive to private enterprise that could have matched that record.

III. RECOMMENDATIONS AND SUPPORTING REASONS

A. Limitation on Artificial Losses

When Secretary of the Treasury George Schultz first put forward the concept of LAL in a statement before the House Ways and Means Committee on April 30, 1973, he suggested that low and moderate income housing be exempted from its impact, and that has been the position of the Administration ever since. The most recent statement of the Administrations position is contained in a letter dated October 10, 1975 from Carla Hills, Secretary of the Department of Housing and Urban Development, speaking for the Administration, to Chairman Ullman of the Ways and Means Committee. (See Exhibit A) Secretary Hills stated that such exemption should be permanent or, at a minimum, for a period of five years.

The need for exemption from LAL for low and moderate income housing has also been recognized by many others, for example, Ralph Nader's Tax Reform Research Group and Senator Edward M. Kennedy (D-Mass.). Senator Kennedy put the argument well in his statement on the Senate floor on March 1, 1976 in a speech entitled: "Tax Reform: Dream or Reality?" He said: "In other cases, it may be appropriate to reduce or eliminate the tax expenditure program—because its costs outweigh its benefits, or because its benefits are distributed unfairly—but part or all of the revenues saved need to be added to more efficient and more equitable federal programs in the same budget areas. For example, tax shelters for real estate should be eliminated because they are a source of serious tax inequity and because there is substantial evidence that the tax expenditures involved in real estate tax shelters are inefficient and counter-productive. But, the revenues gained by Congress to direct spending programs for the construction and rehabilitation

of low and middle income housing. This simultaneous action is required to meet our housing needs and to insure that needed tax reform does not reduce unnecessary disruption in the construction industry.

It is important that we amend the House bill by developing stronger anti-tax shelter rules ready to go into effect. *But the House bill wisely delays until 1981 the imposition of its tax shelter rules in the case of the construction of low income housing. In the interim, Congress should require HUD to develop and submit an alternative direct spending program to encourage construction and rehabilitation of low income housing.*

I will not support any proposal to change the present tax benefits for low income families until a better alternative program is designed. We can then use the revenues gained from closing down tax shelters to help fund more effective and more equitable methods of providing low income housing. In this way, tax reform and spending reform can go hand in hand." (Emphasis added.)

Like Secretary Hills and Senator Kennedy, we believe that LAL should not be applied to low and moderate income housing until Congress has developed, tested and implemented a successful alternative program to produce low and moderate income housing. Hopefully, five years will be sufficient.

H. R. 10612 seeks to accomplish this, but we believe that it fails because proposed Code Section 470(c)(3) set forth on page 31 of H. R. 10612 exempts from LAL low income housing the construction period of which begins before January 1, 1981 if a Section 8 or comparable state or local subsidy commitment is obtained before January 1, 1979. The requirement of a subsidy commitment within the first three years of the exemption period results in only a three year rather than a five year extension of present law. This is so because construction normally begins within approximately 30–60 days after a subsidy commitment is issued.

The precondition of a subsidy commitment is troublesome for two additional reasons. First, it would eliminate from the exemption any construction not yet begun under the older Section 221(d)(3) and Section 236 housing programs, which although considerably diminished, still remain in effect and still have projects in the "pipeline." Secondly, there is no comparable subsidy under any present state or local housing program, and so the precondition of a subsidy commitment effectively eliminates entirely from the exemption all state and local programs for low and moderate income housing which function separately from the federal Section 8 Leased Housing Program. There are many of these and to date they have been the heart of the state low income housing programs.

We urges that sub-paragraph (A) of proposed Code Section 470(c)(3) be deleted from H. R. 10612 so that the section exempts low income housing (as defined in the bill) from LAL if the construction period for such property begins before January 1, 1981.

B. Depreciation Recapture

We believe that the decision of the House to establish a sixteen-year eight-month recapture rule for low and moderate income housing represents the minimum incentive necessary to sustain investment interest in such housing and to discourage early disposition or foreclosure. However, we believe that applying this new rule, rather than the present ten-year rule, to existing investments in low- and moderate-income housing is a serious breach of faith with thousands of investors who were urged by Secretary Romney and others to make this investment. Such investments are highly illiquid and cannot be disposed of easily if the tax law changes. This breach of faith is likely to create a "credibility gap" which will discourage future investment in Section 8 and other new low- and moderate-income housing based on representations as to the tax benefits.

Retroactive application of the new sixteen-year eight-month rule to existing projects is also opposed by the Administration. In her October 10, 1975 letter to the Ways and Means Committee (see Exhibit A) Secretary Hills says:

"*Third*, the Committee should avoid retroactive application of the new recapture rules to projects already built or started—a feature that seems certain to contribute to investor resistance to residential real estate investment in the future—and should provide for timing of recapture changes so that they parallel changes in the timing of LAL as recommended above."

We urge that Section 201(a) of H. R. 10612 be modified to provide that low and moderate income housing the construction of which began before January 1, 1976 continue to be subject to the ten-year recapture rule presently provided for by Section 1250(a)(1)(C)(ii) of the Internal Revenue Code.

C. Section 167(k)—Rehabilitation Expenditures

There is a pressing need for the rehabilitation and restoration of our nation's older housing inventory. Essential to that objective has been Section 167(k), which was added to the Internal Revenue Code by the Tax Reform Act of 1969. This is the five year write off of rehabilitation expenditures for housing of families of low and moderate income.

When Section 167(k) was enacted in 1969, it was for a trial period of five years—later extended to six years. At the end of 1975, Section 167(k) expired and, despite repeated efforts, we have been unable to obtain even a stop-gap extension. This has created a severe break in the rehabilitation pipeline—which is not a process easily turned on and off—and there is a need for emergency action to repair that break.

Section 167(k) fills a programmatic void without which there can be no meaningful production or operation of this type of housing. Because of the complexities involved in working with old structures located in inner cities and the limitations imposed by the rent paying ability of low and moderate income tenants, rehabilitation of low and moderate income housing cannot work without some external basis for developer and builder profit. Equity syndication in conjunction with Section 167(k) is ideally suited to provide a profit source and encourage the business community to enter the field. Despite suspension of the Section 236 program in January, 1973 and the depression in the economy in general and the housing industry in particular, 80,000 units of low and moderate income rehabilitated housing were produced with government assistance in the United States from 1969 through 1974, as contrasted with only 15,300 such units in all prior years.

The new emphasis on the Section 8 Leased Housing Program, often utilized in cooperation with state housing finance agencies, and the new Community Development block grant program administered by local agencies, each have a substantial rehabilitation component which has sparked renewed interest in rehabilitation. Neither program will be successful without the inclusion of a significant amount of rehabilitation, and that rehabilitation will be accomplished only with the extensive use of Section 167(k).

Therefore, we urge immediate action—not as part of H. R. 10612, but by amendment to separate pending legislation which can expect to be enacted at a very early date—to extend Section 167(k) for at least five years, until January 1, 1981, a period of time sufficient to encourage developers and builders to rely on it and to gear up their production.

The two year extension provided for in H. R. 10612 is not adequate. The Administration supports extension of Section 167(k) (See Secretary Hills' letter of October 10, 1975—Exhibit A) and Dr. Laurence Woodworth, Chief of Staff of the Joint Committee on Internal Revenue Taxation, has suggested a five year extension through 1980. (See Exhibit B).

Section 167(k) should also be amended to bring it into line with legislative and other changes which have occurred since the time that it was enacted.

The amendments which we urge are:

1. *Increase Expenditure Ceiling.*—In recognition of inflation, modify the ceiling amount that may be taken into account per dwelling unit from the present $15,000 to $20,000, with respect to rehabilitation begun after December 31, 1975.

This amendment is contained in H. R. 10612, was supported by HUD before the Ways and Means Committee, and is endorsed by Dr. Woodworth.

2. *Authorize Use of Section 8 Income Limits.*—In view of the enactment of the Housing and Community Development Act of 1974, amend Section 167(k) to authorize the Secretary of the Treasury to set income limits consistent with those established for the Section 8 Leased Housing Program.

Presently Paragraph (3)(B) of Section 167(k) permits the Secretary of the Treasury to determine families and individuals of low or moderate income "in a manner consistent with the policies of the Housing and Urban Development Act of 1968." Since the Section 8 Leased Housing Program was

enacted as part of the Housing and Community Development Act of 1974, the Treasury Department takes the view that Section 167(k), as presently enacted, precludes the Secretary of the Treasury from adopting regulations which would define families and individuals of low and moderate income in accordance with the Section 8 income test. That leaves available only the outmoded test of the Section 236 housing program. The amendment suggested above would properly expand the Secretary's authority in this respect.

This amendment was supported by HUD before the Ways and Means Committee during consideration of H. R. 10612.

3. *Confirm "per dwelling unit" Application of Section.*—In view of the enactment and implementation of the Section 8 Leased Housing Program, which contemplates both low and non-low income housing within a single building, codify the present Treasury Department interpretation that Section 167(k) can be applied on a "per dwelling unit" basis.

This amendment, which would clarify an ambiguity in the present statute, was supported by HUD before the Ways and Means Committee during consideration of H. R. 10612.

4. *Apply Section to Expenditures Incurred pursuant to a "Binding Contract".*—A definition would be added to Section 167(k) to provide that rehabilitation expenditures incurred pursuant to a binding contract entered into prior to January 1, 1981, and rehabilitation expenditures incurred with respect to low-income rental housing the rehabilitation of which has begun prior to January 1, 1981, shall be deemed incurred prior to January 1, 1981.

It is important that Section 167(k), as amended, apply to expenditures incurred pursuant to binding contracts entered into prior to January 1, 1981, rather than just to expenditures incurred by that date. The IRS Regulations presently take the view that an expenditure is not incurred until "all events have occurred which establish the fact of the taxpayer's liability with reasonable accuracy." (See Treas. Reg. 1.167(k)-1(a)(2).) That accounting definition of the word "incurred" does not include work in process and would tend to discourage the commencement now of rehabilitation that cannot or may not be completed by December 31, 1980. The amendment is based upon the precedent set by a prior extension of Section 167(k) contained in P. L. 93-482 (see Exhibit C). Occasionally rehabilitation is done by the owner or developer himself, rather than contracted for with an outside party. To cover that situation, the definition of "incurred" should also include expenditures later accrued when the rehabilitation actually has begun prior to January 1, 1981.

Dr. Woodworth has endorsed this amendment, and we understand that HUD does not object to it.

Attached as Exhibit D is language of a proposed bill that would achieve all of the foregoing with respect to Section 167(k).

D. Minimum Tax on Tax Preference Items

H. R. 10612 makes significant changes in current minimum tax provisions. It is not an overstatement to say that the changes, taken together, will virtually eliminate private investment in low and moderate income housing.

We concur in the view expressed by Secretary Simon in his testimony on March 18, 1976 when he said that treating construction period interest and taxes not limited by LAL as tax preference items is "conceptually unsound" and we agree with his further statement that "HUD and Treasury are convinced that this treatment can have an adverse affect on real estate development." We believe that that conclusion is especially true in the case of low and moderate income housing, where almost the entire return to the investor is made up of tax benefits and cash return is of little importance.

Exhibit E demonstrates, in the context of an actual National Housing Partnership syndication, the effect of the minimum tax on a modest investor. As can be seen, such an investor under present law would pay no minimum tax on an investment of $117,200, but under H. R. 10612, as reported by the Ways and Means Committee, he would pay $26,395 in minimum tax; and under H. R. 10612 as passed by the House he would pay $49,600 in minimum tax! In other words, under the House bill, in order to achieve eventual tax benefits of $196,350, the investor must risk $117,200 of his own cash and pay $49,600 in taxes, leaving a "profit" of only $29,550. Not a very attractive offer, when one considers that a 19 year tax exempt bond in the principal

amount of $117,000 bearing interest at the rate of 7% per annum would return $155,610 in tax free interest, plus the holder's original investment. Given such a choice, how many investors can be expected to choose low and moderate income housing in preference to tax exempt bonds and similar less troublesome investments.

We urge that all tax preference items—accelerated depreciation included—arising from low and moderate income housing be exempt from the minimum tax presently set forth in H. R. 10612. Without that exemption, the exemption from LAL already granted has no meaning.

E. Other Technical Matters

The definition of "low-income housing" set forth in proposed Section 470(a)(4) of the Code (p. 27 of H. R. 10612) in our opinion requires certain technical revision in order (i) to include the small but important Section 515 low income housing program administered by the Farmers Home Administration for rural areas, and (ii) to correctly reference the state and local programs for financing and assisting families and individuals of low and moderate income. Comparable corrections should also be made in the proposed amendments to Section 1250 of the Code (pp. 42–43 of the Bill).

Similarly, should proposed Section 470(c)(3)(A) of the Code (p. 31 of H. R. 10612) be retained (which we oppose), then it also requires technical amendment to correctly reference commitments under the appropriate state and local low and moderate income housing programs.

These technical drafting problems have been discussed and explained to Dr. Woodworth and other members of the staff of the Joint Committee on Internal Revenue Taxation. Our suggestions for revision are attached hereto as Exhibits F–1, F–1, and F–3.

This Technical Memorandum is submitted by the Ad Hoc Coalition for Low and Moderate Income Housing, which consists of the organizations and individuals whose names re shown on Exhibit G.

Exhibit A

THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT,
Washington, D. C., October 10, 1975.

Hon. AL ULLMAN,
Chairman,
Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: I fully appreciate the importance of the Committee's efforts to reform the laws applicable to tax shelters. At the same time, I would like to take this opportunity to express my strong concern that certain of the tentative decisions made to date by the Ways and Means Committee will have a serious adverse impact on housing production, particularly production of housing for lower income families.

The Committee I am sure will recognize that its decisions are coming at a crucial time for housing. After a two-year period during which new commitments under the previous subsidized housing program were suspended, we are just commencing the new Section 8 program to produce much needed low and moderate income housing. New construction and substantial rehabilitation under the Section 8 program require the investment incentives which are currently provided through the tax laws. As to unsubsidized housing, the multifamily sector is exceptionally depressed, and it is therefore critical that the Committee's proposed tax changes be commenced in a manner which will not abort currently planned construction if we are to sustain the housing recovery that is so essential to the nation's economy.

I believe that a limited number of modifications to these tentative decisions will preserve the Committee's approach to tax reforms, and at the same time reconcile these important tax reforms with the need to produce housing. I strongly urge the Committee to make the following modifications to its tentative decisions—

First, low and moderate income housing should be exempted from the Limitation on Artificial Losses (LAL). At a minimum, if the Committee does not provide such an exemption, it should at least defer application of LAL for

five years. This would permit production under the new Section 8 program to go forward uninterrupted over the next two years while the Administration and Congress consider possible alternatives. The Committee's two-year deferral with three-year phase-in, while similar to a five-year deferral, is inadequate because of the long lead time often required for subsidized projects. I would add that accelerated depreciation should be subject to the minimum tax.

I recognize that our existing tax provisions present serious issues from the standpoint of the overall operation and fairness of our tax system. The difficulty is that, particularly where lower income housing is concerned, we do not currently have an alternative. Such an alternative may require both revised tax laws and revised housing legislation. I have appointed an intradepartmental Task Force chaired by General Counsel Robert R. Elliott to determine whether there are better tax or non-tax alternatives.

Second, in order to assist the housing recovery generally, and the depressed multifamily rental sector in particular, we would urge the Committee to provide rules for the commencement of LAL as to non-subsidized housing which will avoid cancellation of planned construction.

Third, the Committee should avoid retroactive application of the new recapture rule to projects already built or started—a feature that seems certain to contribute to investor resistance to residential real estate investment in the future—and should provide for timing of recapture changes so that they parallel changes in the timing of LAL as recommended above.

In addition to the above modifications in its tentative decisions, I strongly urge that the Committee add to its bill an extension of Section 167(k) of the Internal Revenue Code relating to the depreciation of costs of rehabilitating housing for low and moderate income use. This provision is needed if we are to achieve any significant volume of rehabilitation in support of neighborhood preservation efforts in communities across the country. The Department favors increasing the maximum and minimum per unit amounts to $20,000 and $5,000, respectively.

We will be pleased to provide more detail on the basis for each of the above recommendations, as well as recommendations incidental to the above, such as recommendations regarding the definition of low and moderate income housing. My staff will be available to discuss the specific technical issues with Committee staff.

Sincerely,

CARLA A. HILLS.

Enclosure.

MAJOR HUD CONCERNS IN CURRENT TAX LEGISLATION MARK-UP

The Department of Housing and Urban Development believes that several of the tentative decisions of the Ways and Means Committee on changes in tax law applicable to real estate investments will have a serious adverse impact on low and moderate housing production and upon current prospects for a housing recovery. A summary of these concerns and recommendations is set forth below.

1. APPLICATION OF LL TO LOW AND MODERATE INCOME HOUSING

In 1974, the Committee, while agreeing upon LAL, voted to exempt low and moderate income housing from its terms. This year's tentative decisions reflect an intention to apply LAL to low and moderate income housing beginning in 1978.

The problem is that, without the favorable tax treatment permitted by current law, there is no reasonable prospect that we will be able to build the low and moderate income housing which is needed and which the Congress expects to see our program produce. It is true that with the enactment of the new Section 8 program, our housing subsidy laws have been modified in some material ways from those which were in effect in 1969 when the present pattern of tax incentives was fixed.

These modifications, however, have not changed the one fundamental feature that requires special investment tax incentives—the exceptional risks associated with ownership and long-term successful operation of projects occupied by low and moderate income famlies. These risks are accentuated in the new

Section 8 program to the extent that the program by statutory direction is expected to serve more of the very low income tenants for whom proper management may be most difficult. The present favorable tax treatment is also important for construction of housing under state and local programs for low income housing.

The fact is that builders will not build subsidized projects unless they are able to sell the projects to investors. And the fact is that investors will not purchase subsidized apartment projects unless their investment produces the substantial tax advantages available under current law.

As a means of obtaining production of subsidized projects, there is currently no alternative to the tax incentives provided in the present law. The Department has begun a thorough study of possible alternatives.

We believe low and moderate income housing should be exempted from LAL. We believe that if the Committee is not prepared to exempt low and moderate income housing projects from LAL, it should at least defer application of LAL for a sufficiently long period to permit consideration of possible alternatives without curtailing investment decisions over the next several years. For this purpose, the Committee should allow at least three years as the time lead for a subsidized project from conception to subsidy commitment. This means that if production of subsidized housing is to continue uninterrupted during the next two years—which would allow time for consideration and enactment of a possible alternative—the bill should provide an additional three years for developers to obtain final subsidy commitments.

We would stress that the lead time required for low and moderate income projects is much longer than that typically required for non-subsidized projects, given the local and Federal approvals and special reviews required. Further, the time needed to process a particular subsidized project is much more uncertain. Thus, the two-year period during which, under the Committee's decisions, new construction could be started without application of LAL will be completely inadequate, since investors who might incur substantial costs would have no reasonable assurance that construction would in fact begin within that period. The two-year time lag accordingly would not only fail to stimulate new investment but would probably adversely affect some of the investment decisions already made.

2. LAL APPLICATION TO NON-SUBSIDIZED HOUSING PROJECTS

The Committee has tentatively decided to apply LAL to new residential projects not designed for low and moderate income families which are started after December 31, 1975. This means that the legislation would have an immediate impact not only on future project planning but also on projects ready for construction.

Our concern with this aspect of the bill is that, coming just now, it adds to our difficulties in stimulating and supporting housing recovery that is vital to our overall economic recovery. The slump in housing which began last year has been marked by an unusual weakness in the multifamily sector and an adequate recovery in that sector is likely to be difficult to achieve. We estimate that in this calendar year there will be fewer than 150,000 new or rehabilitated non-subsidized multifamily rental housing starts, as compared to an average of 400,000 per annum in the 1964-1969 period, and 550,000 per annum in the 1970-1973 period. There are current indications of a modest recovery next year. An immediate application of the new rule to all projects where construction is to commence after December 31, 1974, may cause cancellation of much planned construction.

We urge that the Committee establish rules regarding commencement of LAL which will avoid cancellation of planned construction of non-subsidized projects.

3. RECAPTURE OF DEPRECIATION

At present, the Internal Revenue Code provides for recapture as ordinary income of depreciation in excess of straight-line depreciation as a decreasing method over ten years in the case of certain low and moderate income projects and 16⅔ years in the case of other residential housing projects. The Committee's proposed provision would provide that all such accelerated de-

preciation attributable to taxable years beginning after December 31, 1975, be recaptured as ordinary income regardless of when the project was constructed.

One of our concerns with this feature—apart from arguments of fairness that might be made on behalf of those who relied upon the prior rules—is that, from a housing standpoint, a retroactive change may shake investor confidence, if they had before them the example of a retroactive change in the recapture rules.

Our more basic concern arises simply from the belief that the recapture rules should be considered as part and parcel of the present system of incentives for production. Thus, if housing considerations suggest that these incentives should be continued to some extent, we think that the same considerations apply to recapture. We therefore recommend that the timing of recapture changes be meshed with the application of LAL so that the new full recapture rules would apply only to those future projects—subsidized or non-non-subsidized—that would be subject to LAL. However, in the case of subsidized housing, if the Committee wishes to make an immediate change, we urge that it consider a provision which would apply to subsidized projects the same 16⅔ year rule as applies under current law to non-subsidized projects.

4. EXTENSION OF SECTION 167(k)

Section 167(k), enacted as part of the Tax Reform Act of 1969, provides that owners of multifamily rental property may depreciate costs in five years so long as the property is rented to low and moderate income tenants and certain other requirements are met. Section 167(k) expires December 31, 1975, unless extended by Congress.

We strongly urge the extension of section 167(k). Section 167(k) is an essential measure to foster rehabilitation of existing housing stock for low and moderate income families. Congress in the Housing and Community Development Act of 1974 specifically amended the national housing goal to emphasize the preservation of existing housing stock. Rehabilitation is crucial now in view of current costs of new construction and the broader public policy interests in maintaining the vitality of older urban areas.

Initiation of rehabilitation projects for low and moderate income families has ground to a halt due to the imminent expiration of section 167(k). An extension is necessary if planning and execution of new projects is to go forward.

Section 167(k) currently sets a $15,000 maximum and a $3,000 minimum on the amount of rehabilitation expenditures per unit. In order to provide for increases in costs since section 167(k) was enacted, we recommend that these limits be increased to $20,000 and $5,000, respectively.

5. OTHER RECOMMENDATIONS

a. *Definition of related income for LAL purposes-aggregation.*—With one minor exception, the Committee's tentative decision on LAL contemplates that "artificial" losses—including construction period interest and taxes as well as accelerated depreciation—can only be taken against income from the same projects. We believe that this concept of related income is too narrow in that it would operate not only in syndication arrangements where investors otherwise would deduct the artificial losses against unrelated ordinary income from completely different activities, but also against established builder-developers who are developing and operating successful housing projects without syndication of ownership. The most important tax incentive now provided to those developers is the availability of a current deduction for construction period interest and taxes. This would in nearly every case be unavailable so long as related income is defined on a project-by-project basis, since a project under construction would ordinarily not be producing income. Accordingly, we urge that related income for LAL purposes be defined to include at least income from other housing projects held for rental or sale.

b. *Reform to curb abuses related to project foreclosures.*—We urge, as a reform to avoid abuses which have occurred, that the percentage of ordinary income recapture be determined under the existing rules as of the date of

commencement of foreclosure, rather than as of the date foreclosures is completed. There have been instances in which foreclosures have been litigated and dilatory tactics pursued in order to extend a tax shelter and reduce the percentage or ordinary income recapture. We urge this change to counteract incentives which otherwise exist for such abuses.

Exhibit B

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., October 22, 1975.

Hon. JAMES A. BURKE,
House of Representatives,
Washington, D.C.

DEAR MR. BURKE: This is in response to your request for my candid appraisal of a proposed bill that provides for continuation through 1980 of section 167(k) which provides for five-year amortization of the expenses incurred in rehabilitating rental housing for low or moderate income families.

The increases in the limitations from $3,000 and $15,000 to $5,000 and $20,000 are reasonable in view of the increase in construction costs during the past several years.

The mixture of low and nonlow income tenants within the same building may be a desirable social objective, but it may be difficult to assure that the tenants fit the income restrictions applicable to each dwelling unit. This is a general observation, but actual implementation of the program may be able to avoid such complications as an ineligible tenant occupying a rehabilitated dwelling unit.

The binding contract provision that would permit completion of projects begun before the expiration date is reasonable and desirable.

The history of this provision, however, indicates that it has had limited success. Where it has been used, this has occurred in conjunction with other forms of housing subsidies, such as mortgage guarantees and rent subsidies. The combination provides the investor who is interested with a combination of subsidies that is topped off with the tax shelter opportunity under section 167(k). Many potential rehabilitation projects, however, have floundered on the difficulty that rehabilitation has begun after neighborhoods have undergone serious deterioration, and it has been difficult to convince moderate income tenants to return. As a consequence, low income families have been the major tenant group, and in the view of developers and investors, this has raised the risks of the projects.

'Low income families also need adequate housing and require financial assistance to obtain it. To the extent section 167(k) helps achieve this objective, it should be extended through 1980.' The Department of Housing and Urban Development now may have sufficient experience to assure effective accomplishment of the program's objectives. On the basis of past experience, however, the rehabilitation program has to be judged as a limited success, and section 167(k) has been useful chiefly as an additional tax shelter rather than as an incentive to rehabilitate housing for low and moderate income families.

Sincerely yours,

LAURENCE N. WOODWORTH.

Exhibit C

A BILL To amend Subsection 167(k) of the Internal Revenue Code to promote the rehabilitation of housing for families of low income

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Subsection 167(k) of the Internal Revenue Code of 1954 (relating to depreciation of expenditures to rehabilitated low-income rental housing) is amended by—

(1) striking out "January 1, 1976," in paragraph (1) and inserting in lieu thereof "January 1, 1981,";

(2) striking out "$15,000" in paragraph (2)(A) and inserting in lieu thereof $20,000";

(3) striking out the words "existing building" in paragraph (3)(A) and inserting in lieu thereof "existing building, or any portion thereof,";

(4) striking out the words "any building the dwelling units in" in paragraph (3)(B) and inserting in lieu thereof "any dwelling units";

(5) striking out words "pursuant to regulations prescribed under this subsection" in paragraph (3)(B) and inserting in lieu thereof ", the Housing and Community Development Act of 1974, and subsequent acts related to federal housing programs, pursuant to regulations prescribed under this subsection."

(6) adding the following new paragraph (3)(D): "(D) REHABILITATION EXPENDITURES INCURRED—Rehabilitation expenditures incurred pursuant to a binding contract entered into prior to January 1, 1981, and rehabilitation expenditures incurred with respect to low-income rental housing the rehabilitation of which has begun prior to January 1, 1981, shall be deemed incurred prior to January 1, 1981."

SECTION 2. The amendment made by this Act to paragraph (2)(A) of subsection 167(k) shall apply to rehabilitation expenditures incurred with respect to low-income rental housing the rehabilitation of which begins after December 31, 1975.

EFFECTS OF CHANGES IN THE MINIMUM TAX ON A TYPICAL NATIONAL HOUSING PARTNERSHIP SYNDICATION

We have used an actual syndication of the National Housing Partnership to demonstrate the impact on an investor of the present law and various changes in the minimum tax.

Attached are three schedules illustrating the effect on a "typical" investor of:

1. The present minimum tax.
2. The version adopted by the Ways and Means Committee.
3. The version passed by the House of Representatives (The "Corman Amendment").

In preparing these schedules, the following basic assumptions were made:

1. The investor has primarily salary income, is taxed at the 50% rate, and has $20,000 of other tax preference income.
2. The investor acquires two units in the Merrill Lynch VI offering of the National Housing Partnership at a cost of $117,200.

WAYS AND MEANS COMMITTEE VERSION—EFFECT OF MINIMUM TAX ON INVESTOR

	Investment	Tax loss	Tax saving before minimum tax at 50 percent	Minimum tax Ways and Means	Tax saving after minimum tax	Net investment
Year:						
1976	($29,760)	$57,500	$28,750	($2,850)	$25,900	($3,860)
1977	(24,000)	45,500	22,750	(4,000)	18,750	(9,110)
1978	(24,000)	36,000	18,000	(3,625)	14,375	(18,735)
1979	(20,880)	31,700	15,850	(3,370)	12,580	(27,035)
1980	(18,560)	27,400	13,700	(2,910)	10,790	(34,805)
1981		24,600	12,300	(2,515)	9,785	(25,020)
1982		24,600	12,300	(2,125	10,175	(14,845)
1983		22,500	11,250	(1,760)	9,490	(5,355)
1984		20,300	10,150	(1,370)	8,780	3,425
1985		18,200	9,100	(1,000)	8,100	11,525
1986		16,000	8,000	(640)	7,360	18,885
1987		16,000	8,000	(330)	7,670	26,555
1988		13,700	6,850		6,850	33,405
1989		11,400	5,700		5,700	39,105
1990		9,100	4,550		4,550	43,655
1991		6,700	3,350		3,350	47,005
1992		6,400	3,200		3,200	50,205
1993		3,800	1,900		1,900	52,105
1994		1,300	650		650	52,755
Total	(117,200)	392,700	196,350	(26,395)	169,955	52,755

HOUSE VERSION—EFFECT OF MINIMUM TAX ON INVESTOR

	Investment	Tax loss	Tax saving before minimum tax at 50 percent	Minimum tax—Corman amendment	Tax saving after minimum law	Net investment
Year:						
1976	(29,760)	$57,500	$28,750	$11,480	$17,270	($12,490)
1977	(24,000)	45,500	22,750	4,985	17,765	(18,725)
1978	(24,000)	36,000	18,000	4,620	13,380	(29,345)
1979	(20,880)	31,700	15,850	4,255	11,595	(38,630)
1980	(18,560)	27,400	13,700	3,890	9,810	(47,380)
1981		24,600	12,300	3,500	8,800	(38,580)
1982		24,600	12,300	3,110	9,190	(29,390)
1983		22,500	11,250	2,745	8,505	(20,885)
1984		20,300	10,150	2,355	7,795	(13,090)
1985		18,200	9,100	1,990	7,110	(5,980)
1986		16,000	8,000	1,625	6,395	395
1987		16,000	8,000	1,315	6,685	7,080
1988		13,700	6,850	980	5,870	12,950
1989		11,400	5,700	785	4,915	17,865
1990		9,100	4,550	695	3,905	21,770
1991		6,700	3,350	505	2,845	24,615
1992		6,400	3,200	365	2,835	27,450
1993		3,800	1,900	280	1,620	29,070
1994		1,300	650	170	480	29,550
Total	(117,200)	392,700	196,350	49,600	146,750	29,550

PRESENT LAW—EFFECT OF MINIMUM TAX ON INVESTOR

	Investment	Tax loss	Tax saving before minimum tax at 50 percent	Minimum tax—present law	Tax saving after minimum tax	Net investment
Year:						
1976	($29,760)	$57,500	$28,750	None	$28,750	($1,010)
1977	(24,000)	45,500	22,750	do	22,750	(2,260)
1978	(24,000)	36,000	18,000	do	18,000	(8,260)
1979	(20,880)	31,700	15,850	do	15,850	(13,290)
1980	(18,560)	27,400	13,700	do	13,700	(18,150)
1981		24,600	12,300	do	12,300	(5,850)
1982		24,600	12,300	do	12,300	6,450
1983		22,500	11,250	do	11,250	17,700
1984		20,300	10,150	do	10,150	27,850
1985		18,200	9,100	do	9,100	36,950
1986		16,000	8,000	do	8,000	14,950
1987		16,000	8,000	do	8,000	52,950
1988		13,700	6,850	do	6,850	59,800
1989		11,400	5,700	do	5,700	65,500
1990		9,100	4,550	do	4,550	70,050
1991		6,700	3,350	do	3,350	73,400
1992		6,400	3,200	do	3,200	76,600
1993		3,800	1,900	do	1,900	78,500
1994		1,300	650	do	650	79,150
Total	(117,200)	392,700	196,350		196,350	79,150

Exhibit E-1

* * * * * * *

"(4) LOW-INCOME HOUSING.—The term 'low-income housing' means—

"(A) property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under Section 515 of the Housing Act of 1949 or under provisions of State or local laws intended primarily to finance or assist housing for families or individuals of low or moderate income, and with respect to which the owner is subject to the restrictions of section 1039(b)(1)(B), or

"(B) dwelling units held or to be held (pursuant to commitments) for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under

the provisions of State or local law providing for subsidies of a similar nature for low or moderate income families and individuals.

In the case of a building (or the portion of a building devoted to dwelling units), if 85 percent or more of the dwelling units are units described in subparagraph (B), such building (or portion thereof) shall be treated as low-income housing.

* * * * * * *

Exhibit E-2

"(3) LOW-INCOME HOUSING.—In the case of low-income housing, this subpart shall not apply to real property if—

"(A) before January 1, 1979, there is a subsidy commitment to support new construction or substantial rehabilitation under section 8 of the United States Housing Act of 1937, as amended (or a commitment under the provisions of State or local law to finance or assist new construction or substantial rehabilitation for low or moderate income families and individuals) and such commitment was made before the beginning of the construction or rehabilitation of such property, and

"(B) the construction period for such property begins before January 1, 1981.

"(4) COORDINATION WITH SECTION 167(k).—For purposes of this subpart, any expenditure incurred before January 1, 1978, to which section 167(k) (relating to depreciation of expenditures to rehabilitate low-income rental housing) applies shall not be treated as an accelerated deduction.

* * * * * * *

term 'applicable percentage' means—

"(B) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A), the

[Exhibit E-3]

"(i) in the case of section 1250 property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under Section 515 of the Housing Act of 1949 or under provisions of State or local laws intended primarily to finance or assist housing for families or individuals of low or moderate income, and with respect to which the owner is subject to the restrictions described in section 1039 (b)(1)(B), 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;

"(ii) in the case of dwelling units which, on the average, were held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law providing for subsidies of a similar nature for low or moderate income families and individuals, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;

"(iii) in the case of section 1250 property with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k), 100 percent minus 1 percentage point for each full month in excess of 100 full months after the date on which such property was placed in service; and

"(iv) in the case of all other section 1250 propery, 100 percent.

In the case of a building (or a portion of a building devoted to dwelling units), if on the average, 85 percent or more of the dwelling units contained in such building (or portion thereof) are units described in clause (ii), such building (or portion thereof) shall be treated as property described in clause (ii). Clauses (i) and (ii) shall not apply with respect to the additional depreciation described in subsection (b)(4).

* * * * * * *

[Exhibit F]

Membership of Ad Hoc Coalition for Low and Moderate Income Housing

ORGANIZATIONS

Council of State Housing Agencies.
National Housing Partnership.
Institute for Government Assisted Housing.
National Housing Rehabilitation Association.
National Leased Housed Association.

INDIVIDUALS

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Nathan Betnun, Department of Economic and Community Development, 2525 Riva Road, Annapolis, Maryland 21401 (301) 267-5830.

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Edward Butler, Jr., Forest City Dillon, Inc., 10800 Brookpark Road, Cleveland, Ohio 44130 (216) 267-1200.

Sandra Butter, South Bronx Community Housing Corp., 349 E. 149th Street, Bronx, New York 10451 (212) 585-2100.

E. Anthony Buzzetti, Operations Officer, R. I. Housing & Mortgage Finance Corp., Suite 1420, 40 Westminster St., Providence, Rhode Island 02903 (401) 751-5566.

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James Ginsburg, CRC Development Corp., 762 Fairmount Avenue, Towson, Maryland 21204 (301) 823-1383.

William Hirshson, c/o Greater Hartford Community Development Corporation, 100 Constitution Plaza, Hartford, Connecticut 06106 (203) 249-1331.

George C. Hobson, Cumberland Housing Authority, 1 Mendon Road, Cumberland, Rhode Island 02864 (401) 724-8590.

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Keith A. Waldrop, Executive Director, Georgia Residential Finance Auth., LaVista Perimeter Office Park, Building 1, Suite 101, 2163 Northlake Parkway, Tucker, Georgia 30084 (404) 934-1192.

Stephen Ziegler, Esq., Young, Kaplan & Edelstein, 277 Park Avenue, New York, New York 10017 (212) 826-0314.

Mark Munley, New Jersey Development of Community Affairs, 363 West State Street, Trenton, New Jersey 08618 (609) 292-8117.

Mr. Tom Forrester Lord, Houston Housing Development Corp., 430 Lamar, Suite 200, Houston, Texas 77002 (713) 225-1017.

The CHAIRMAN. Next we will hear from Kenneth Hance, Jr. Please proceed.

STATEMENT OF KENNETH G. HANCE, JR., PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES; ACCOMPANIED BY BRUCE S. LANE, ESQ., LANE AND EDSON, GENERAL COUNSEL

Mr. HANCE. Mr. Chairman, my name is Kenneth G. Hance, Jr. I submit this statement in my capacity as president of the Council of State Housing Agencies and as a member of the executive committee of the Ad Hoc Coalition for Low and Moderate Income Housing. I am accompanied today by the council's general counsel, Bruce S. Lane, Esq., of Lane and Edson, P.C., Washington, D.C.

The Council of State Housing Agencies is an association representing the State housing agencies of virtually all of the approximately 35 States that have enacted such a program. Each State housing agency is an arm of the State government that has created it.

I am executive director of the Virginia Housing Development Authority, a political subdivision of the Commonwealth of Virginia and one of the more active state agencies in the Nation responsible for the financing and development of low and moderate income housing.

State housing programs have already become an important element in the field of Government-assisted housing. To date these programs have assisted the development of over 250,000 units of low and moderate income housing, representing an aggregate investment of over $6 billion. The bulk of this housing was developed in conjunction with the interest subsidies provided by the Federal section

236 program. Roughly 20 percent of all housing produced under the section 236 program was developed in conjunction with financing provided by State housing finance agencies.

As a result of the enactment by Congress of the section 8 leased housing program as a part of the Housing and Development Act of 1974, and the implementation of that program by HUD, a very large and special responsibility has been placed on the State housing agencies for financing and developing a large portion of the Nation's low and moderate income housing in the future. State housing agencies are intended to be one of the primary leaders of mortgage money to the builders and rehabilitators of section 8 leased housing, and HUD has requested the State agencies to assist in financing and developing 100,000 units, 25 percent of the entire national section 8 production goal for fiscal 1976. The State agencies cannot do the job alone. There must be equity money in every project. That equity money, as the previous witness has pointed out, invariably comes from private investors, primarily through the incentive of tax benefits.

H.R. 10612 recognizes that the present tax incentives are essential to the continued production of low- and moderate-income housing and, in effect, provides that such incentives not be removed for at least 5 years, which should permit Congress time to develop, test, and implement workable substitute incentives, perhaps under provisions other than the tax laws. Our position with respect to such a 5-year exemption is supported by the administration, by Senator Edward M. Kennedy, by Ralph Nader's Tax Reform Research Group, and by many others.

We urge, however, that the provision of section 470(c)(3) of H.R. 10612, which exempts from LAL low-income housing the construction period of which begins before January 1, 1981 if a section 8 or comparable State or local subsidy commitment is obtained before January 1, 1979, be modified to eliminate the latter requirement. The requirement of a subsidy commitment within the first 3 years of the exemption period results in only a 3-year rather than a 5-year extension of present law, since construction normally begins shortly after such a commitment issues.

Second, there is no comparable subsidy under any present State or local housing program, and so effectively eliminates entirely from the exemption all State and local programs for low- and moderate-income housing which function separately from the Federal section 8 leased housing program—and there are many of these. Indeed, they have thus far been the heart of the State low income housing programs. The technical memorandum submitted by the ad hoc coalition, which we endorse, explains this point further.

Also, Mr. Chairman, the increases in the minimum tax on tax preference items and the inclusion therein of construction period interest and taxes, essentially remove with the left hand the exemption conveyed with the right hand. We urge that all tax preference items generated by low- and moderate-income housing be exempt from the minimum tax. And, for the same reasons stated by the previous speaker, we also urge that the proposed change in the recapture rules, insofar as they affect low- and moderate-income

housing, affect only housing the construction of which begins after the effective date of this legislation.

State housing agencies take their responsibility very seriously, and they have developed many techniques, including escrow arrangements and strict supervision of syndication, to prevent the abuses and injustices about which many Senators and Congressmen have expressed concern. In that controlled atmosphere, with exemptions from LAL and the minimum tax, and with the program formulated recently by Congress through the section 8 leased housing program, the States can be a major force in assisting in achieving the Nation's needs for low- and moderate-income housing and, in particular, in coming nearer to achieving the goal of Secretary of Housing and Urban Development Hills to have 400,000 units of leased housing under commitment by October 31, 1976.

Without attempting to duplicate what has already been said before, we certainly endorse the comments of Mr. Dukess and Mr. Freidberg with respect to immediate extension of 167(k).

Thank you for consideration of this matter.

The CHAIRMAN. Thank you very much.

Senator HARRY F. BYRD, JR. Do you feel the House-passed legislation would be very detrimental to moderate- and low-income housing? I assume you also feel it would be detrimental to the entire housing industry whether it be low or middle income or whatever.

Mr. FREIDBERG. That is correct. We were only expressing our own parochial point of view, but we agree that the House-passed legislation would be detrimental to all housing.

The CHAIRMAN. Our next witness is Albert A. Walsh on behalf of the National Realty Committee.

STATEMENT OF ALBERT A. WALSH, PRESIDENT, NATIONAL REALTY COMMITTEE; ACCOMPANIED BY ALAN J. B. ARONSOHN, ESQ., NRC TAX COUNSEL

Mr. WALSH. Mr. Chairman and members of the committee, my name is Albert A. Walsh, and I am appearing today as president of the National Realty Committee, Inc., a nonprofit business league of owners, operators, and developers, of all types of real estate throughout the United States. I am accompanied by Alan J. B. Aronsohn, Esq., NRC's tax counsel.

Mr. Chairman, we appreciate this opportunity to present the views of the National Realty Committee on the House-passed Tax Reform bill, H.R. 10612, and on certain other current tax reform proposals.

In the interest of time, we will submit our full statement for the record and Mr. Aronsohn and I will try to briefly summarize the main points.

The real estate industry in the United States is an immense but highly fragmented industry which has an enormous impact on the American economy. With all of its fragments taken as a whole, it is the third largest industry in the United States.

Contrary to popular belief, this high economic impact industry is composed of a very large number of very small firms. Of some

450,000 firms which may be said to comprise the real estate industry, a majority have three or fewer employees and less than 10 percent have 20 or more employees.

Because it is essentially an industry of small business units, and because the decision to invest in real estate is always highly discretionary, real estate is unusually susceptible to even small changes in the law law.

Other witnesses, most of whom have never developed, owned or operated a piece of real estate, will tell this committee that even the most drastic tax reform proposal will not significantly affect the amount of capital investment flowing to real estate, or that, even if it does, the flow of capital out of real estate into other forms of investment will not adversely affect the gross national product or any other vital aspect of our national economy.

Mr. Chairman, this is pure sophistry. Builders and developers will, of course, continue to build wherever and whenever they can, but the rate of return to potential investors will have to be increased in order to compensate for any new tax disadvantages and to compete with alternative investment opportunities. Where the market is strong, these increases will initially be passed on to the tenant or purchaser in the form of increased costs or rents and, in the case of industrial or commercial property, ultimately to the consumer in the form of increased costs for goods and services. If the market will not absorb these increased costs or rentals, which is certainly the case in many areas today, the proposed development will simply not be built, with all of the consequent losses of jobs, national income and gross national product.

There was reference made earlier today to the real estate tax impact model which, in fact, Mr. Chairman, was constructed by Dr. Ture for the National Realty Committee as long ago as 1973. It has since been updated, including Dr. Ture's recent analysis of the provisions of H.R. 10612. The figures that were given earlier did not include the provisions of that bill which affected only residential real estate: namely, the depreciation recapture limitation. So, the aggregate figures on the effect of that legislation on the industry and the economy are as follows: if enacted, that bill would cause a $6.3 billion drop in real estate investment which, in turn, would cause an $11.2 billion loss in real estate GNP, and a 280,000 increase in real estate unemployment, principally in the construction trades.

I would say to Senator Byrd that we do have or can easily get, because we have the whole thing broken down on a state-by-state basis, the breakdown as to how those same numbers, including employment, would come out in the State of Virginia.

We think it most significant, Mr. Chairman, that in contrast to the House Ways and Means Committee's estimate of $1.5 billion in tax revenue to be gained through enactment of H.R. 10612, Dr. Ture predicts a net annual loss in Federal revenues of $2.8 billion from the real estate industry alone, to say nothing of the other provisions of that bill. A summary of Dr. Ture's analysis is attached to this statement for the record and for the convenience of the committee.

If anything will discourage housing recovery, Mr. Chairman, the House bill is certainly it.

As I am sure you know, multifamily housing starts are down from 1.05 million in 1972 to 445,000 in 1974 and 269,000 in 1975 and, notwithstanding the general economic recovery, there is almost no hope of a significant increase in 1976. For some of the same reasons, and because commercial development is so intimately related to an adequate supply of housing, th ame is true for private nonresidential construction.

As a result, we now have 873,000 unemployed construction workers in the United States, a 122 percent increase since 1972.

With your permission, Mr. Chairman, I would like to turn the microphone over to Alan Aronsohn for a few specific comments on the provisions of H.R. 10612 and for our recommendations for a more appropriate approach to the difficult problem of taxpayers with excessive tax preferences.

Mr. ARONSOHN. I wil try to limit my remarks to only a few points, because we have filed a very substantial statement, and you have certainly listened to a lot of witnesses this morning.

The first point I would like to briefly allude to is the complexity of the House bill.

Do we really need to have two minimum taxes, one for corporations, one for individuals, a different set of LAL rules for each industry covered by LAL plus a large number of industries not covered by LAL at all, and a multitude of different kinds of limitations on certain sorts of interest?

We do not think that the tax shelter problem, while it may be a problem, is such a substantial problem in the United States, that we have to turn the Internal Revenue Code inside out, and very substantial industries like the real estate industry inside out, to try to handle problems that people may believe are abuse situations.

In that respect, the Chairman referred earlier to the report of the Tax Committee of the Association of the Bar of the city of New York with which we are familiar; we would support their approach which is more of a limitation on the deductibility of tax preferences, somewhat comparable to the Treasury Department's suggestions back in 1969 which, to some extent, I think, are superior to anything that has been suggested since. At least an approach of that kind has the merit of being easily understandable by the American people. I think it can be administered fairly by taxpayers and by Government agencies. It has a large element of fairness in it.

I do not think that under the Bar Association proposal, people can end up finding themselves in an impossible position, which would be the effect of some of the whimsicalities implicit in the MTI approach; we would recommend the Bar Association's approach.

In any event, we certainly recommend the notion of some kind of alternative minimum tax as opposed to the minimum tax approach in the House bill which has many elements of unfairness in it.

The only other point I would like to touch on is a remark made by Senator Packwood before he left, reporting Secretary Simon who last week referred to real estate construction items in terms of being artificial losses. We find its very frustrating discussing this issue, particularly in terms of the media treatment which always seems to associate real estate with paper losses, artificial losses, accounting losses.

The real estate industry is a large industry. I am not discussing the merits for the moment of particular incentives introduced into the code by Congress in order to induce, for example, the construction or rehabilitation of low-income housing. That is a totally separate field. Deductions for commercial and nonsubsidized housing involved in the payment of interest and taxes during the construction period, we reiterate in our judgment are certainly not artificial; and they are certainly not paper losses when they are paid.

Now, where does this notion of artificiality come from? Certainly on the House side we repeatedly heard the statement that good accounting practice would require that construction period interest and taxes be capitalized and, therefore, since they are not capitalized under the code, they constitute an artificial accounting loss and the taxpayer ought to feel, as the chairman put it before, that he has been given a Government handout because he has been permitted to deduct these items.

The fact of the matter is that interest has been deductible under the United States Income Tax Laws since the Revenue Act of 1890. If you go back to the debates in Congress over those early income tax laws, you will find they are talking about mortgage interest, and I don't think they were intending to subsidize anybody. They just felt there was an elementary fairness if you had a tax on net income, not gross income, that you would permit someone to deduct certain expenses. I think that is true today.

There are similar deductions accorded to other industries. For example, in the House bill, preproduction expenses incurred in farming are included under LAL, but interest and taxes paid in farming are excluded even if paid in connection with planting a citrus or almond grove, the expenditures for which are required to be capitalized by the code since 1969. Here, again, the current Treasury regulations except from the requirement to capitalize such expenditures, the deduction for interest and taxes. Why? We think it does make sense.

The fact of the matter is that, if you check with the accounting societies, there is no accepted accounting method which mandates the capitalization of construction interest. It is not treated under generally accepted accounting methods necessarily as the cost of the asset. In fact, the Securities and Exchange Commission in an accounting release which they issued in 1974, which we cite in our written statement, specifically stated, that, except for public utilities, interest cost on debt is generally reflected as an expense of the period during which the debt is used rather than being allocated as a cost of the asset acquired by the use of the debt. They give several reasons for that rule, and they make sense.

It is difficult to trace interest. It is not only difficult to trace interest in terms of where the borrowed funds came from, but it is difficult to distinguish interest as a cost of debt capital as opposed to the lack of income that results from the foregone use of equity or nondebt capital.

As we attempted to illustrate by a very simple example in our written statement, if the tax law is changed in a way that deprives a taxpayer who borrows money of a current deduction for the in-

terest he pays constructing a building, he is going to be discriminated agaist as compared with a taxpayer who does not borrow money but uses equity capital that would be otherwise devoted to taxable income-producing activity. In order to put the two in the same tax position, you must preserve the current deduction for construction interest and not penalize it by treating it as a preference under an add-on minimum tax.

I know that when I made this statement previously, proponents of the other view stated that our example is an extreme case. Nobody builds buildings with all equity. You get out and get the biggest mortgage you can. However, the simplicity of the example we have given does not change the underlying merit of the argument, which gets down ot the fact that under a provision like LAL, the more somebody borrows, the more he is discriminated against, and the less he borrows, the better off he is. In addition, generally, if he puts up more equity, he gets a lower rate of interest and, therefore, is penalized to an even lesser degree.

I would say, in conclusion, that except for our differing views with respect to the proper treatment of construction period items, we find our selves largely in agreement with many of the proposals suggested by Secretary Simon last week, and we very much appreciate the opportunity the committee has granted us to testify here today.

The CHAIRMAN. As I indicated earlier, I am going to try to see that Dr. Ture's study is carefully looked at by the Treasury and by the Joint Committees staff. If they cannot agree on the merits of that study, perhaps we might try to hire some independent group—an impartial group, if there is such a thing—and see what those people come up with by the time they make the same type of study.

To me, it is shocking to have a person of Dr. Ture's credentials come up with a study that shows that a proposal which is supposed to bring in $1.5 billion in taxes will not make the $1.5 billion but loses about twice that much in revenues to the Government. In other words, instead of making $1.5 billion, the proposal would lose $2.8 billion and, further, that it would lose us——

Mr. WALSH. 208,000 jobs would be lost.

The CHAIRMAN. When we passed that tax-cut bill last year, it was estimated to cost the Treasury about $17 billion in revenue a year. We estimated at that time that we were going to gain about 700,000 jobs. Now, that is an expensive way to gain 700,000 jobs, but we concluded it would be better than having all those people out of work.

If Dr. Ture is even halfway correct in what he is saying here, and we are going to lose 280,000 jobs—not gain but lose 280,000 jobs—a revenue loss of anything even approaching $2.8 billion is such that you would think we would have to be out of our minds to do that.

You may see different arguments made, but I think sometimes even eloquence must yield to commonsense in the public interest and, therefore, I am going to make this information available to the Congressional Record and ask the Treasury to study it and ask the Joint Tax Committee staff to study it. I will ask them to look at

the same factors and also to look at some of these secondary factors because, if you are not looking at the ripple effect of these things, you are not looking at the whole system to see if this is correct.

May I ask, Mr. Aronsohn, are you familiar with the suggestion being made by the New York Bar Association as a way of moving toward tax uniformity?

Mr. ARONSOHN. I am familiar with their report on tax preference and their suggestion for a limitation on the utilization of aggregate tax preferences as a substitute for both LAL and the minimum tax.

The CHAIRMAN. It is in their prepared statement; they will be down here in the next day or so to testify. There is a great deal to be said for their proposal, comparing it to the complexities and the mischief already done to the economy, comparing it to the proposal to add a 14 percent tax on top of the tax one already pays on capital gains, and that sort of thing.

It would seem to me that that is one very simple approach compared to the infinite complexities of what we have now and, even worse, some of what is being suggested. We ought to further explore this idea before we go for anything that others suggest.

I take it that you as well as the other witnesses do not complain about the concept of paying the kinds of taxes that are suggested, but that——

Mr. ARONSOHN. We are in favor of it, and we think the logic of the bar association's report is pretty overwhelming.

I would think as a political matter the major opposition to that position, based upon what happened to the alternative minimum tax proposals on the House side, will be comparing the revenue estimates with what are in the House bill. It is our view for the reasons you have given that that should not be the deciding factor in choosing one minimum tax approach over another minimum tax approach, that it is not really revenue you are looking for because you probably won't get it anyway, and, in any event, most of the tax derived from the House provision is derived from the House provision is derived from increasing the capital gains rate.

The CHAIRMAN. Actually, it would be difficult to predict. I am confident the income to the Government, not to mention the good to our economy by putting 2 or 3 million idle workmen back on the job, would bring billions of additional dollars of revenue to the Government and, even more important, bring tens of billions of dollars of additional income to our workers and their families. That is something we ought to be concerned about in this country.

We have gone along with the suggestion that we provide an investment tax credit. The ones who claim to have the prior credentials as tax reformers are always talking about tax expenditures. As far as the investment tax credit is concerned, if ever there was a tax expenditure, that would be it.

You give somebody a 10 percent handout from the Government because you think it is justified. You say that if you will buy this new equity, in addition to depreciating 100 percent of the cost you paid for it and all expenses in connection therewith, we will reduce your tax by that amount to encourage you to accumulate capital

and to invest it somewhere where it would expand our economy and make a workman's endeavor more productive.

If we are going to recognize capital accumulation, about the best chance the average little family has to accumulate some capital is to accumulate the complete equity in the ownership of their own home. But when these same people take a look at the deduction of mortgage interest, they say, "Oh, my goodness, that is something that is unconscionable; that is a tax expenditure."

Perhaps that is so. But if you think of it as something to encourage everybody to accumulate some capital, his home is one area where capital accumulation could be accrued.

This Nation benefits from the construction of shopping centers just as it benefits from the construction of a factory, maybe not in precisely the same degree, but it benefits from it when you are putting idle hands to work and making taxpayers out of those who would otherwise be taxeaters.

I find great appeal in your statement. I am going to try to see to it if this estimate that we are going to make $1.5 billion by those additional taxes on your industry is actually an error and you will instead lose $2.8 billion and you will also lose 280,000 jobs in an area which is depressed already, with a lot of people out of work. I think we should try to find out who is telling the truth or who comes more nearly being right and who is more nearly in error about the effect of that proposal.

Mr. ARONSOHN. On the investment credit, may I note that it has been previously stated that every time the investment credit goes up a point, you lose some capital out of the real estate industry. We are faced with all sorts of suggestions for enhancing capital formation, most of which are good ideas, but they will have all by themselves the effect of probably moving capital away from real estate into other areas.

If we add onto that movement specific tax disincentives to investing in real estate, such as adversely treating construction period items, we will have some serious problems. Certainly we will change the real estate business, as it has been known for the last 100 years in the United States.

Senator HARRY F. BYRD, JR. When new buildings or new houses or apartments are constructed, the builder must go out and hire workers, and he pays the workers x number of dollars. He hires or buys equipment and pays x number of dollars for that. Then he must hire, in most cases, money. So, what he is really doing is hiring money when he borrows money and pays 8 or 9 or 10 percent interest, or whatever it might be.

Is it not logical to include interest in as an essential part of doing business? You are hiring the use of somebody else's money, are you not?

Mr. WALSH. Absolutely, and that point is treated at length in our full testimony. Something which has been said many times today has has to be kept in mind: The amount of interst paid on that construction loan does not change the value of that construction one iota. If two identical buildings are built, one totally out of equity capital and the other with a mortgage, they are not worth a different

amount of money. They are worth the same thing. So, you cannot capitalize that interest into the value of your building.

If someone were coming out and doing an appraisal for real property tax assessment purposes or estate taxation or anything else, the interest you paid on that construction loan is totally irrelevant, and it should be treated just like any other interest on borrowed money in the production of income.

Senator HARRY F. BYRD, JR. It is like any other business expense.

Mr. ARONSOHN. It is different than the expense of labor and bricks because the more labor I put into a building and the more bricks I put into it, the more valuable building I will have. The more interest I pay means nothing. If I can borrow interest at 3 percent and you have to pay 12 percent for it, your building is not going to be worth any more than mine because you pay a higher rate of interest.

Mr. WALSH. It may be worth less.

Senator HARRY F. BYRD, JR. You say the housing starts are down to 300,000 in 1975. What are the main reasons for that sharp drop?

Mr. WALSH. Senator, there are a variety of reasons—the high interest rates and the unavailability of mortgage money for apartment construction. Even though you will hear all kinds of statements in testimony about the savings inflows and a lot more money being available, it is not readily available today for apartment construction. That basically is for three reasons.

First is the threat of rent control which is growing around the country, particularly in California, and you had one witness from California testify today. Second, there is increasing hostility in the whole area of the landlord/tenant relationship, and third, this tax bill has been kicking around since 1973, and limitation on artificial losses has been hanging in the air since 1973.

In addition to all of that, construction costs, interest costs, costs of operation, energy costs as well as all other costs have risen so rapidly that many less American families are able to afford the product, whether in terms of the cost of a one-family home or the rental of an apartment. As that number shrinks, there is less and less of a market to build for.

The House bill would inevitably increase, as I testified earlier, the cost of the rental price of housing. There is no doubt that it would also increase the square-foot costs of shopping centers and, ultimately, the costs of the goods in the shopping centers. All of which means there will be no housing built, or less because there will be less people able to afford it.

The real reasons for the recession in the multiple-dwelling field, in multifamily housing starts, are: (a) the pendency of this bill; (b) the costs are high; (c) the fear is they will go higher if this bill is enacted.

Senator HARRY F. BYRD, JR. One reason you ascribe is the sharp increase in interest rates?

Mr. WALSH. Yes.

Senator HARRY F. BYRD, JR. If the Government does not permit interest deduction, that would have the practical effect of increasing the cost of borrowing money.

Mr. WALSH. Absolutely.

Senator HARRY F. BYRD, JR. It would further reduce the construction.

Mr. WALSH. You heard a witness testify it would increase his equity requirements on a typical project by 40 percent, and he is going to have to get that back some place. That is another cost factor into the whole equation of housing costs.

Senator HARRY F. BYRD, JR. That would tend to substantially increase the cost of housing?

Mr. WALSH. Absolutely.

Senator HARRY F. BYRD, JR. If the Congress were to adopt the New York City Bar Association approach and it also wants to, and I assume it does, cut back on tax incentives, do you have any ideas where revenue may be obtained under those conditions?

Mr. WALSH. Senator, first of all, I would like to point out that I agree with Mr. Aronsohn. When you are talking about a minimum tax or an alternative minimum tax, the revenue to be gained should not be the significant criteria. Tax equity probably should be. Tax neutrality, I would hope, is a better word because everybody's definition of tax equity is very, very different. I would also like to call your attention to Dr. Ture's study with particular reference to the minimum tax provisions of the House bill.

I do not recall offhand what the Treasury or Joint Committee staffs were estimating as the gain out of just that portion of the bill, but Dr. Ture's study estimates that just that portion of the bill alone will cause a revenue loss of $1.2 billion.

The CHAIRMAN. They are estimating that the minimum tax provisions will raise $707 million in the first year and that eventually it goes up to a revenue gain by 1981 of $1,091,000,000.

Mr. WALSH. In any year according to this, you are going to lose more out of the real estate industry alone, out of that minimum tax, than you could gain even if the Treasury's estimate of that first impact were correct. Even the Treasury's first-round estimates assume that when that bill passes, the guy who is getting ready to build is going to build anyhow, and both you and I know he will not build.

So, even in the first instance, the Treasury and Joint Committee estimates are wrong. I think that the Ture study only measures the secondary, not tertiary, effects because when we talk about loss of jobs, we are not able to go down to the guy who manufacturers the nuts and bolts and the guys that make refrigerators that go into the house. You just cannot get that far.

The CHAIRMAN. By the time you get through with the other industries, many of them are going to be able to show that they are going to be losing money, just like the man from savings and loans showed us where his industry is going to be losing money.

Mr. WALSH. Absolutely. I think if we get caught in the game of revenue estimates on a minimum tax and if we follow the approach used in the House of Representatives, we are going to lose the fight because their first-round revenue estimates are going to be hard to fight. I will get asked the question Senator Byrd just asked—where do you pick up the revenue? I do not think there is any revenue to be picked up.

The CHAIRMAN. We are talking about how you go about losing those billions this bill would lose for you.

For example, if we had before us a House bill that was going to put a 100 percent income tax on everybody, one could assume we are going to make $1 trillion. If you assume everybody is going to continue to do exactly what he was doing before you put the 100 percent tax on his back, perhaps that is what we would make.

But who in his right mind is going to proceed to go out and work and give it the best he has day in and day out for no pay whatever? The result will be, therefore, far from making the $1 trillion, you would not make the $300 billion you are picking up now. You would be lucky to wind up making $30 billion where you had been making $300 billion, just because some poor folks are so used to working that they would continue to do so even though the Government was taking 100 percent.

By the same token, if you are going to tax them 150 percent of what they make, you could be presented with a revenue estimate that you are going to make $1.5 trillion. Then you would know even the poor souls who were left would quit by that point, even those who were working from force of habit. They would do some repairs around the house. But the last thing they would do is work if they had to pay 150 percent of their income in taxes to the Government.

If you are looking at it in terms of what is in the national interest, it would be to forget about the trillion dollars because that is money you are not going to make anyhow and try to think in terms of saving the $300 billion that would be lost. I suspect this Ture study is correct.

Mr. WALSH. I should state that the basic work on the Ture study comes out of a volume that Dr. Ture did for the National Realty Committee in 1973. I believe a copy of that volume called "Real Estate in the United States' Economy" has sometime ago been delivered to your office. We are in the process of updating some of that basic data because the real estate industry in 1976 is not quite the real estate industry that existed in 1973. Our early impressions are that the effect that comes out in this tax impact model will be even more dramatic on the current situation than they were then.

For example, as has been testified to earlier today, lending institutions are requiring more equity rather than less, so you need more capital investment in order to build a given project. If you need more dollars and you have additional disincentives, then each disincentive dollar is going to have a multiplier effect in terms of loss of gross national income, jobs. If it requires more dollars to build a job and you have in fact less, then the impact could be higher than the 280,000. It could be 350,000.

The CHAIRMAN. In many instances, we are talking about the same figures in a different connection.

I could give you an illustration. I am asking that the International Trade Commission give us some figures that would come nearer to showing us what we are making or losing in trade, not quarreling with the Commerce Department about the figures from which they are working. Where we give something away and do not get paid for it, we should put it down as having made money

from it. We might have created a little good will, and you cannot even be sure of that, but when you gave something away, don't put that down as though you are being paid for it. Another thing any businessman can understand, when you buy something, you should consider the cost of the freight as part of your expense.

When you take things like that into account, something any businessman would do, you wind up with a different conclusion than you do if you start out assuming you are being paid for things everybody knows you are not going to be paid for and leaving out a great deal of the costs everybody knows you had to pay.

Mr. ARONSOHN. We might point out that the real estate industry, like a great many other industries, is dependent upon discretionary investment. If you put a tax rate up high enough, say, below 100 percent, but up to 90 percent, most of us would still have to work because we would have to try to support ourselves on the 10 percent the Government kindly left us, but none of us has to invest in a discretionary investment.

We don't have to spend money we have paid taxes on and put it in apartment houses. You can put it in a mattress or in a savings account. That is why these suggested tax changes can have a much larger impact on an industry of this kind.

The CHAIRMAN. Some of our so-called reformers who want to get a 70 percent or 90 percent tax from the taxpayers, think that if they close enough so-called loopholes, they can collect that much income, because the man would still be out there trying to earn money notwithstanding that.

I honestly think if they were permitted to go through all those exercises, they would find the ingenuity of the taxpayers in finding ways to defeat their purposes is just as good as their ingenuity to find ways to increase taxes. If worst comes to worst, the taxpayer can resort to victory gardens for his food and he can spend his time repairing his own home, and he can find various and sundry ways he can get by in ways that are beneficial to him in the economic sense, where our so-called reformers have still not been able to find the way to fully achieve that task.

Mr. WALSH. And they never will.

Quoted in our written statement, Mr. Chairman, are specific examples not only of the fact that the House bill does not close all of the so-called loopholes but does not mention some of the biggest tax shelters in existence which still go on. If those were closed, somebody, including some very smart people at this table, and behind us, will find some more tomorrow.

I have said many times if it were possible to draft a completely neutral tax bill, at least this segment of the real estate industry would support it. But it is not possible, and certainly H.R. 10612 is as far from neutrality as any piece of legislation that we have ever seen.

The CHAIRMAN. I think one knows how we reach a point of diminishing returns. It applies to taxation, like everything else. I see you are nodding your head, indicating you know that is correct. It works even more so when you are talking about the area where one needs an incentive in order to do something. It is very frustrating to try to proceed on the basis that you are going to tax right up to the

point of diminishing returns, because when one does that, he often finds he has gone far beyond that and in ways he never anticipated and he failed to make money for the Government.

John Kennedy could have explained that by reducing the rates and by putting on an investment tax credit, that you are going to increase revenue to the Government and provides more employment.

I hope we have not gone so far that we fail to recognize there is merit to encouraging people to make investments that are good for the country to provide employment and provide for jobs that all of us will benefit from. The tax law should give enough encouragement so that that will happen.

Thank you very much.

Mr. WALSH. Thank you very much for your extreme generosity in staying so long with us, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Walsh follows. Oral testimony continues on p. 593.]

STATEMENT OF NATIONAL REALTY COMMITTEE, INC.

Mr. Chairman and members of the Committee.

My name is Albert A. Walsh and I am appearing today as President of the National Realty Committee, Inc., a non-profit business league of owners, operators and developers of all types of real estate throughout the United States. I am accompanied by Alan J. B. Aronsohn, Esq., NRC's tax counsel.

We appreciate this opportunity to present the views of the National Realty Committee on the House-passed Tax Reform Bill—HR 10612—and on certain other current tax reform proposals.

For the purpose of these hearings, it would be well to keep in mind certain undisputed, but not widely understood, facts about the nature and character of the real estate industry.

1. Real estate is an immense, but highly fragmented, industry which has an enormous impact on the American economy. With all of its fragments taken as a whole, it is the third largest industry in the United States, generating $1 out of every $7 of the private GNP, originating one-ninth of the national income, carrying an inordinate total tax burden, including almost half of all state and local taxes, and providing one out of 18 non-agricultural jobs.

2. Paradoxically, however, and contrary to popular belief, this high economic impact industry is composed of a very large number of very small firms. Of some 450,000 firms that may be said to comprise the real estate industry, a majority have three or fewer employees and less than ten percent have twenty or more.

3. Perhaps because it is essentially an industry of small business units, and because the decision to invest in real estate is always highly discretionary, real estate is unusually susceptible to even small changes in the tax law.

Other witnesses, most of whom have never developed, owned or operated a piece of real estate, will tell this Committee that even the most drastic tax reform proposal will not significantly affect the amount of capital investment flowing to real estate, or that, even if it does, the flow of capital out of real estate into other forms of investment will not adversely affect the gross national product or any other vital aspect of our national economy.

This is pure sophistry. Builders and developers will, of course, continue to build wherever and whenever they can, but the rate of return to potential investors will have to be increased in order to compensate for any new tax disadvantages and to compete with alternative investment opportunities. Where the market is strong, these increases will initially be passed on to the tenant or purchaser in the form of increased costs or rents and, in the case of industrial or commercial property, ultimately to the consumer in the form of increased costs for goods and services. If the market will not absorb these increased costs or rentals, which is certainly the case in many areas today,

the proposed development will simply not be built, with all of the consequent losses of jobs, national income and gross national product.

For example, using the Real Estate Tax Impact Model which was constructed for the National Realty Committee in 1973, Dr. Norman B. Ture estimates that, if enacted into law, HR 10612 would result in a $6.3 billion drop in real estate investment which, in turn, would cause a $11.2 billion loss in real estate GNP and a 280,000 increase in real estate unemployment, principally in the construction trades. In contrast to the House Ways and Means Committee's estimate of $1½ billion in tax revenue to be gained through enactment of HR 10612, Dr. Ture predicts a net annual loss in federal revenues of 2.8 billion from the real estate industry alone. A summary of Dr. Ture's analysis is attached to this statement for the record and for the convenience of the Committee.

4. While there are some hopeful signs that the real estate industry is beginning to work out of its biggest slump since the Great Depression, this incipient recovery is almost exclusively confined to the construction of one family houses in suburban and rural areas. Multi-family housing, which is urgently needed in urban and suburban communities across this nation, and without which no real housing recovery can take place, simply will not and can not recover with the continuous threat of punitive tax reform hanging over its head.

As you know, multi-family housing starts are down from 1.05 million in 1972, to 445,000 in 1974 and 269,000 in 1975 and, for a variety of reasons which are well known to the members of this committee and even better known to the members of the Banking, Housing and Urban Affairs Committee, there is almost no hope of a significant increase in 1976. For some of the same reasons, and because commercial development is so intimately related to an adequate supply of housing, the same is true for private non-residential construction.

5. As a result, we now have 873,000 unemployed construction workers in the United States; a 122 percent increase since 1972. In my own home city of New York, where construction unemployment approaches 40 percent, more than 16,000 construction jobs were lost last year alone. The situation is the same in most cities north and east of the so-called "sun-belt." And for every construction job lost there are 1.1 jobs lost in allied fields.

Of course, there are those who say that the way to stimulate a housing recovery, and ultimately the entire real estate industry and the national economy, is through a program of direct federal housing subsidies, which are more effective and efficient than tax incentives anyhow.

I am certainly not against a better, and more adequately funded, federal housing subsidy program. As a matter of fact I have testified in favor of such a program on numerous occasions. But I do have serious reservations about the simplistic proposition that all existing tax incentives should be removed from the law, and new disincentives added, in the hope that some new, and as yet unknown, direct subsidy program will take over and do a better job.

It may be that, in some cases, direct subsidies would be more effective and more efficient than the tax incentives that are now in the law or are being proposed. I say it "may" be because, in the case of multi-family housing where the replacement of existing tax incentives (principally accelerated depreciation and present limitations on recapture) by direct subsidies is most frequently recommended, I doubt it.

I have spent twelve years of my life as a government housing official, at a state and local level, and I would hate to hold my breath until we got an effective, adequately-founded housing subsidy program out of this Congress that will be vigorously and faithfully implemented by this Administration.

And when we do, it will probably be a tenant subsidy, like HUD's "housing allowance" experiment or the current Section 8 program, and not a production subsidy at all.

With your permission, Mr. Chairman, I would like to offer a few rather conclusory observations, from my twelve years' experience as a housing official, about past, present and potential future housing subsidy programs and their utility as alternatives to the limited tax incentives now in the law. For the sake of brevity, I will not attempt to prove any of these statements at

this time but I am prepared to document each statement with detailed economic analysis and specific case examples if the Committee wishes.

1. It has been my experience that, at least in the housing field, direct government-administered subsidies are less effective and less efficient than indirect tax incentives. If you don't agree with me, take a look at the production record and cost effectiveness of HUD over the last 3½ years.

2. The only broad-based production subsidy programs that we have ever had in this nation are the public housing program and the 221(d)(3) BMIR direct loan program; both of which are now dead or dormant and, in any event, produced only a limited amount of housing for a very limited segment of our population—for the most part far below the median income.

3. With the exception of the Veteran's Emergency Housing Program and the G.I. Home Mortgage Loan Program, neither of which can be characterized as a broad-based program, we have never had a subsidy program that even attempted to produce housing for the vast majority of "middle income" Americans—and I do not expect that we ever will have. Yet, even with the "incentives" that are now in the law 70–80 percent of our population cannot afford the cost or rental of new housing. Take away those incentives, or add new disincentives (as would be the case with construction period interest and taxes under both the LAL and minimum tax provisions of HR 10612) and this percentage will inevitably increase.

4. The much abused Section 236 program did serve as a production incentive for a very limited segment of the population, but various studies (including one done for HUD) have shown that it could not have worked at all without the companion tax incentives that were then and are now in the law. The risks were simply too high and the potential return either non-existent or much too low to justify private investment on any other basis.

It has been said that the combination of direct subsidy and tax incentives that existed in the 236 program allowed the construction of some housing that should never have been built or permitted some owners to disregard the normal obligations and responsibilities of long term ownership and management. Both of these statements are true, to a much more limited extent than is generally believed, but the fault lies in part with the legal and regulatory structure of the 236 program and in part with its administration by HUD—not with the tax law.

5. It must be clear to the Congress by now that the Section 8 program is also structurally defective as a housing production program. It isn't working, and it probably never will. And even those few Section 8 projects that appear to be working have relied heavily on the tax incentives now in the law for their economic viability.

As I said earlier, it may be possible to structure—and fund—a direct housing subsidy program that would replace the existing tax incentives and compensate for the new disincentives that are being proposed, and that would produce housing for the vast majority of middle income Americans as well as for low income groups, but I doubt it; and it would be a cruel hoax to enact a tax law which is based on such an unrealistic and unlikely assumption.

Therefore, for the time being at least, we submit that Congress must continue the existing incentives for multi-family rental housing—and not add new disincentives.

As a matter of fact, if this Committee really wants to stimulate a broad-based "housing recovery" perhaps it should consider the notion of a tax credit for multi-family housing investments in urban areas; or, if you really want to deal with the more fundamental disinvestment problems of our older cities, a tax credit for any private development in conformity with a locally-approved community development plan. Such a program might well be the only thing that could turn the tide in some of our declining urban areas.

In any event, the essential issues involved in the current controversies over attempts to "reform" the tax treatment of real estate, as embodied in HR 10612, involve many questions extending beyond the proper nature of housing subsidies.

HR 10612 proposes massive changes in the tax treatment of many items affecting capital flows and investment in the American economy. As such its enactment, without substantial changes, would drastically affect the future amount and character of real estate investment.

In large part, these adverse effects on real estate investment would not result from removing or decreasing existing tax incentives to investment in real estate, but rather would be the result of enacting provisions resulting in especially disadvantageous treatment to real estate. Our primary concern, therefore, is not simply to preserve the existing tax incentives for multi-family housing, which we believe are currently necessary; our major concern is the growing tendency among tax reform groups to single out the real estate industry for additional punitive treatment. Many of the proposals made would deprive the industry not of special benefits such as the investment credit, ADR, percentage depletion or other similar provisions designed to benefit particular industries or investments (none of which are available to investments in real estate), but rather would exclude real estate from the benefits of deductions generally accorded to other industries, such as the proposed treatment of real estate construction period interest under HR 10612.

Our more specific comments concerning primarily Title I, II and III of HR 10612 are as follows:

GENERAL OBJECTIONS

Unnecessary Complexity

We share the disappointment of many others in assessing the overall impact which enactment of HR 10612 would have upon the equity of our tax system, the ease and practicality of its administration, and the effects of the proposed tax changes upon the economy of the nation.

A great deal of lip service has been given over the years to the notion of simplifying the income tax laws or at the very least halting the apparently inexorable growth in complexity of the Internal Revenue Code. Nevertheless, while everyone inveighs against sin and in favor of motherhood, virtually every amendment to the Code since its enactment in 1954 has been in the direction of compounding the complexities which theretofore existed.

We are not naive; we acknowledge that a complex society cannot have simple tax laws. Nevertheless we are of the opinion that the complexities which have been introduced into the Code over the last fifteen years, always in the interest of trying to perfect what is inherently not perfectable, have created a level of complexity and confusion which can only be counterproductive in terms of taxpayer equity, fair administration of the tax laws, and minimally disruptive effects on the national economy.

There comes a point when the game is no longer worth the candle; HR 10612 appears to us to illustrate this maxim. In an attempt to curtail certain perceived abuses by a relatively small number of taxpayers the first three titles of HR 10612 add to the Internal Revenue Code page after page of increased complexity, and layer after layer of multiple differing approaches, without any general or unifying concept other than the apparent notion that a specific alleged taxpayer "abuse" requires a specific legislative "remedy". This approach ignores both the possibility of administrative remedies and the increased costs to taxpayers and government alike of attempting to administer complex specific statutory "remedies".

The Bill contains a large number of provisions applying the general concept of a Limitation on so-called Artificial Accounting Losses (LAL) to a number of specific industries, but without uniformly applied rules. Different rules apply to different industries. Construction—period interest and taxes, for example, become subject to LAL in the real estate industry, and are specifically excepted from LAL as an item of pre-productive expense to farmers. Interest paid to carry non-farm inventory, to construct machinery or equipment, or for other capital expenditures incurred in business, is not covered by LAL at all. Corporate enterprises are not covered by LAL.

This piecemeal approach effectively creates differing tax systems for each of the industries covered by HR 10612 and those not covered.

In addition to the varied and diverse LAL provisions, the Bill layers, on top of these, additional recapture provisions relating to depreciation on real property and gain from dispositions of certain interests in oil or gas property, limitations on the treatment of pre-paid interest and on the deduction for non-business interest generally, a limitation of losses with respect to investments in certain industries to amounts for which the taxpayer is "at risk", amendments to certain partnership provisions, and, on top of all of this, fundamental changes in the minimum tax on individuals which would have

the effect of substantially increasing the effective rate of tax on long term capital gains.

In our view the Bill in its entirety represents a massive case of overkill. It not only will have serious unintended consequences in terms of its effects, but will not even accomplish what its proponents have claimed for it. Enactment of HR 19612 with all of its many varied layers of so-called "reform" provisions, intended to close "loopholes" and put "tax shelter sellers" out of business, will not cause the end of taxpayer practices considered by some as "loopholes" or "tax shelters".

As a matter of fact, even the most reform-minded members of the Ways and Means Committee concede that the Bill is a very discriminatory and inequitable piece of legislation and will probably do more harm than good. In supplemental views annexed to the Report of the Ways and Means Committee, Rep. Charles Vanik (D-Ohio), a leading tax reform advocate, admits that "the bill does little more than 'reshuffle' tax loopholes and preferences" while "the really big loopholes still persist". Similarly Rep. Sam Gibbons (D-Fla.), who gets equally high marks as a tax reform proponent, voted against reporting the bill because it "adds further unnecessary complications and tax loopholes to the Internal Revenue Code" and "in a number of areas, we ended up with a worse tax policy".

In terms of media publicity, the current vogue in "tax shelters" involves purchases and sales of silver and put and call transactions in the option market. Neither of these activities would be limited by anything contained in HR 10612.

In fact, it is clear that no tax reform bill can ever hope to deal with the complex tax problems which arise in actual practice and which inevitably often involve generalized concepts such as the "reality" of a particular transaction or its "business purpose", issues which have been dealt with far more effectively in the past by the judiciary than by legislation.

The question must be seriously asked why evenhanded, intelligent and thorough administration of existing tax laws isn't a better solution to most tax abuse situations than almost bi-annual attempts by Congress to close up alleged tax loopholes.

For example, the prepaid interest problem with which Section 205 of HR 10612 proposes to deal appears to have been virtually eliminated by a change in the Service's ruling policy, coupled with aggressive audit and litigation action by the Service; enactment of any provision comparable to Section 205 or HR 10612 was not necessary.

Similarly, court decisions favorable to the Government would appear to have eliminated the need for any statutory provision comparable to Section 210(a) of HR 10612.

Discriminatory Provisions

In addition to its complexity and lack of general consistency, we object to the provisions of Title I, II and III of HR 10612 on the following additional grounds.

We believe that these provisions represent a general bias against upper middle-class individual investors and in favor of corporate enterprises. Most of the so-called reforms proposed by HR 10612 apply solely to unincorporated investors. As a result, the real impact of these provisions will not be upon large accumulations of capital which can afford the flexibility of incorporating or taking other action designed to minimize the burdens of an income tax, but will be imposed largely upon individual enterpreneurs having sufficient income for discretionary savings and investment but possessing only moderate capital. Under HR 10612 capital accumulation becomes the increasingly exclusive privilege of corporate or tax-exempt institutions, rather than a generally available stepping-stone for individual economic and social mobility.

HR 10612 continues the current bias in the Code favoring investments in machinery and tangible personalty (as opposed to real estate) by extending the previous temporary increase in the investment credit, a tax preference which is not dealt with by any of the limitations proposed in HR 10612. Furthermore, the provisions of the Bill which clarify extension of the investment credit to movies and TV films, in a manner intended to encourage their production in the United States, may be contrasted with the *lack* of any credit designed to encourage production of housing and commercial buildings in the

United States, even though this is an industry which employs a far more substantial number of individuals and is one in which we probably currently suffer the highest rate of unemployment.

We believe that HR 10612 would also increase the bias that currently exists in the Code against long term investments such as real estate, and in favor of shorter term investments, such as option trading in the stock market, by increasing substantially the maximum effective capital gain rate without any amelioration for the effects of inflation (which, in the case of long-term holdings typical of real estate investments, has made many gains illusory in terms of real purchasing power). The effect has been to tax capital, not any real capital gain.

Finally, we believe that the proposals contained in HR 10612 evidence a strong bias against borrowing which ultimately must favor taxpayers who do not need to borrow over those with lesser resources. The bill contains multiple limitations upon the deductibility of certain types of interest, particularly so-called "non-business interest" and interest incurred in connection with the construction of real property improvements. The provisions proposed in this regard appear superficially simple, but on analysis they clearly involve an extremely substantial increase in the complexity of the tax law, and the difficulties faced in fairly administering the law.

In short, we favor reform of the tax laws, but true reform, which comes to grips with basic problems in our income tax system, not simply an additional series of patchwork provisions which treat every industry differently, and in effect creates a series of tax codes.

A PROPER APPROACH TO TAX PREFERENCES

We recognize some differences both in the nature of business and in the social utility of various tax incentives designed to produce certain desired national goals. Our nation has a long history of utilization of tariff duties and excise taxes for this purpose. The more recent growing utilization of income tax provisions for similar purposes (such as the deduction for percentage depletion, the investment credit, and the accelerated depreciation deductions for expenditures incurred in the rehabilitation of low-income housing) should, we believe, be limited to those situations in which Congress has determined that the use of an income tax incentive does produce a socially desirable result consistent with the cost to the nation in public revenues and simplified administration of the tax laws. We believe that Code Section 167(k) providing certain incentives for investment in the rehabilitation of qualifying low income housing satisfies such criteria.

Similarly, we believe that the long standing Congressional decision to grant preferential rates of tax to gains realized on long term capital gains is sound and should not be subject to direct or indirect erosion. Capital transactions generally differ from the realization of ordinary income in several ways. Perhaps the most important from the standpoint of tax policy is the voluntary nature of most capital transactions. The imposition of very high rates of tax on capital transactions does not result in increased tax revenues; it simply reduces the frequency of transactions, as sales tend to become limited to involuntary situations in which taxpayers are forced to sell. Capital becomes "locked in" to economically less efficient investments, a result which is clearly not desirable in a society based upon the notion of preserving and expanding a healthy and relatively efficient free market economy substantially based on private capital.

We might note that proposals for realization of capital gain at death will not cure the problem of investment "lock-in" during life. The life-time lock-in results from the inability of the taxpayer to have sufficient net after-tax proceeds to reinvest on a profitable basis after the disposition of an asset resulting in the payment of a very substantial tax.

In any event, we believe that once Congress has established to its satisfaction that the use of any particular income tax incentive does produce a socially desirable result consistent with its cost, such decision should not be vitiated by additional Code provisions, inserted in the name of "reform", which have as their sole goal the negation of such incentives.

We recognize that in any income tax system including tax incentives, objections may be raised that either such incentives are not justified or that they are being abused by being utilized in ways not intended by Congress.

With respect to the first objection, Congress should, and it appears to us frequently does (perhaps too frequently), review incentives. Adjustments have been made periodically in the investment credit, the rates of depreciation on tangible personalty (although not with respect to real estate where useful lives pursuant to Treasury guidelines remain at the inordinately lengthy periods specified over 30 years ago) and recently in rates of percentage depletion. The exemption for interest on tax-exempt bonds, the deduction for charitable contributions, the tax treatment of private foundations, pension funds, and foreign income have all received extensive Congressional attention in recent years.

Once Congress has determined the objectives to be sought in these areas, and consciously chosen the tax treatment designed to foster such objectives, there would appear to be little merit in the resulting complaints of some members that certain taxpayers are responding to the Congressionally-legislated inducements by taking the action Congress intended, such as increasing charitable contributions or investing in machinery, oil drilling or the rehabilitation of low income housing, and thereby becoming entitled to the tax preferences Congress enacted in order to encourage such activity. If experience shows a particular incentive to be excessive or unnecessary, then it should be reduced or eliminated—not offset by a contrary "reform" which serves only to complicate the law, confuse the public and, in many instances create substantial inequities.

For example, enactment of the add-on minimum tax proposal contained in HR 10612 would impose substantial additional taxes upon taxpayers who have previously invested in low-income housing projects in reliance upon the tax inducements granted to such projects by Congress in 1969. While HR 10612 evidences an intention on the part of the House of Representatives to preserve such inducement for the construction and rehabilitation of low-income housing, as evidenced by the projected future effective dates for the applicability of LAL to such investments, there are no comparable exclusions from the scope of the minimum tax. Enactment of the minimum tax contained in HR 10612, therefore, would immediately put an end to any future private sector investment in low-income housing, despite any exception for such projects from the LAL provisions. Furthermore, imposing such a minimum tax on projects which have already been built or rehabilitated would be grossly unfair to taxpayers who made their investments in reliance upon the then existing law.

On the other hand, it is arguable that, whatever the social desirability of any particular conduct, there is another important social goal in preventing taxpayers from making such extensive use of tax incentives that little or no income remains to be taxed.

For this reason, we support the concept of an overall limitation on the use of tax incentives where the aggregation of such incentives in any taxable year would otherwise result in little or no contribution by the taxpayer to the public treasury. We believe that the basic parameters of such a limitation should be similar to those set forth by the Treasury Department in 1969 (then referred to as LTP) and consisting essentially of the following:

1. an overall limitation on tax preferences equal to a percentage of the taxpayer's income including preferences.
2. a carryover of unused preferences to future taxable years.

Such a system balances the maximum incentive effect of the preferences enacted by Congress with the goal that every taxpayer will pay some tax, every taxable year, with respect to his income undiluted by preferences.

We are aware that the Chairman of this Committee has expressed a tentative preference for an alternative minimum tax approach in lieu of the add-on minimum tax contained in HR 10612. We have also studied with interest the suggestion of Secretary of the Treasury Simon for a modified minimum taxable income (MTI) provision. While we believe that a limitation on tax preferences is a simpler and more equitable approach to the problem posed by the excessive use by individual taxpayers of tax preferences, we are strongly of the opinion that an alternative minimum tax approach is far more sensible than the minimum tax provisions contained in HR 10612.

We recognize objections will be raised to any LTP or alternative minimum tax approach on the grounds that such proposals generally will not produce revenue estimates comparable to those predicted by advocates of the add-on minimum tax proposal contained in HR 10612, and than an alternative minimum tax is arguably less progressive than an add-on minimum tax.

With respect to the first argument, we believe that revenue gain is not the objective to be sought in the enactment of a minimum tax. The objective should be enhancing the equity of the system by requiring each taxpayer to pay some tax each year on his total income undiluted by preferences.

Secondly, the largest source of the revenue expected to be derived from the minimum tax proposed in HR 10612 relates to the imposition of that tax on long term capital gains. We believe that the current rate of federal income tax on long term capital gains is excessive and socially counterproductive when viewed in the context of increasing state and municipal tax burdens on capital gains and the continuing inflationary nature of our economy. We believe that the entire subject of the treatment of long term capital gains deserves separate study and decision. An adjustment to remove inflationary gains entirely from tax is probably overdue. In any event, effective rates of tax on long term capital gains should not be increased through the back door of the so-called minimum tax. Capital gains are subject to tax; the rate can and should be set by Congress directly and there is no need to include any portion of such gains as a preference item under a minimum tax (note may be taken that capital gain was excluded as a preference from the 1969 Treasury Department LTP proposal).

Thirdly, we believe most revenue estimates in the minimum tax areas are seriously deficient since the estimates are based upon the unreal assumption that taxpayer conduct will be unaffected by the tax. Imposition of an add-on minimum tax will not produce revenue. It will simply reduce the activity in those areas such as the rehabilitation of low income housing, which are subject to the tax, many of which, presumably, are areas in which Congress intended to increase taxpayer activity by enacting the preference.

Finally, with respect to the arguments concerning progressivity of the minimum tax, we believe that progressivity is present under an LTP or alternative minimum tax approach. If desired by Congress, progressivity can be increased under either approach by utilizing varying percentages of limitation or tax depending upon total income levels.

Consequently, we believe that Secretary of the Treasury Simon's proposals, embodied in his statement made to your Committee on March 17, represent, in large part, worthwhile suggestions for improvements in our tax system.

In particular, we support his proposals to stimulate capital formation and encourage savings, and to alleviate the existing burden resulting from the imposition of tax on illusory "paper" gains caused by inflation, through the enactment of a sliding-scale rate of tax on capital gains. We agree with him that our tax system must be fair, and must enhance our economic growth. We also support his proposals for estate tax reform by: (a) increasing the amount of the estate tax exemption from $60,000 (the exemption level which was established in 1942) in order to offset the ravages of inflation; and (b) liberalizing the procedures for payment of estate tax on the death of a principal owner of a small business in order to make it easier (and in many instances, possible) to continue family ownership of such a small venture after the principal owner's death.

On the other hand, we must reluctantly part company with Secretary Simon with respect to certain details of his proposals for a minimum taxable income (MTI) combined with LAL.

MTI, as proposed by Secretary Simon, is similar to the minimum tax contained in HR 10612 to the extent that both provisions represent an indirect increases in the maximum effective rate of tax on long-term capital gains. For reasons which we have previously noted, we do not believe that any such increase is warranted.

We also believe that adding "excessive itemized deductions" to the MTI base may be very inequitable to certain taxpayers having large involuntary expenses during a particular year, such as major medical expenses, casualty losses, or substantial state or local income taxes (which may relate to income realized in a prior taxable year). The possibly punitive treatment of such taxpayers appears particularly difficult to justify when it is proposed that a completely voluntary itemized deduction, namely the deduction for charitable contributions, be excluded from the MTI base.

Of greater importance, we must differ with Secretary Simon both in his support of the concept of the LAL approach and his inclusion of real estate construction-period interest and taxes among the deductions designated as "artificial" losses.

We note that Secretary Simon himself finds the application of LAL to oil and gas investments to be "inappropriate and inefficient". We feel that these comments might be made with respect to the application of LAL to real estate as well. Secretary Simon also stated that application of LAL to sports franchises "is an unwarranted extension" of the concept. Since the "Code contains no special tax benefits for sports franchises . . . abuses can be dealt with adequately by the Internal Revenue Service." We feel these comments are also equally applicable to real estate, at least in so far as the deduction for construction period interest and taxes is concerned.

Secretary Simon particularly stressed that the problem of securing adequate capital investment in the oil and gas industry "will be compounded if outside investors, an important source of capital, become disenchanted" by reason of the tax "reforms" proposed in HR 10612. At the same time, the Secretary stated that application of LAL to real estate will "have no significant adverse effect on new construction". We must respectfully disagree. Dr. Ture's analysis, a copy of which is annexed to this statement, indicates that, on the contrary, by severely impairing the ability of the industry to attract private investment capital, LAL would have a tremendous impact on construction activity.

The Deduction for Interest

The treatment of interest under the income tax law presents special difficulties.

Interest is usually defined as payment for the use of money. Distinguishing interest from other payments has not generally been a problem presenting great administrative difficulties. However, trying to categorize interest by reference to the purpose for which the borrowed funds may be used has historically been extremely difficult. Money is fungible; tracing the application of borrowed funds with respect to which interest is paid is in many instances well-nigh impossible.

This point was made by the Securities and Exchange Commission in its Accounting Series Release #163 (issued November 14, 1974) in which the Commission "noted with concern an increase in the number of non-utility companies changing their accounting method to a policy of capitalizing interest cost."

In this Accounting Release the Commission observed: ". . . it is impossible to follow cash once it has been invested in a firm. Even when a loan is made for a designated purpose and secured by a lien on specific assets, it can be argued that capital made available for one purpose frees other capital for other purposes, and it is therefore unrealistic to allocate the cost of any particular financing to any particular asset. Thus, any allocation of capital cost to particular assets is based on allocation decisions which are inherently arbitrary."

This point was acknowledged by Congress many years ago. A deduction for interest was included in the Revenue Act of 1890 and in each succeeding Revenue Act imposing an income tax through and including the Revenue Act of 1913. In the Revenue Act of 1917, Congress introduced an exclusion to the deductibility of all interest, by providing that there would be no deduction for interest incurred for the purchase of tax-exempt obligations. In the debates relating to the Revenue Act of 1918, 1924, and 1926, the House of Representatives attempted to remove or limit this exclusion because of the difficulty in administering it. In each case the exclusion was restored in Conference.

Section 23(b) of the Internal Revenue Code of 1939 retained the deduction for all interest paid with the exception of interest on indebtedness incurred or continued to purchase certain tax-exempt obligations.

In the 1942 Revenue Act, Congress added an exclusion for interest "on indebnedness incurred or continued to purchase a single premium life insurance contract". The 1954 Code expanded this exclusion to include life insurance, endowment or annuity contracts purchased either with a single premium or through a plan involving systematic borrowing.

Generally, therefore, subject to two minor exclusions, interest was treated, without any limitations, as a deductible item in determining net income subject to tax under every United States federal income tax statute from the Revenue Act of 1890 to the Tax Reform Act of 1969.

In 1969, the House of Representatives, over the objections of the Treasury Department, included in the 1969 Tax Reform Bill a provision placing a $25,000 limit on the current deductibility of so-called "excess investment in-

terest". At that time, the Secretary of the Treasury, in testimony before this Committee, opposed the proposed limitation on the ground that the proposal was discriminatory and in fact "fails to correct many of the problems in this area . . . The only truly equitable solution would require tracing the interest expense to the particular investment for which the funds were borrowed. We are inclined to believe, however, that an attempt to trace investment interest to the related investment would be administratively unworkable. Other alternatives do not appear to correct any substantial number of the actual abuses and uniformly add extraordinary complexity."

This Committee thereafter deleted the proposed limitation on investment interest from the House bill, but the limitation was reintroduced in modified form in Conference.

In practice, since its introduction in 1969, this limitation has added extraordinary complexity and administrative difficulties to the Code. It is seven years since the passage of the 1969 Tax Reform Act, but the Treasury still has not promulgated final regulations with respect to this provision. The essentially artificial definitions of "net lease" contained in the provision were the subject of additional legislative amendments in the Revenue Act of 1971 and continue to plague taxpayers and tax collectors.

An example of the virtually unintelligible distinctions which accountants and agents are asked to make in connection with this limitation may be illustrated by the instructions to the Partnership Income Tax Return (Form 1065), published by the Internal Revenue Service, which contain the following language: "A partnership cannot deduct interest expense it incurred on funds borrowed to purchase or carry property held for investment. Although a partnership can deduct all interest expense on funds it borrowed to purchase or carry rental property subject to a net lease, each partner must take only his distributive share into account in computing his investment interest expense deduction limitation."

Since "rental property subject to a net lease" is treated as an "investment" under the investment interest limitations, the result of these confusing directions is that partnership tax returns throughout the United States differ in their treatment of interest subject to the Section 163(d) limitation.

Other problems result from the definition of the term "net lease" contained in Section 163(d)(4)(A)(i). Under this definition a taxpayer may own two essentially similar properties, one of which is treated as an "investment" under Section 163(d), while the other constitutes a "trade or business". The interest relating to the first cannot be deducted against the income from the second. We believe that all rental real estate should be treated as a trade or business under Section 163(d) unless the property is held as a truly passive investment.

In any event, the problems involved in the administration, or lack of administration, of the investment interest limitations have been ameliorated by the high $25,000 floor which must be exceeded before the provision becomes operative. Section 206 of HR 10612 would drastically reduce this floor (in some cases to zero) by combining the limitation on "excess investment interest" with all "personal interest" and making the combination subject to a $12,000 limit. To further complicate the issue, Section 206 of HR 10612 preserves a carryover of unused "excess investment interest" to future taxable years, but provides no carryover for "personal interest" in excess of the limitation.

This proposal defines the term "personal interest" to mean "interest on indebtedness other than business interest and investment interest". The provision defines "business interest" as "interest on indebtedness to purchase or carry a trade or business or property held for use in a trade or business" and states that "interest shall be presumed to be personal interest unless it is established that it is business interest or investment interest, as the case may be".

After nearly sixty years of litigation over what constitutes interest on indebtedness to purchase or carry tax-exempt obligations, it requires no great powers of clairvoyance to predict that distinguishing "personal interest" from "investment interest" from "business interest" under the helpful definitions contained in HR 10612 will produce an annuity for a whole new generation of litigating tax lawyers and accountants.

Construction Interest

A particular problem to the real estate industry is the inclusion in HR 10612 of provisions treating interest and taxes incurred during a period of

construction of real property as a tax preference subject to the provisions relating to limitations on so-called artificial accounting losses and also subject to the minimum tax on individuals.

The sponsors of these provisions have made repeated statements to the effect that interest paid during construction of real property is properly a cost of construction, that under good accounting practice it should be capitalized rather than deducted, and that proper reflection of a taxpayer's income requires that the deduction for such interest be matched against the subsequent income to be produced from the property being constructed rather than deducted against a taxpayer's other income during the year in which such interest is paid.

Despite the constant repetition of such statements, they are clearly incorrect.

The Securities and Exchange Commission, in Accounting Series Release #163 (issued November 14, 1974) states:

"The conventional accounting model applicable to companies other than public utilities has not traditionally treated the cost of capital as part of the cost of an asset and, except for two specific industries [Savings and Loan Associations; Retail Land Sales], no authoritative statement on this subject presently exists. Interest cost on debt is generally treated as a period expense of the period during which debt capital is used, while the cost of equity capital is reflected neither in asset cost nor in the income statement.

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For these reasons, interest cost has generally been reflected as an expense of the period during which capital was used rather than associated with the assets acquired by the use of the capital. . . ."

Interest paid on a loan incurred to construct a building fails to satisfy the basic text for identifying a capital expenditure under the income tax laws. Payment of such interest adds nothing to the value of the building. A building constructed entirely with equity funds is worth exactly as much as the same building constructed entirely with borrowed funds. Interest paid on any such borrowed funds represents the cost for using such funds, not the cost of the building. Therefore, unless the Code is amended to impute taxable income to taxpayers on non-currently income producing equity investments (a clearly farfetched proposition), disallowing or penalizing the current deductibility of such interest must discriminate against taxpayers who borrow more and in favor of taxpayers who borrow less.

For example, compare the alternatives open to a taxpayer who needs $100 to construct a building, and who has a $100 certificate of deposit (CD) bearing interest at 10% per annum. He has the option either to (1) cash in the CD and invest the proceeds in the building; or (2) borrow $100, at 10% interest, to build the building, and retain the CD.

If he takes the first alternative, cashes in the CD and puts up the cash for construction, rather than borrowing, he has no interest deduction, but, of course, he no longer has $10 per year taxable income from the CD. The taxpayer, in effect, avoids the $10 interest cost and has also reduced his taxable income by $10, by eliminating this amount of income. The net result is the same as if he had elected the second alternative, i.e., his taxable income is the same as if he had retained the $100 CD, received the $10 interest income therefrom, and at the same time paid interest of $10 on a loan of $100.

Current law properly treats the taxpayer in the same way whether he chooses alternative 1 or alternative 2. Under the LAL and minimum tax proposals contained in HR 10612, however, the taxpayer choosing alternative 2 may find that, although his interest income from the CD is currently taxed, his deduction for interest paid on the borrowed funds is either postponed or penalized, while a choice of alternative 1 would avoid these penalties.

Of course, in the real world, not every taxpayer has the ability to choose between alternatives as drastic as those given in the above example. However, the example does clearly illustrate that the proposals in HR 10612 do result in subjecting individual taxpayers who borrow more for construction purposes to tax detriments which will not be borne to an equivalent degree by those who borrow less. In addition, of course, the detriment to taxpayers who are forced to borrow will be greatest upon those having to pay the highest rates of interest. The proposals, therefore, discriminate most heavily against those with the least equity capital. In cases where more equity capital is available, the adverse impact of the proposals will be lessened since the

amount of borrowing may be less and the rate of interest paid will probably be lower.

The alternative argument, that even if construction period interest does not represent a real capital expenditure deductibility of such interest should nevertheless be postponed and matched against the income from the property when, as and if realized, distorts income in the year in which the interest is paid, since the interest is paid for the current use of money and should be a charge against any current income earned during that year from any source by the taxpayer. This is certainly the view underlying the Securities and Exchange Commission's Accounting Series Release #163 previously referred to.

In addition, if, as has been suggested by some advocates of "reform", the deduction for interest during construction were postponed until income was generated by the particular property with respect to which the deduction was incurred, severe discrimination would result against unprofitable or marginally-profitable investments. The more profitable the investment, the quicker the deduction would be. In a break-even investment, the deduction would be postponed indefinitely. It is difficult to think of a provision which would be more apt to discourage risk-taking than one which would have the result of doubly penalizing a less-than-expected rate of return by disappointing the investor both in terms of the hoped-for yield and denying the investor a deduction for interest already paid.

It may be noted that the deduction of construction interest was not introduced in the Internal Revenue Code as a special incentive for the construction of buildings. As previously pointed out, interest has generally been deductible since the earliest Revenue Acts. Section 266 of the Internal Revenue Code, which permits taxpayers to elect to capitalize interest, taxes and other charges properly chargeable to capital account but otherwise deductible, was introduced in the Revenue Act of 1942. The purpose of this provision was not to grant any special tax incentive, but, as indicated by the Congressional debate accompanying its passage, its purpose was to permit social security taxes paid with respect to labor to be capitalized in the same manner as labor costs, rather than being required to be deducted, as would have been the consequence under the Code prior to amendment.

Interestingly enough, the highly-publicized tax expenditure budgets introduced by Professor Stanley Surrey and now prepared annually for the Congress pursuant to the Congressional Budget Act did not, prior to 1975, include the expensing of construction period interest and taxes as a "tax expenditure".

The truth of the matter is that for over half a century interest incurred by taxpayers in connection with the construction of real estate improvements has been treated as a current deduction without question and without any notion that Congress was granting to the real estate industry any special tax preference over and beyond the deduction for interest generally accorded to all taxpayers since 1890. From 1890 to date Congress has never enacted any limitation on the deductibility of interest incurred in a business.[1]

Within the last few years it has become fashionable to point to the deduction for interest in connection with the construction of real estate as a special tax preference, as if it were in the nature of an investment credit or other special allowance accorded only to certain taxpayers. In fact, interest is generally deductible in the computation of net income derived from the conduct of a business or incurred in connection with a venture entered into for profit. (For example, Section 278, added by the 1969 Tax Reform Act, required capitalization of expenses incurred in planting and developing citrus and almond groves. The Regulations specifically excluded "expenditures attributable to real estate taxes or interest." Regs. § 1.278–1(a)(1)(iii)). So long as this is true, any special limitation, or add-on minimum tax, imposed on the deductibility of interest incurred only in connection with construction of real property must operate in a discriminatory manner and must in effect impose a tax disincentive against such activity.

With respect to HR 10612 since both the LAL provisions and the minimum tax provisions contained in that Bill can be avoided by corporations, the enactment of such provision would most assuredly result in the elimination from the American economic scene of many small family building operations, leaving the market to large corporate enterprises which in the past have

[1] Code Section 279, added by Congress in 1969, may agruably represent an exception to this statement, but the purpose for its enactment and its extremely narrow scope indicate that it was not intended to affect the general deductability of business interest.

operated less efficiently in this area. The ultimate result would not be increased revenue for the United States government, but be increased rents to be paid by American consumers.

Conclusion

The real estate industry is not a vast tax shelter mechanism. It is a major sector of the American economy, upon whose success millions of Americans depend for wages, adequate housing, commercial facilities and livable cities and neighborhoods.

The facts do not substantiate a need for the imposition of drastic changes in the tax treatment of real estate, particularly of the nature contained in HR 10612. The changes proposed in that Bill involve very pointed discrimination against real estate investment, and would certainly imperil the flow of private capital into the industry as we know it. The end result of discouraging private capital investment in real estate will be a requirement for increased government participation in areas such as housing and revitalization of urban commercial facilities. Few would find this result attractive today; fewer would believe it possible.

Strong arguments can be made for the position that the housing and other building needs of this country, as enunciated innumerable times by many governmental agencies and commissions, require much more favorable tax treatment than they presently receive. Real estate is a major employer of labor in the United States, but was the only industry to which the Job Development Investment Credit was not extended in 1971. Real estate currently does not receive the benefit of ADR or even of the guideline life reductions administratively promulgated in 1962. If we believe in maintaining or increasing private private sector capital involvement in this industry, we cannot continue to make investment in real estate less and less desirable when compared with other opportunities for capital investment.

Finally, we must appreciate that there are no simple or easy answers to the complex tax problems which we have discussed. It is incorrect to consider as genuine tax "reform" any change which results in an inconsistent and complicated statute, and which would give rise to overwhelming problems in administration. True reform at this time would move in the direction of increased clarity in the tax law and towards enactment of provisions having uniform effect with respect to all taxpayers.

Economic Effects of Tax Changes Affecting Real Estate Investment—The Real Estate Tax Impact Model

(Developed by Norman B. Ture, Inc., for The National Realty Committee, Inc.)

Summary

H.R. 10612

The Tax Reform Act of 1975, passed by the House of Representatives on December 4, 1975, would have the following economic and tax revenue effects:

EFFECTS OF TAX REFORM ACT OF 1975

[Dollar amounts in billions]

Tax change	Change in real estate			Change in Federal revenues
	Investment	Gross National Product	Employment (000)	
1. Reduction of preference exemptions plus increase in minimum tax rate	−$2.8	−$5.0	−125	−$1.2
2. Full recapture on residential property	−1.3	−2.4	−59	−.6
3. LAL	−1.7	−3.0	−74	−.9
4. Interest deduction limitation	−.4	−.7	−17	−.2
5. Combined effects	−6.3	−11.2	−280	−2.8

Note: Items may not add to combined effects due to rounding.

To estimate the economic effects of tax changes affecting real estate, it is necessary first to describe, in quantitative terms, the response of real estate investors and developers. To do so, we have developed an conomic model which expresses the amount of real estate investment in relation to the cost of capital invested in real property. This cost of capital is affected by various tax provisions which are represented in the investment equation. Specifying changes in one or more of these provisions permits estimation of the change in the amount of investment. This change in investment affects employment and GNP originating in the real estate sector; the magnitude of these effects are estimated by reference to relationships among real estate investment, GNP, and employment derived from the National Income Accounts. Based on these estimates of the economic effects in the industry, changes in Federal tax revenues are estimated on the basis of the effective marginal rates of the principal Federal taxes as derived from the National Income Accounts.

Tax changes aimed at curbing tax "loopholes" or "preferences" allegedly enjoyed by persons investing in real estate increase the cost of investment and lower the return on investment in real estate. Investors will react to such changes by trying to raise rents and by reducing their real estate investments. Since the proposed tax changes do not increase the demand for real property services, buyers of these services are not willing to pay higher rents for any given amount of real property services. The tax changes, therefore, result in reduced investment in real estate projects. However, as the supply of real property declines relative to the amount in the absence of the tax change, the rent per unit rises. Adjustment to the tax change is complete when the amount of real property supplied at some rental rate is equal to the amount demanded at that rent.

This reduction in real estate investment may occur almost immediately, if investors cancel some or all of their projects, or over a number of years, if owners reduce their maintenance budgets and undertake a smaller volume of new projects than otherwise. The model estimates the change in the stock of real property when adjustment is complete, but does not attempt to distribute that change over time.

The economic characteristics of individuals investing in real property and the types of properties in which such investments are made are highly diverse. Representation in the model of all possible combinations of investors and property clearly is impractical. This model, however, uses 18 classes of taxpayers investing in real estate and three classes of property holdings; these are assumed to represent the bulk of owners who would be affected by the proposed tax changes and most of the property which would be involved. The taxpayer classes comprise five levels of taxable income, three average amounts of investment, and three levels of preference income.[1] The three property classes are residential, commercial, and industrial. In order to analyze the impact of the interest deduction limitation, principally affecting shopping center, investors in such properties are explicitly included among the 18 classes.[2] In addition, specific assumptions are made regarding construction and holding periods, financing, and discount rate of each investor (with assumptions for shopping centers noted where different):

It is assumed that financing consists of a mortgage amortized over 25 years (30 years for shopping centers) at 9 percent interest, starting at the end of construction. A constant payment schedule with declining interest and increasing amortization appears to be more in line with actual practice than other loan repayment patterns. An initial equity of 20 percent is specified (15 percent for shopping centers).

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[1] The taxpayer-investor classes were derived on the basis of data in the Internal Revenue Service's Statistics of Income—1972, Individual Income Tax Returns.

[2] The interest deduction limitation restricts the amount of investment interest a taxpayer may claim to investment income plus the excess, if any, of $12,000 per year less the taxpayer's personal interest. Net leases, a common arrangement for shopping centers, are considered investment for this purpose. It is estimated that 9% of nonresidential property would be affected by this provision based on unpublished data from the Treasury Department and from the F. W. Dodge division of McGraw-Hill, Inc. Not all shopping center investors would be affected, since some have sufficient investment income and some do not have net leases as defined by the tax code.

A 9 percent discount rate is used.[3]

The preopening and construction period is assumed to be 2 years.

It is assumed that the developer expects to hold the property for 10 years after its completion before selling it.

Deductible preopening costs are taken as 10 percent of total investment.

Land costs are assumed to be equal to 20 percent of total cost (10 percent for shopping centers).

The useful life of the property is taken to be 33 years (27 years for shopping centers).

To simplify computation, it is assumed that rental income net of operating expenses (but before deducting interest and depreciation) and the investor's taxable income from other sources remain constant over the life of the property.[4]

Finally, it is assumed that the investor sells his property after 10 years for an amount equal to the present value of the after-tax cash flow he would receive if he continued to hold the property.[5]

Of course, investors are not identical in terms of desired holding period, discount rate, or any other variable specified above. There appears to be no reason, however, to expect large or systematic differences from one category of investor to another with respect to these variables. Nor is there empirical evidence on the correct value or distribution of values for these variables. Therefore, one value, selected after investigation of the economic literature and discussion with government and industry sources, is used for each variable for all taxable income and property size classes.

These variables are assembled in a set of investment equations, one for each investor-taxpayer class, for which a computer program has been developed. The program calculates the net income per dollar or project cost needed annually by each investor class to undertake a residential or nonresidential project, under existing tax provisions. A proposed change in the tax law is analyzed to determine how it would affect any one or more of the terms in the investment equations. These changes are then fed into the computer to determine the change in required net income. Weighted average changes for residential and nonresidential property are computed separately, using as weights the share of all property estimated to be held by each investor class. The computer prints these weighted average changes for each tax alternative.

The percentage changes are then multiplied by the existing stocks of residential and nonresidential property to yield estimates of the impact on real estate investment. Estimates of existing stocks of these properties were obtained from the Commerce Departments' Bureau of Economic Analysis (BEA).

The change in Gross National Product originating in real estate is about 1.77 times the change in investment, based on data in Real Estate in the U.S. Economy, a report prepared by Norman B. Ture, Inc. for the National Realty Committee. The same source shows that approximately 44,500 jobs are lost for each $1 billion reduction in real estate investment.

That volume also shows that labor and net capital income total about 70% of real estate GNP. The marginal tax rate on each of those shares is approximately 33%, or .33 x .7 = 23.1% of GNP according to IRS and BEA figures. In addition, indirect business taxes amount to about 1.9% of GNP. Net changes in Federal tax revenues, therefore, total approximately 25% of the change in real estate GNP, or 44% of the change in investment.

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[3] The discount rate is the factor which equates the value of a future sum to its value in the present. Since a dollar to be received a year hence is regarded as less valuable than a dollar received today, while a dollar of outlay a year hence is less dear than the same dollar outlay today, virtually all contractual arrangements which extend through time involve the process of discounting future values to the present. The discount rate appropriately used by any investor with respect to any given project reflects both the rate of return he might expect to earn on an alternative investment and any difference he perceives in the riskiness of the project under consideration compared with that of the alternatives available to him. The 9 percent discount rate used in the model applies to the after-tax cash flow. A discount rate applied to pretax cash flow would be higher depending on the investor's tax bracket.

[4] For shopping centers, income is assumed to equal one-third of its eventual level in the first year following construction, two-thirds in the second year, and 100 percent thereafter. No evidence as to the most realistic time pattern of these variables is available. This assumption could be relaxed without significantly affecting the results.

[5] Clearly, he would not willingly sell for less, since he would then be better off by retaining the property. It is assumed that market conditions prevent him from receiving more than this minimum price.

As passed by the House of Representatives, the Tax Reform Act of 1975 contains four provisions of particular concern to real estate investors. These are: 1) Changes in the minimum tax. The exemption from preference items would be lowered from $30,000 plus income tax due to a maximum of $20,000 with a further decrease of $1 for every $1 by which preferences exceed $20,000, with no exclusion of ordinary income tax. Thus, the exemption would disappear altogether for taxpayers with $40,000 or more in preferences. In addition, the list of preferences would be expanded and the minimum tax rate raised from 10 to 14 percent. 2) Recapture of the excess of accelerated depreciation over straight-line would apply fully to residential property, as it now does to nonresidential, instead of declining 1 percent per month for each month over 100 months that a property is held. 3) Limitation on artificial losses (LAL). Property owners would no longer be able to deduct preopening interest and taxes or the excess of accelerated over straight-line depreciation unless they have sufficient real estate income to cover these expenses. Any amount not deducted must be carried forward in a "deferred deduction account' until real estate income rises sufficiently. 4) Interest deduction limitations. Instead of the present virtually unlimited deduction for interest paid, taxpayers would be restricted to a total of $12,000 per year in personal interest, and investment interest equalling invest income plus the excess if any, of $12,000 over personal interest.

The CHAIRMAN. Our next witness is John C. Hart, president, National Association of Home Builders.

STATEMENT OF JOHN C. HART, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, ACCOMPANIED BY LEONARD L. SILVERSTEIN, TAX COUNSEL, AND CARL A. S. COAN, JR., LEGISLATIVE COUNSEL

Mr. HART. Mr. Chairman and members of the committee:

My name is John C. Hart and I am a home builder from Indianapolis, Indiana. I am appearing before you today in my capacity as president of the National Association of Home Builders. NAHB is the trade association for the home building industry. Its membership totals over 74,000 firms in 603 associations.

Accompanying me today are Leonard L. Silverstein, our tax counsel, and Carl A. S. Coan, Jr. our legislative counsel.

The principal concern of our members is the maintenance of a level of housing production, including rental housing, adequate to meet the national housing goal reaffirmed by Congress in 1968 of a decent home and suitable living environment for every American family. Over the past 2 years we have fallen far short of the rate of production necessary to meet the target of 26 million housing units to be constructed or rehabilitated during the decade 1968–78. The principal factors in our failure to achieve that goal have been inflation, recession and extraordinarily high interest rates. This failure is clearly illustrated by the fact that housing starts in 1975 fell to 1.17 million units, the lowest level in almost 30 years.

While housing construction activity has picked up somewhat since the disastrous depths of last year, we still only expect total starts this year to be about 1.4–1.5 million units. This is far below the Nation's needs. In it is multifamily construction that much of the shortfall is occurring. Multifamily starts last year were only 268,300 units, the lowest since 1958 and no real improvement is in the offing. Yet the national rental vacancy rate declined to 5.4 percent in the fourth quarter of 1975 and appears to be heading even lower, at

the very time when a lot of young people forming families and requiring rental units are coming on the market. This is not the time to tinker with the provisions of the tax laws which are designed to encourage the construction of multifamily housing.

The Federal income tax laws have had a major, positive impact upon home building, particularly in providing incentives for raising the equity capital necessary to construct rental housing. Such incentives have operated during periods of normal economic conditions to attract the outside equity capital necessary to finance the construction of rental housing. Unlike other industries, only a few builders can provide the capital necessary to sustain the production of rental units at an adequate level. Tax incentives are thus necessary in order to encourage capital formation for the construction of housing.

Maintenance of existing Federal income tax incentives for the construction of rental housing would clearly be consistent with the overall goal of the administration to provide incentives to encourage capital formation. In the absence of these tax incentives, the home building industry, in view of the risks involved in the nature of rental housing, particularly for low and moderate income families, would be unable to compete against the other investment opportunities available. This would result in investors abandoning our industry in favor of other types of investments with a higher return and less risk. This will prevent the industry from constructing the housing necessary to meet the Nation's housing needs.

We believe that the policy of encouraging the construction of necessary housing through the provision of Federal income tax incentives is one which Congress should continue in the national interest. Accordingly, we strongly oppose enactment of any changes in the present income tax laws which would seriously impede the flow of capital into the construction of rental housing.

We are quite concerned that several provisions contained in H.R. 10612, the Tax Reform Act of 1975, as passed by the House last year would, if enacted in their present form, have a substantial, adverse impact upon the construction of multifamily housing. At a time when the demand for housing is increasing, such result would not only have a severe impact on our members but would be counter productive to the overall national interest.

Before I give you my comments on the House-passed bill and other changes we would recommend to the tax code, I should like to express our great appreciation to the Chairman of this committee for passing last year the tax credit to purchasers of new homes. Despite claims to the contrary, the credits' opponents in the administration, our members feel the credit was most helpful to them in reducing the large inventory of housing on hand last March.

Our principal concern with LAL is that it would unfairly discriminate against rental housing. We are completely opposed to LAL. It would strike at a major source of equity capital for rental housing that is coming from outside the industry.

We believe a more appropriate method of assuring that nobody escapes taxes is to impose a reasonable minimum tax. We fully support the efforts of the Chairman to provide such a minimum tax and recomment that it be substituted for LAL.

However, we urge rejection of the House provisions, eliminating the regular income tax deduction for computing the minimum tax.

We also urge rejection of the inclusion, as an item of tax preference, of the amount of deductions for interest and taxes paid during construction of real property. These deductions represent actual business expenditures made and should be allowed to their full extent.

We are strongly opposed to the House provision which would impose a limitation on the amount of nonbusiness interest that an individual could claim as a deduction in any taxable year especially as this relates to the inclusion of interest on home mortgages. Interest deduction has been allowed since the Internal Revenue Code was initially enacted. We believe it is a justifiable one. We urge the rejection of the House provision which excludes home mortgage interest from it.

We urge the committee to reject amendments to 1250 increasing the amount of recapture on residential housing.

We wholeheartedly support the House provision exempting from taxation amounts received by homeowners' associations, condominium associations and cooperative housing corporations from their members.

I should now like to turn to an area of great importance to the home building industry. We appear to be coming out of the serious housing slump that started in the summer of 1973. However, this past cycle was much worse than any other experienced in the past 30 years, dropping more precipitously and lasting longer than its predecessors.

The principal cause of this cycle was the nonavailability of mortgage money and the high cost of that money that was available. It started with severe disintermediation in the Nation's thrift institutions, the principal suppliers of residential mortgage credit and snowballed into a disaster. Something must be done to prevent the recurrence of such a situation. We have three proposals to help us which we believe deserve most serious consideration by the committee.

One would bring more money into the residential mortgage market and protect the financial mortgage markets from disintermediation. The first would provide a tax cut in connection with the Financial Institutions Act passed by the Senate. It would encourage banks, lenders, life insurance companies to invest more funds in residential mortgages.

I commend to your attention the attachment to our full statement setting out our specific views on the credit and how be believe it should function.

The second would require pension funds to invest at least 20 percent of their assets in residential mortgages in order to retain their present exemption from taxation. Pension funds have over $250 billion in assets, but less than 2 percent of the assets of the private funds are invested in the residential mortgages. We believe that this is inexcusable, that these repositories of peoples' savings are being used primarily to speculate in the stock market and are ignoring the housing needs.

The third would give the small saver a tax break on the interest earned on his savings. It would also encourage him to keep his

savings in a bank or thrift institution during times of tight money when higher yields appear. Such a provision should help moderate considerably the periods of disintermediation which have become more frequent in recent years.

We propose that the first $1,000 on the interest earned be exempt from taxation or, in the alternative, a tax credit of up to $250 be allowed.

I appreciate the opportunity to appear before you today to present our views with respect to tax reform. As is evident, the income tax laws have a major effect on the home building industry, particularly the construction of multifamily housing. Accordingly, we urge no action be taken to change the laws in matters that have an adverse effect upon the flow of outside equity capital into our industry.

We also urge serious consideration be given to approving the three proposals designed to assure greater stability in the residential mortgage market. These proposals to enact a mortgage interest tax credit, to require a 20 percent minimum investment in residential mortgages by pension funds, and to encourage savings by the small saver are essential if we are to avoid repetition of the disastrous housing cycle from which we are just recovering.

I want to thank you for allowing us to shift position today while we testified over on the House side.

The CHAIRMAN. So many of you are familiar faces to me, like Mr. Silverstein who has been before us many times to help advise on tax matters. I want to help the real estate industry and the home builders to do what they are trying to do in the national interest. but I am not sure I am going to be able to do you much good unless you people help yourselves.

You made an impressive statement, but prior to the time you got here we had some other impressive statements that referred to a study by Dr. Norman B. Ture. His study etimates that if enacted, H. R. 10612 would result in a $6.3 billion drop in real estate investment, which in turn would cause $1.2 billion loss in real estate gross national product and a 280,000 increase in real estate unemployment. principally in the construction trades. In contrast, the House Ways and Means Committee estimates $1.2 billion gained in revenue in this bill. Dr. Ture predicts a net annual loss of revenue from $2.8 billion from the real estate industry alone. A summary of his study is attached to their statement. I suggest you get a copy of that and make it available to your members.

To the extent that Senators go home during this Easter recess, you ought to see if you can get your people together with those who build the shopping centers and those associated with these other witnesses and make them acquainted with that study.

I am going to give Dr. Ture's statement the attention it deserves. I am going to try to get the Treasury to take everything that Dr. Ture ran through his computers and run it through theirs. I am going to try to get the Joint Tax Committee staff to do the same thing and perhaps analyze the secondary and tertiary effect which causes people to quit making investments and causes them to do something else with their money.

If your people will undertake to see to it that every Senator hears the kind of testimony I have heard here today including what you

have said, I predict with confidence this Congress is not going to do the kind of mischief to this Nation's economy that could result from that House-passed bill. I am frank to tell you that you people need to get your message across to others.

At the moment, you are talking to only one Senator. I was convinced you were right before you got here, frankly. As I said before, in some respects, while you have made a magnificent statement and it is there for the record, most people will not have read it and when the debate comes up they will not have heard what you and these other witnesses have said. You just ought to make it a point to see to it that when they come home you have a committee talk to them. Half the time they are too busy with other things to talk to you, but they will talk to their own constituents if you have a committee of realtors and real estate agents and builders of shopping centers in their own hometown waiting for them when they get there. If your people take full advantage of the right the Constitution gives you to petition Congress for redress of grivances, my guess is that the Congress will treat you fairly and that they will pass laws that will assure that the people who are making money pay a fair amount of taxes—but at the same time the Congress will refuse to accept this invitation to destroy this Nation's economy in the name of tax uniformity.

Mr. HART. Senator, I just completed six grassroots meetings around the country where we met with builders who never have the opportunity to come into Washington. We were asked at each of those meetings to set up a meeting this spring in Washington at the time of our spring board meeting. We will have a political education seminar. If you are available on Sunday afternoon, May 23, when we reconvene, I would like you to come over to address the 1,200 or 1,500 people who will be there. We are going to go to the Hill the next day. We know that businessmen, in order to survive, about 85 percent of our builders build 15 homes or less a year. But they are all becoming dominated by the Government. We know how to survive. We just have to get active and take a more active role and educate ourselves on the problems.

The CHAIRMAN. I have made many mistakes in life, usually because I did not know better. I would hope I will be forgiven those. In fact, I hope I will be forgiven all my mistakes, but those that are the sadedst are those I made because I did not know better. The same thing is true with the average Member of the Senate or House of Representatives.

For the time being, I think as far as the real estate industry is concerned, the first objective is going to be to get the attention of the Members of the Senate and explain to them what the facts are. If that Ture study is correct, it would be an absolute crime for Congress to pass what the House of Representatives sent us in the name of tax reform as it applies to the real estate industry.

If the Secretary of the Treasury says he will cooperate, we will have them check out Dr. Ture's figures and have the joint committee check them out, and we may have to call some neutral people to add their views.

Mr. HART. We would be glad to give you a study we have that shows the man-hours and dollar contribution. Every dollar of con-

struction that is put into a local community is there for life, and the average property tax is about 3½ percent of true value. The reasons these mayors were all up here last week asking for more revenue sharing, when the housing starts drop, their revenue dropped, too.

[The study referred to above follows:]

ESTIMATED MAN-YEARS OF WORK REQUIREMENTS AND WAGES PAID FOR CONSTRUCTION OF A SINGLE FAMILY HOUSE

	Man-year [1] requirements	Wages [2]
All industries	1.853	$23,918
Construction	.714	10,667
Onsite	.595	8,889
Offsite	.119	1,778
Other industries	.867	9,187
Manufacturing	.476	4,779
Wholesale trade, transportation, and services	.238	2,475
Mining and all others	.153	1,933
Land development	.272	4,064

[1] 2,000 man-hours=1 man-year.

[2] The wages and man-years shown in this table include wages paid with fringe benefits and man-years utilized directly for construction of the unit, as well as for labor which goes into producing materials, development of land, and other connected services such as: marketing, engineering, financing, etc.

Source: Bureau of Labor Statistics, U.S. Department of Labor, (1) man-year requirements derived from study entitled "Labor and Material Requirements for Construction of Private Single Family Houses," Bulletin 1175, p. 11, table 1, (2) February 1976 wages from "Employment and Earnings," March 1976, pp. 88-100, table C-2; data compilation and analysis by NAHB Economics Department.

Selected average material usage in single-family homes

	Per 1,000 units
Board feet of lumber	10,700,000
Square yards of carpeting	66,000
Square feet of softwood, plywood	5,500,000
Bricks	5,000,000
Pounds of cement	2,200,000
Gallons of paint	23,000
Tons of steel	2,000
Water closets	1,860
Bathtubs, shower enclosures	1,610
Furnace or other central heating unit	870
Square feet of ceramic tile	220,000
Square feet of asphalt roofing shingles	1,400,000
Square feet wall and ceiling insulation	2,400,000
Convenience outlets	34,000
Electrical switches	15,000
Garbage disposals	620
Exhaust fans	900
Central air-conditioners	970
Lineal feet of cabinets	28,000
Complete windows	14,000
Square feet of gypsum board products	5,900,000
Doors	22,000
Garage doors:	
1 car	180
2 car	570

Source: NAHB Economic Department, Mar. 1976.

The CHAIRMAN. I might accept your invitation. By then, from what we know, if your people go and talk to their Senators, it might be more meaningful.

Mr. HART. We think it would be wonderful. Thank you very much.

[The prepared statement of Mr. Hart follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Committee: My name is John C. Hart and I am a home builder from Indianapolis, Indiana. I am appearing before you today in my capacity as President of the National Association of Home Builders. NAHB is the trade association for the home building industry. Its membership totals over 74,000 firms in 603 associations.

Accompanying me today are Leonard L. Silverstein, our Tax Counsel, and A. S. Coan, Jr., our Legislative Counsel.

The principal concern of our members is the maintenance of a level of housing production, including rental housing, adequate to meet the national housing goal reaffirmed by Congress in 1968 of "a decent home and suitable living environment for every American family". Over the past two years we have fallen far short of the rate of production necessary to meet the target of 26 million housing units to be constructed or rehabilitated during the decade 1968–1978.The principal fa<tors in our failure to achieve that goal have been inflation, recession and extraordinarily high interest rates. This failure is clearly illustrated by the fact that housing starts in 1975 fell to 1.7 million units, the lowest level in almost 30 years.

While housing construction activity has picked up somewhat since the disastrous depths of last year, we still only expect total starts this year to be about 1.4–1.5 million units. This is far below the nation's needs. It is in multifamily construction that much of the shortfall is occurring. Multifamily starts last year were only 268,300 units, the lowest since 1958 and no real improvement is in the offing. Yet the national rental vacancy rate declined to 5.4% in the fourth quarter of 1975 and appears to be heading even lower, at the very time when a lot of young people forming families and requiring rental units are coming on the market. This is not the time to tinker with the provisions of the tax laws which are designed to encourage the construction of multifamily housing.

The Federal income tax laws have had a major positive impact upon home building, particularly in providing incentives for raising the equity capital necessary to construct rental housing. Such incentives have operated during periods of normal economic conditions to attract the outside equity capital necessary to finance the construction of rental housing. Unlike other industries, only a few builders can provode the capital necessary to sustain the production of rental units at an adequate level. Tax incentives are thus necessary in order to encourage capital formation for the construction of housing.

Maintenance of existing Federal income tax incentives for the construction of rental housing would clearly be consistent with the overall goal of the Administration to provide incentives to encourage capital formation. In the absence of these tax incentives, the home building industry, in view of the risks involved in the nature of rental housing, particularly for low and moderate income families, would be unable to compete against the other investment opportunities available. This would result in investors abandoning our industry in favor of other types of investments with a higher return and less risk. This will prevent the industry from constructing the housing necessary to meet the nation's housing needs.

We believe that the policy of encouraging the construction of necessary housing through the provision of Federal income tax incentives is one which Congress should continue in the national interest. Accordingly, we strongly oppose enactment of any changes in the present income tax laws which would seriously impede the flow of capital into the construction of rental housing.

We are quite concerned that several provisions contained in H.R. 10612, the "Tax Reform Act of 1975", as passed by the House last year would, if enacted in their present form, have a substantial, adverse impact upon the

construction of multifamily housing. At a time when the demand for housing is increasing, such result would not only have a severe impact on our members but would be counter productive to the overall national interest. In light of the extremely unfavorable economic conditions which have existed for the last several years, enactment of significant changes in the Federal income tax laws adversely affecting the flow of outside equity capital into our industry would deal a critical blow to our ability to meet the nation's housing needs.

I would like now to comment upon several of the specific provisions in the House-passed Bill which would, in our judgment, adversely affect our industry. These provisions are as follows:

Limitation on Artificial Losses ("LAL")—We strongly oppose the adoption of the "LAL" proposal which would limit the full deduction during a taxable years of accelerated depreciation on, and mortgage interest and real property taxes incurred in the construction of, residential rental property and other real estate. The "LAL" proposal unfairly discriminates against real estate. While we recognize that there may have been tax abuses in certain situations, we believe that the overkill approach of LAL is an inappropriate solution. This approach would severely limit the flow of outside equity capital into rental housing and thereby deprive our members of the capital required to construct such housing. While the aggregation approach adopted by the House is more moderate than some original LAL proposals, we are heavily dependent on equity capital investment from outside the industry and aggregation will not alleviate that problem.

It is our judgment that rather than LAL the more appropriate method of assuring that all persons pay their fair share of tax would be to impose a reasonable minimum tax. NAHB has consistently maintained that every person should bear his fair share of Federal income taxation and that the minimum tax is the appropriate mechanism to effect such equity. We fully support your efforts, Mr. Chairman, in reaching this desired objective. Accordingly, we strongly recommend that this Committee reject the "LAL" proposal and instead concentrate on the minimum tax as the mechanism to achieve the goal of assuring that everyone pays some reasonable proportion of his income in taxes while still preserving desirable tax incentives.

Minimum Tax for Individuals.—Consistent with the foregoing, we would not object to a reasonable increase in the rate of minimum tax provided in Section 56 of the Code. The House Bill provides for an increase in the rate of minimum tax from 10 to 14% which we would support. However, we urge rejection of any attempt to effect a further increase in the minimum tax rate.

We believe that the legislative history of the Tax Reform Act of 1969 makes it clear that the minimum tax was intended to result in the payment of a minimum tax by those persons who would not otherwise be paying income tax under existing rules. However, it was clearly not intended to be applicable to those taxpayers who were paying a substantial amount of regular income tax. Accordingly, we oppose the provision in the House Bill eliminating the deduction for regular income taxes paid in computing the minimum tax, and the corresponding carryover of regular income taxes. This provision, if adopted, would convert the minimum tax to a penalty tax on preferences, regardless of the amount of regular income taxes paid, which is inconsistent with the concept of a minimum tax.

In addition, we strongly oppose the inclusion, as an item of tax preference, of the amount of deductions for interest and taxes paid during construction of real property to the extent not subject to the LAL proposal. These deductions represent actual business expenditures made and should be allowed to their full extent. To subject them to inclusion in any list of tax preferences is analogous to saying that you can deduct only a certain portion of your actual business expenditures for such items as the light bill or office supplies. We urge the Committee to reject such an absurd result.

Limitation on Non-Business Interest Deduction.—We strongly oppose the provision in the House Bill to impose a limitation on the amount of non-business interest that an individual could claim as a deduction in any taxable year. We are particularly concerned about the inclusion of interest on home mortgages in this category of "personal interest". The full deduction of interest paid on home mortgages has been in the Code since the beginning and it has been one of the major contributors to the fact that over 60% of American families own their home. The proposal would require that interest

on home mortgages be taken together with interest on other personal loans (e.g., automobile, education and home appliance loans) and, a $12,000 limitation be imposed on the total deduction, with the excess not deductible in any subsequent year. In light of the rampant inflation of the past few years and the existing high interest rates on home mortgages, interest paid on home mortgages, when added together with interest paid on other personal loans, could result in many middle income taxpayers approaching or exceeding the $12,000 level. We are even more concerned with the possible future implications of imposing such a limit and then subjecting it to piecemeal reductions in future years, thereby raising the cost of home ownership. With multifamily housing already in dire straits, this is not the time to attack home ownership also.

Moreover, such a proposal would have an adverse effect on our members as a result of making the amount of investment interest deductible in a taxable year dependent upon the a mount of the taxpayer's personal interest. For example, a builder may find that interest paid on his own home mortgage and other personal loans will severely limit the amount of the current deduction for interest paid on investment property such as unimproved land held for possible future development in his home building business. This could significantly affect the flexibility needed by builders to plan for the future.

For these reasons, NAHB strongly opposes enactment of the proposed limitation on the deduction of non-business interest and instead urges the retention of the rules in section 163(d) of the Code which are limited to investment interest. If, however, this cannot be accomplished, we urge adoption of an exclusion from the category of personal interest for interest paid on home mortgages.

Extension and Amendment of Section 167(k)—We urge the prompt extension of section 167(k) providing for a five-year amortization of rehabilitation expeditures incurred with respect to low-income rental housing. This provision expired on December 31, 1975 and the failure to take action since that date has created substantial uncertainty as to the continued viability of rehabilitation as a means of providing housing for families of low and moderate income. We urge immediate enactment of a minimum one-year extension, even before the Committee acts on major tax legislation.

We then urge that the Committee give serious consideration to making the provision permanent. It was originally enacted for a five-year term on an experimental basis. We believe that it has achieved its purpose in encouraging rehabilitation that would not otherwise have occurred.

We also support the provision in the House Bill to increase from $15,000 to $20,000 the dollar limitation on the aggregate amount of rehabilitation expenditures with respect to any dwelling unit which may qualify for the rapid amortization. This recognizes the substantial inflation that has occurred since 1969.

Moreover, we urge that section 167(k) be amended so as to be made specifically applicable with respect to a project where substantially all of the units are held for occupancy by families or individuals eligible to receive subsidies under Section 8 of the Housing Act of 1937, or state or local programs authorizing similar levels of subsidy. Section 8 is the principal Federal housing assistance program presently utilized by the Department of Housing and Urban Development and it is essential that buildings under Section 8 (or provisions of state or local law authorizing similar levels of subsidy) be specifically covered under section 167(k) in order to provide the tax incentive to rehabilitation of low-income housing which Congress sought to provide in enacting section 167(k) in 1969.

Depreciation Recapture.—We oppose the provision in the House Bill which would amend section 1250 to increase the amount of depreciation recapture treated as ordinary income on the sale or other disposition of residential housing, including subsidized housing. Such an action would apply rules to real property which are substantially similar to those applicable to depreciation recapture with respect to personal property. This ignores the special nature of real property which Congress recognized when it enacted section 1250 in 1964, i.e., that the impact of price level changes in real estate is often far more severe than that which occurs with respect to personal property.

Asserted gains which occur with respect to realty held for a considerable period of time often represent mere changes in price levels, rather than a real

economic gain which might justify recapture of previously granted deductions. This is particularly true in times like the present which are characterized by rapid inflation. Moreover, unlike personal property, real property does not qualify for the investment tax credit provided for by section 38 of the Code.

Furthermore, these changes would in essence sharply reduce the present incentives to invest in rental housing by removing entirely the distinction between nonsubsidized housing and nonresidetial real estate. At a time when multifamily construction is at such a low ebb, such an action would be like driving another nail in the coffin.

We therefore urge retention of the existing provisions of section 1250 and recommend that two amendments be made with respect thereto. One is to make permanent the provisions of section 1250(a)(1)(C)(ii) covering low-income housing. This provision, which expired on December 31, 1975, has proven its worth just as has 167(k) and is needed to encourage builders and investors to take the much greater risks inherent in low and moderate income housing. The second amendment would be to expand the category of low and moderate income housing covered by 1250(a)(1)(C)(ii) to include projects which qualify under Section 8 or provisions of state or local law authorizing similar levels of subsidy.

Tax Exemption for Condominium and Homeowners' Associations—We urge enactment of the provision in the House Bill respecting the tax treatment of amounts received by a homeowners' association, a condominium housing association or cooperative housing corporation from its members. These organizations are formed and are operated for the maintenance of common facilities in condominium, townhouse and planned unit developments and clearly qualify for the tax-exempt status. The Internal Revenue Service, however, by rulings in 1974 denied such status, which represented a change in its previous position. The result is that such associations are subject to current taxation on amounts set aside for future capital improvements, exterior maintenance and replacement of common facilities. Imposition of such taxation is unwarranted and will adversely affect the financial structure and continued operation of these associations. Moreover, in view of the uncertainty created for several thousand associations by reason of the change in IRS position in 1974, we urge retention of the December 31, 1973 effective date for the provision in the House Bill.

Capital Gains.—We have no objection to the House provision extending the holding period from six months to one year for qualification for long-term capital gains and losses. However, we urge that the Committee adopt a proposal to provide for an increase in the amount of capital gains excluded from taxation for assets held for long periods. For example, if a taxpayer sold a parcel of real estate held for twenty years, the taxpayer would be entitled to exclude from taxation a larger portion of the capital gain than the 50 percent exclusion under existing law. A similar provision was included in the Tax Reform Bill approved by the House Ways and Means Committee in 1974 and we urge that this Committee include such a provision in the current bill.

Deduction of Expenses for Vacation Homes.—We oppose adoption of provision imposing a limitation on the amount of deductions for expenses with respect to a vacation home which is used by the taxpayer for personal purposes during some portion of the taxable year. We believe that this proposal is too restrictive in application and that the more appropriate rule would be to allow a deduction for a portion of each expense, otherwise incurred in a trade or business or for the production of income, attributable to the portion of the use of the residence for business purposes, even if the total of such allocation exceeds the gross income derived from the business. Limitation of the deductibility of such expenses to the amount of gross income fails to reflect the fact that persons owning such residences are engaged in the conduct of a trade or business for the production of income, regardless of the portion of personal use of such property, and such provision unfairly discriminates against such persons in relation to persons engaged in other forms of income-producing activity.

Exclusion of Gain from Sale of Residence.—We urge inclusion in the Bill of a provision expanding the exclusion from gross income provided in section 121 of the Code for all or part of the amount of gain from the sale of the taxpayer's residence. Under section 121, an exclusion from gross income of all or part of the capital gain of the sale of a residence is available only to

a taxpayer over 65 who has used the property as his principal residence for five or more out of the preceding eight years. The House Ways and Means Committee approved a provision as part of the Tax Reform Bill of 1974 which would have extended the exclusion to all taxpayers, regardless of age, and would have increased the amount of the exclusion from $20,000 to $35,000. We support this proposal as a means of increasing the attraction of home ownership.

Treatment of FNMA Commitment Fees and Similar Expenses Paid with Respect to Federal and State Housing Programs.—We urge consideration by the Committee of an amendment to the Code which would eliminate the problem created by recent IRS rulings respecting the tax treatment of commitment fees and other related payments made in connection with Federal or state assisted housing programs. The IRS has ruled that the FNMA commitment fee paid with respect to a Section 236 project constituted interest which was deductible over the entire period of the 40-year loan, and not merely over the period of construction. The Service position was based on an unfounded analysis of the financing of a Section 236 project as involving "one loan". We believe that this analysis fails to properly categorize the fact that two separate loans, for construction and then for permanent financing, are obtained for Section 236 projects as well as for other types of multi-family projects. A similar result was reached by the IRS with respect to fees paid to a state housing agency. We urge that the Committee add to the bill an amendment which provides that FNMA commitment fees, financing fees and other similar expenditures incurred with respect to Federal or state housing projects should be deductible ratably over the period of construction. This is the more appropriate characterization of such expenditures as related to the construction period.

Investment Account for Dealers in Real Estate.—We urge that consideration be given to the adoption of a provision authorizing the creation of an investment account for dealers in real estate. Unlike persons who deal in securities, persons who engage in the real estate and home building business have no statutory provision (similar to that provided in section 1236 of the Code for dealers in securities) authorizing the segregation of real estate as investment property and the treatment of the gain realized on the subsequent disposition thereof as a capital gain. As a result, the availability of capital gains and the sale of real estate has been the subject of hundreds of judicial decisions which in total create substantial uncertainty as to the tax treatment of real estate acquired for investment rather than for development.

The purpose of such a provision would be to eliminate the uncertainty and avoid unnecessary litigation by providing an express statutory rule which, if satisfied, would permit an electing home builder or other dealer in real estate to acquire real estate for investment and thereafter dispose of such property with clear assurance of treatment of the gain thereon as a capital gain. In order to insure that the provision would be applicable only to real estate held for investment purposes, the property would qualify for capital gains treatment only if, within thirty days after acquisition, the taxpayer elected to identify the real property as property held for investment; the manner of such identification could be prescribed by the Secretary. Moreover, the taxpayer would have to refrain from improving the property by expenditures of not more than some minimal percent of the market value thereof and would have to hold the property for a certain minimal period.

The concept of an investment account is presently provided in section 1236 of the Code in the case of dealers in securities. We believe that home builders and dealers in real estate should be entitled to the same certainty of tax treatment.

TAX INCENTIVES TO ASSURE A MORE STABLE SUPPLY OF RESIDENTIAL MORTGAGE FUNDS

I should like now to turn to an area of great importance to the home building industry. As I have mentioned earlier, we appear to be gradually coming out of the serious housing slump that started in the summer of 1973 and at its depths reached the lowest production level since World War II. One more housing cycle thereby seems to be ending. However, this past cycle was much worse than any other experienced in the past 30 years, dropping more precipitously and lasting longer than its predecessors.

The principal cause of this cycle was the non-availability of mortgage money and the high cost of that money that was available. It started with severe disintermediation in the nation's thrift institutions, the principal suppliers of residential mortgage credit, and snowballed into a disaster. At one time in the course of the shortage of funds, home mortgage interest rates were at the 10% level, multifamily mortgage interest rates were above 11%, and construction money was rarely available for less than 15%. Many builders went bankrupt and most people, whether buyers or renters, found themselves priced out of the new housing market at a time when we are experiencing the highest demand for new housing in our nation's history.

Something must be done to prevent the recurrence of such a situation. There have been many proposals made within and without the Congress to deal with the situation. In December, the Senate passed the Financial Institutions Act of 1975; in the House the Financial Reform Act of 1976 is now pending before the Banking Committee. In fact, we testified on the FRA before the Banking Committee earlier today. These bills propose significant changes in the structure of the nation's financial institutions, with the prime goal being to expand the powers of the thrift institutions so as to give them a broader deposit base and thus make them presumably better able to deal with threatened disintermediation.

NAHB has strongly opposed these financial restructuring proposals on the basic premise that, while we were perhaps making thrift institutions better able to withstand disintermediation, it would be done at the expense of housing. The proposals would result in a decrease in the investment in housing mortgages by thrift institutions, without any assurances that this loss would be made up through some other sources. Even in the depths of the recent housing depression, 1974, close to 80% of the single-family, conventionally financed home mortgages were made by savings and loans and mutual savings banks. We cannot afford as a nation to dilute such a mainstay for meeting the nation's housing needs without taking other actions to offset any such dilution.

Mortgage Interest Tax Credit

The implementation of the Senate-passed bill is premised upon enactment of the mortgage interest tax credit. This tax credit, on a sliding scale from 1½% to 3⅝% based on the percentage of assets invested in residential mortgages, is designed so as to make it attractive for thrift institutions to remain substantially invested in residential mortgages and to increase the investment in residential mortgages of commercial banks and life insurance companies. Incidentally, the latter have almost completely abandoned the residential mortgage market in the past ten years.

We support the mortgage interest tax credit as one of the actions that needs to be taken to stabilize the supply of residential mortgage money, especially if the Congress sees fit to enact legislation such as that proposed in FIA and FRA. We believe that the proposal set out in S. 1267, as reported by the Banking Committee, should be modified so as to change it, from its present straight-line progression, to one under which the credit increases more rapidly as the percent of investment in residential mortgages increases and, conversely, drops off sharply when this investment decreases. We also believe that the maximum credit should be increased from the 3⅝ percent proposed in S. 1267 to perhaps 5 or 6 percent. A more detailed explanation of our thoughts on the mortgage interest tax credit is attached as Exhibit "A".

Requiring Minimum Pension Investment in Residential Mortgages

While the mortgage interest tax credit is an absolute necessity if legislation such as FRA or FIA is enacted, we do not believe that it in itself would be a sufficient offset to the expanded non-residential investment powers which would be granted the thrift institutions under those proposals. The tax credit does not reach the problem of how the pension funds are to be induced to increase their present almost nonexistent level of investment in residential mortgages.

Public and private pension funds have assets in excess of $250 billion, nearly approaching that of the savings and loans. As an increasingly major repository of the people's savings, they have major social responsibilities to carry out, particularly in light of their favored Federal tax treatment. Yet

their principal investment has been in the stock market, a much more highly speculative area than housing investment. During the sharp drop in the stock market in 1973 and 1974, the asset value of private pension funds actually declined, a situation which would not have occurred with residential mortgage investments. Attached as Exhibits B, C and D are tables showing the investment experiences of public and private pension funds since 1969.

The declining ratio of assets of pension funds invested in residential mortgages must be reversed. We know of no other way to assure such a reversal and to assure that a reasonable percentage of the assets of such funds are invested in residential mortgages than by conditioning their favorable tax treatment on a minimum percentage of their assets being invested in residential mortgages.

We proposed that 20 percent of the assets of a pension fund above a minimum size (say $5 million) be invested in residential mortgages or related residential mortgage debt. We propose that this minimum level be required to be reached over a 10-year period, by 1985, by directing that by the end of the first year after enactment 2 percent of a fund's assets be invested in residential mortgages and that this requirement increase by 2 percent a year until the 20 percent level is reached.

This proposal will still leave a great bulk of the assets of pension funds available for investment in corporate equities and other presumably more liquid obligations. At the same time, however, it would assure that these major repositories of the people's savings assume a significant role in assuring that people can obtain housing at reasonable interest rates. The enactment of this proposal, in conjunction with the mortgage interest tax credit, would go a long way toward stabilizing the supply of mortgage credit and preventing future sharp swings in its availability and the resultant chaos that comes from such swings.

Tax Incentive for Savings

Another proposal which we believe deserves serious consideration by the Committee is one which would give the small saver a tax break on the interest earned on his savings. In time of tight money and resultant increases in yields on investments other than time and savings accounts, the small saver is frequently attracted to such higher yields causing disintermediation in thrift institutions and even at commercial banks. Granting a small saver an exemption from taxation of a portion of the interest earned on his savings deposits, we believe, would act as a major deterrent to such disintermediation. It would also encourage at all times greater thrift by potential savers.

We therefore urge that the first $1,000 in interest earned on savings deposits in financial institutions be exempt from Federal taxation. To balance out the benefit of such a provision between higher and lower income savers, we also urge that the saver be permitted to take, as an alternative, a tax credit of up to $250. The tax credit could be so structured so that for each dollar of interest earned, 25 cents in tax credit would be allowed.

We realize that in recent months there has been a great inflow of savings into financial institutions. But we also remember very vividly the outflow that occurred in 1973 and 1974. Stability is needed in the flow of funds to these institutions, especially the thrift institutions which have been and we hope will continue to be the mainstays of the residential mortgage market. We also feel that the availability of the tax credit should permit a decline in the maximum rates allowed on certificates of deposit. These rates, which are as high as 7¾% for six-year CDs and 7½% for four-year CDs offered by thrift institutions, have resulted, unfortunately, in keeping the mortgage interest rates charged by thrift institutions at outrageously high levels.

CONCLUSION

I appreciate the opportunity to appear before you today to present the views of the National Association of Home Builders with respect to tax reform. As is evident, the Federal income tax laws have a major impact on the operation of the home building industry, particularly the construction and ownership of multifamily rental housing. Accordingly, we urge that no action be taken to change the tax laws in a manner which would have an adverse effect upon the flow of outside equity to our industry.

We also urge that serious consideration be given to approving the three proposals designed to assure greater stability in the residential mortgage market. These proposals to enact a mortgage interest tax credit, to require a 20% minimum investment in residential mortgages by pension funds, and to encourage savings by the small saver are essential if we are to avoid a repetition of the disastrous housing cycle from which we are just recovering.

Thank you for this opportunity to appear today.

Exhibit A

Mortgage Interest Tax Credit

A mortgage investment tax credit in NAHB's opinion should provide incentives as well as disincentives. The tax credit, as now structured in the FIA, is straight-line and increases or decreases on a directly proportional basis. It, thus, only provides a marginal degree of incentive for an investor to increase its investment in mortgages when higher yielding alternatives are available. By the same token, the disincentive for non-investment in mortgages (or penalty if you will) is at best marginal. Within the proposed restructured financial institutions framework of FIA, lending institutions, which now support housing due to the disincentive of increased taxes, will be given much broad alternate investment opportunities. If the penalty for dis-investment in mortgages is not significant, ordinary investment analysis leads to the conclusion that, when housing most requires funds from its traditional sources, the attractiveness of alternative investments made possible by FIA will lure them from housing lending.

Therefore, we believe that any system of tax incentives must provide severe disincentives for non-compliance. NAHB believes that, in the case of a mortgage interest tax credit, the disincentives can only be provided by a progressive scale of increasing benefits for increased investment which falls off quickly when the maximum investment is not maintained.

Using the tax credit proposal contained in the Senate bill which provides for a maximum credit of 3⅚% for investment of 80% of assets in residential mortgages, we would propose that, instead of the 1/30 of 1% decrease in the amount of the credit for each 1% of asset decrease in residential mortgage investment, a rate schedule such as the following be considered:

Percent of assets invested in residential mortgages	*Amount of credit*
Under 10	None.
10 percent	1 percent.
Over 10 percent but not more than 25 percent.	1 percent + 1/30 percent for each 1 percent increase in assets invested in residential mortgages over 10 percent.
Ocer 25 percent but not more than 45 percent.	1½ percent + 1/60 percent for each 1 percent of increase in assets invested in residential mortgages over 25 percent.
Over 45 percent not not more than 65 percent.	1⅚ percent + 1/20 percent for each 1 percent increase in assets invested in residential mortgages over 45 percent.
Over 65 percent but not more than 80 percent.	2⅚ percent + 1/15 percent for each 1 percent increase in assets invested in residential mortgages over 65 percent.

You will note that this schedule makes the initial credit 1%, rather than the 1½% proposed by the Administration and contained in the Senate-passed bill. You will also note that the incentive to increase investment in residential mortgages rises somewhat more sharply between 10% and 25% than it does between 25% and 45%, after which it starts rising sharply again after 45% and even more sharply between 65% and 80%. While we are not locked into the exact numbers set out in the above example, we feel it better meets our concern that there be a higher penalty for a savings and loan, for instance, dropping below the present average S&L investment of approximately 80% of its assets in residential mortgages. Conversely, there is a greater incentive to reach the 80% level for an institution that is below that level now.

Another approach would be to use the same sort of progressions outlined above, but to increase the maximum credit above 3⅝% to, say, 5% or 6%. This would permit an even sharper increase in the credit as the percentage of assets invested in residential mortgages rises from 65% to 80%. Conversely, it would also provide a greater penalty for allowing this investment to drop away from 80%.

[Attachment B]

ASSETS [1] OF PRIVATE NONINSURED PENSION FUNDS, 1969-74

Year	Total assets	Demand deposits and currency	Corporate shares	U.S. Government securities	Corporate bonds	Residential mortgages	Miscellaneous assets
				Dollars in millions			
1969	$102,360	$1,620	$61,400	$2,790	$27,610	$4,220	$4,720
1970	110,630	1,800	67,100	3,030	29,670	4,170	4,860
1971	130,470	1,640	88,600	2,730	29,010	3,660	4,830
1972	156,770	1,860	115,300	3,690	28,210	2,730	4,980
1973	135,190	2,340	90,500	4,400	30,330	2,380	5,240
1974	118,600	4,200	65,900	5,500	34,500	2,700	5,600
1975 [2]	151,800	3,300	91,400	10,900	36,900	2,300	7,000
				Percent distribution			
1969	100	1.58	59.98	2.73	26.97	4.12	4.61
1970	100	1.63	60.65	2.74	26.82	3.77	4.39
1971	100	1.26	67.91	2.09	22.23	2.81	3.70
1972	100	1.19	73.55	2.35	17.99	1.74	3.18
1973	100	1.73	66.94	3.25	22.44	1.76	3.88
1974	100	3.54	55.56	4.64	29.09	2.28	4.89
1975 [2]	100	2.17	60.21	7.18	24.31	1.52	4.61

[1] Corporate shares reflect market value, all other categories reflect book value.
[2] Preliminary.

Source: Federal Reserve Board (1) Flow of Funds Accounts 1965-1973, September 1974, p. 35; (2) Flow of Funds, Assets and Liabilities Outstanding 1974, p. 3; (3) unpublished data for 1975; data compilation and analysis by NAHB Economics Department.

[Attachment C]

ASSETS [1] OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS, 1969-74

Year	Total assets	Demand deposits and currency	Corporate shares	U.S. Government securities	Corporate bonds	Residential mortgages	Miscellaneous assets
				Dollars in millions			
1969	$51,824	$479	$5,877	$7,003	$30,150	$5,984	$2,331
1970	58,089	601	8,014	6,698	33,935	6,809	2,032
1971	64,374	700	11,199	5,143	38,120	7,085	2,127
1972	72,232	799	14,661	4,530	43,445	6,764	2,033
1973	81,647	967	18,583	4,643	49,381	6,658	1,415
1974	93,900	900	22,100	5,200	57,800	7,000	900
1975 [2]	106,500	600	24,700	6,900	65,100	7,200	2,000
				Percent distribution			
1969	100	0.92	11.34	13.51	58.18	11.55	4.50
1970	100	1.03	13.80	11.53	58.42	11.72	3.50
1971	100	1.09	17.40	7.99	59.22	11.00	3.30
1972	100	1.11	20.30	6.27	60.15	9.36	2.81
1973	100	1.18	22.76	5.69	60.48	8.15	1.73
1974	100	.96	23.54	5.54	61.55	7.45	.96
1975 [2]	100	.56	23.19	6.48	61.12	6.76	1.89

[1] Corporate shares reflect market value, all other categories reflect book value.
[2] Preliminary.

Source: Federal Reserve Board (1) Flow of Funds Accounts 1965-1973, Sept. 1974, p. 35; (2) Flow of Funds, Assets and Liabilities Outstanding 1974, p. 3; unpublished data 1975, data compilation and analysis by NAHB Economics Department.

[Attachment D]

TOTAL ASSETS[1] OF PRIVATE NONINSURED PENSION FUNDS AND STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS, 1969-74

Year	Total assets	Demand deposits and currency	Corporate shares	U.S. Government securities	Corporate bonds	Residential mortgages	Miscellaneous assets
				Dollars in millions			
1969	$154,184	$2,099	$67,277	$9,793	$57,760	$10,204	$7,051
1970	168,719	2,401	75,114	9,728	63,605	10,979	6,892
1971	194,844	2,340	99,799	7,873	67,130	10,745	6,957
1972	229,002	2,659	129,961	8,220	71,655	9,494	7,013
1973	216,837	3,307	109,083	9,043	79,711	9,038	6,655
1974	212,500	5,100	88,000	10,700	92,300	9,700	6,700
1975[2]	258,300	3,900	116,100	17,800	102,000	9,500	9,000
				Percent distribution			
1969	100	1.36	43.63	6.35	37.46	6.62	4.57
1970	100	1.42	44.52	5.77	37.70	6.51	4.08
1971	100	1.20	51.22	4.04	34.45	5.51	3.57
1972	100	1.16	56.75	3.59	31.29	4.15	3.06
1973	100	1.52	50.31	4.17	36.76	4.17	3.07
1974	100	2.40	41.41	5.04	43.44	4.56	3.15
1975[2]	100	1.51	44.95	6.89	39.49	3.68	3.48

[1] Corporate shares reflect market value, all other categories reflect book value.
[2] Preliminary.

Source: Federal Reserve Board (1) Flow of Funds Accounts, 1965–1973, Sept. 1974, p. 35, (2) Unpublished data for 1975, Securities and Exchange Commission, Statistical Bulletin, April 1975; data compilation and analysis by NAHB Economics Department.

The CHAIRMAN. Thank you very much.

We will adjourn until 10 o'clock tomorrow morning.

[Whereupon, at 1:45 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Wednesday, March 24, 1976.]

TAX REFORM ACT OF 1975

WEDNESDAY, MARCH 24, 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, Byrd, Jr., of Virginia, Bentsen, Hathaway, Curtis, and Dole.

The CHAIRMAN. This hearing will come to order.

Today we will hear from some of those who are responsible for the success, or lack of it, as the case may be, of professional athletics. We will commence with a panel consisting of Bowie Kuhn, commissioner of baseball, accompanied by Walter J. Rockler and James F. Fitzpatrick.

Also, we will have Robert O. Swados—is that the correct pronunciation?

Mr. SWADOS. That is correct, Senator. I compliment you.

The CHAIRMAN. The director and vice president of the Buffalo Sabres Hockey Club.

We also have John Jones. Which one of you is Mr. Jones?

Mr. JONES. I am, Senator.

The CHAIRMAN. You should have brought Bert Jones.

Mr. JONES. Right. You did pronounce it right, sir [laughter].

The CHAIRMAN. And Andrew Singer on behalf of the National Football League.

We also have Ronald S. Schacht on behalf of the National Basketball Association. Fine, gentlemen.

This group ought to limit its time to 30 minutes, and I will suggest, Mr. Kuhn, that you may proceed.

STATEMENT OF PANEL CONSISTING OF: BOWIE KUHN, COMMISSIONER OF BASEBALL, ACCOMPANIED BY WALTER J. ROCKLER AND JAMES F. FITZPATRICK; ROBERT O. SWADOS, VICE PRESIDENT AND DIRECTOR OF BUFFALO SABRES HOCKEY CLUB; ON BEHALF OF THE NATIONAL HOCKEY LEAGUE, JOHN JONES AND ANDREW SINGER ON BEHALF OF NATIONAL FOOTBALL LEAGUE; AND RONALD S. SCHACHT, NATIONAL BASKETBALL ASSOCIATION

Mr. KUHN. Thank you, Senator.

Obviously, I am very happy to have an opportunity to appear here and address myself to this committee on a subject which is an important one, not only to baseball but to all professional sports.

I have submitted, Senator, a statement and an attached memorandum, which I would ask be included in the record, but my remarks this morning will be more informal than those which appear in my statement.

I would like to obviously address myself to H.R. 10612 and particularly to those provisions which pertain to professional sports and to baseball. There are some provisions, reform provisions, in it to which we have made no objection, but there are others dealing with LAL and minimum tax, unique depreciation recapture, and a 50 percent presumption regarding player contracts, which are very troublesome to professional baseball.

I think it is important that the administration through the Secretary of the Treasury has supported the continuation of the present regulations regarding professional sports. The Secretary has pointed out in his appearance before the committee that the Internal Revenue Code as it exists really has no special benefits for sports franchises. Indeed, they are treated under the code and under the procedures of the Service as any other business and not as a specialized tax shelter with specialized legislation giving them advantages which are not available to other businesses.

The Secretary points out, and I think quite correctly, that the Internal Revenue Service is perfectly capable of handling franchise valuation problems, contract valuation problems, and depreciation problems as they arise, on a case-by-case basis. Indeed, we feel that the case-by-case basis is the only way to handle these problems and that a new statutory basis, is not appropriate because the differences between franchises within a sport and the differences, indeed, between sports are so very great that we do not see how any one statutory standard or set of standards can do the necessary job.

The Secretary also pointed out that the LAL concept, as it was conceived, was not really intended to apply to sports franchises at all. I think that is quite an important point that I did want to focus on.

As the Secretary saw them the special provisions in the proposed tax reform bill applicable to sports, really, he felt, were unwarranted and were, in his words, "arbitrary" in their application to sports. So, I urge that the committee give weight to what the Secretary said on the subject, which we agree with and which we think is very persuasive.

If there is one thing that I would like to particularly stress this morning, gentlemen, it is that professional sports do not constitute tax shelters as that phrase is normally understood. Certainly, if you look at professional baseball, it has none of the attributes of a tax shelter.

You do not find trafficking in franchises in baseball. We have submitted some data to the committee indicating that the average period that a franchise is held in professional baseball is 18 years. That is way beyond the normal turnover you get in a tax shelter situation. If you look at the schedule, you will see some interesting things. For instance, the San Francisco Giants, until their recent sale, had been held in the same corporation for 57 years; the Chicago Cubs have been controlled by the same family for 44 years in an ordinary corporation; the Philadelphia Phillies for 33 years.

Indeed, this 18-year average would be longer than it is except for the expansion in recent years that has pulled the average down without reflecting the fact that the people who own these clubs may also intend to hold them for 44 years, or whatever is characteristic.

So, people who have come into baseball have not really come into it for a fast buck; they have come in because, more than anything else, they love the game and want to be a part of it. I think that the support for this concept is very strong.

Also, if you look at our 23 clubs which are in the United States and subject to our tax laws, 14 of these are ordinary corporations. In other words, these 14 are not partnerships or subchapter S's where depreciation losses can be passed through to individuals. So, in the great majority of our clubs corporations, there is nothing passed through at all.

You do not see in baseball, in the acquisition of clubs, the typical kind of leveraging you see in the tax shelter. You do not see accelerated depreciation; we do not have accelerated depreciation. You do not see the quick in-and-out guys. In other words, you do not see the things that are typical of tax shelters found in the operation of professional baseball. It is a stable business, though it does have financial problems, and, in view of its financial problems, it has been a remarkably stable business. Now, to think of it as a tax shelter is just very unfair when you view the game and view its operating history.

Another thing that I would like to focus on is our player values. These values are not artificial values. When a club is acquired and the values are set, we use professionals, who oftentimes sit down with outside experts, to attach what we conceive of as a market value to the contracts of the various players. We try to arrive at something that is realistic and not artificial for our player contracts.

To give you some idea of how real our player contract values are, I will give you the recent case of Catfish Hunter, who, having become a free agent before last season, was able to negotiate a financial package, the total value of which was $3 million.

I am not saying that all of our players are Catfish Hunters, but it does give you some idea. There is real value, and these values are being established, indeed, on a regular basis, because our clubs work with the Service to establish what is properly depreciable in terms of player contract values.

Also, when a franchise is sold, obviously, the amount of money that the franchise can bring is based on the potential future earnings of the franchise. Now, if you look at the earnings of a baseball franchise, you will find them for the most part closely related to the value of player contracts.

About 60 percent of our income, comes from attendance. Now, in baseball, attendance is a very "iffy" thing. If your ball club is good, your attendance can be very good; if your ball club is not so good, your attendance will turn right around and go down. This is not true of some other sports, but it is true in baseball. An example would be the Boston Red Sox in 1966 and 1967. In 1966 the Red Sox finished in ninth place and drew 800,000 people. The next year they ran up to first place, played a very exciting World Series against the St. Louis Cardinals, and the attendance jumped from 800,000 to

1,700,000, showing you how changeable this can be, depending on how well your athletes are playing.

This comes back again to the real value of player contracts. As I said, about 60 percent of our income comes from attendance, and if you add the local broadcasting revenues, the concession income, the parking income, and the other things which are directly related to the kind of show you put on, you find that 84 percent of our income is related to the quality of the baseball club that you have.

So, this is the heart of baseball.

In some sports they are fortunate enough to be able to sell seats without having good teams. We see examples such as the 50,000 season tickets being sold by an expansion football franchise that does not even have a team yet. In baseball, it is a love affair depending on how good your team is. It is a fickle love affair which changes if your team is not performing well.

So, we have to live with the value of these rights, and I think we know that they are important and that they add up to something.

Also, in talking about player values, we have another facet of our business which is very much distinct from the other sports businesses; that is the cost we have in bringing a baseball player to the major league franchise. Our friends in football and basketball are fortunate to be able to derive their talent from the college campus. I am nothing but jealous of that, but it does not work that way in baseball. Because of the nature of our game, we have to take our talent, and develop it in the minor league system.

We estimate today, with the increasing costs that we are faced with, that it costs us about $500,000 to bring a player to a major league franchise. So, we make a terrific investment in a player just to get him up to a major league franchise. Again, this is an example of how very real the player values are that we have, which we feel should be reflected in the way the tax laws treat professional baseball, and indeed professional sports.

I should also add a somber note, and that is that, while baseball has had a long and solid history, obviously, there are franchises, more today than ever, that have economic problems. We are constantly trying to find good new ownership to bring into our game in those cities where owners are having problems. The San Francisco Giants are a good example of the difficulty that we can have. I feel certain that, if the present tax treatmnet that we have is taken away and replaced by some provisions which we feel are arbitrary in the new tax reform bill, we can anticipate greater difficulty in attracting ownership that can give us the stability to continue operating as we have in the past. We would also lose the ability to bring in people who can make the teams more competitive and therefore better able to attract the fans in those cities. So this is a point that I do want to stress.

Also, we are currently looking at expansion in baseball and we are trying to bring in strong new ownership there. Expansion franchises are notoriously unprofitable. To try to attract the kind of ownership that we want, we would hope that we could at least operate under the tax laws as they now exist, without the kind of changes that are included in the House tax reform bill.

In closing, I should say a word about Bob Short, who owned the Washington baseball club. There has been some feeling, I know, among the people who have analyzed the problems of this franchise that Mr. Short did indeed use baseball as a tax shelter, and that he derived substantial monetary benefits from doing so.

I am not here to defend Mr. Short's operations in baseball; he is perfectly capable of doing that himself, but I do want to say that there is nothing which smacked of benefits from a tax shelter.

First: Mr. Short put a fair amount of equity financing into the Washington baseball club when he acquired it. It is widely said that he had almost no equity financing. I think $5.6 million was equity financing. So it was not something that was highly leveraged and done on $1,000. It was nothing of the kind.

Second: Mr. Short used an ordinary corporation. Since this was not a subchapter S corporation or a partnership, there were no losses flowing down to Mr. Short as an individual of which he was taking advantage.

Third: And perhaps most importantly, what Mr. Short proved himself to be was one heck of a good bargainer when he was selling things. When he took the ball club to Texas, he promptly proceeded to sell the broadcasting rights for the next 10 years for $7½ million in hand, and then turned around and sold the ball club for approximately the same price he had paid for it in Washington.

So Mr. Short was a shrewd trader but was not a man who was taking advantage of the tax laws in any improper way in his ownership of the baseball franchise.

There are a lot of other things that I have included in my statement that was submitted, but I did want to touch on these highlights. I do want to very strongly to emphasize to the committee that we think the special provisions pertaining to sports are really not needed and that under the existing procedures of the Internal Revenue Service there is more than adequate protection for the public interest.

I thank you for your time, Senator.

Senator DOLE. Can I ask him to comment on one other thing.

The CHAIRMAN. Yes.

Senator DOLE. There has been a recent story, not directly on what you said, about baseball players drawing unemployment compensation, making $48 to $50 to $60 thousand a year. You are quoted as saying that you see nothing wrong with that.

Is that an accurate statement?

Mr. KUHN. What I said, Senator Dole, was that I felt this was a matter of local law and not one over which the commissioner of baseball had any control.

Now, what my personal views may be as to the desirability or undesirability of ballplayers doing that is something else again, but in the Milwaukee case, which was one that was publicized, the local law permitted the payments that were made, and I must say that I think it is a matter for local law to handle. If they want to call me to testify, I will be happy to tell them what I think of it.

Senator DOLE. Well, they still do have of the school personnel, cafeteria workers in schools. They eliminated the teachers, but they

still have the other people and some movie industry people and others, where they have sort of seasonal employment, but it is a matter of concern.

Mr. KUHN. I can understand that.

The CHAIRMAN. One of the reasons it is that way is that if you get them into the 70-percent tax bracket, complete idleness has great attraction.

If a fellow was permitted to keep as much as half of what he makes a day, he would have a greater incentive. Some people are not satisfied for the Government to take just half of what he makes—they feel the way you ought to judge what a man is considered to make after taxes is by letting them measure his eggs in their basket, how much they think they ought to give him to eat and spend on clothes, and so forth. If he wants to go fishing, and has to buy a boat, shall they give him an inboard motor or an outboard motor?

I feel that we ought to let a man keep enough of what he makes, so that he can decide for himself whether he wants to go fishing or not. But if the tax law is going to be so demoralizing that it becomes more attractive for a man to work for 5 or 6 months and spend the rest of his time fishing or in leisure, then that is counterproductive law that makes it less attractive to work than it does for the man to find something to do with his spare time.

Do you want other members of your panel to testify at this point?

Mr. KUHN. Yes, sir.

Mr. JONES. Mr. Chairman, I am John B. Jones, Jr., of the law firm of Covington & Burlington, Washington, D.C. I am accompanied by my partner, Andrew Singer. We are tax counsel to the National Football League.

Commissioner Rozelle hoped to be here today, but he has to testify in a lawsuit out on the west coast and could not be here. He has submitted a brief statement, which he would have presented orally, as well as a fuller statement of the principles. I ask that those be made a part of the record.

Mr. JONES. I am not going to read all through this. In the first place, many of the points have been very well stated to the committee by the commissioner of baseball, Mr. Kuhn, I just want to emphasize briefly why football finds this a vital matter and is in full agreement with baseball in saying that the legislation which was passed by the House of Representatives last year and is presently before you is unjustified by any tax abuse known to us in the case of professional sports.

We are not a tax shelter. We have never had accelerated depreciation. Certainly, in professional football the leverage factor which is common in tax shelters is not present. We do not see the shuttling in and out of franchises that would be the hallmark of people getting into it for tax advantages and then getting out. We are a stable business and what we really want is to be taxed like other businesses. Losses if they occur, as they do sometimes, particularly in the start-up years, are matched by income which comes along in the later years.

Other businesses get these deductions and so should football and all professional sports.

We find inclusion of sports in the LAL proposals putting them somewhere where they do not belong. We do not have any hallmarks of other people in that category. We cannot understand why this one case in the whole entire Internal Revenue Code appears where a purchaser's basis should be determined by the seller's basis when there is no tax-free exchange between them. We do not think that is justified in terms of tax law.

We do not think that the provisions which provide simply for writeoff of costs attributable to player contracts is the kind of preference which belongs in the minimum tax.

When we look at the recapture rule, with all due respect, I have to say as a tax lawyer, it seems to me to be a technical nightmare. The main disadvantage would come down to an owner who stayed in a long time. If we were in a situation for somebody to come along like George Halas to get in on football and stay in it for 40 to 50 years, you would find that he would be paying recapture on 8 to 10 generations of football players as ordinary income because of the necessary inflation that would have taken place during his lifetime.

That provision on recapture makes no distinction between contract purchases and simple bonuses, which are paid to players but must be capitalized because of the manner of payment. Those bonuses are nothing but a salary payment in deferred form, and there is absolutely no justification for having any recapture of these amounts once a player has performed his services. We find no counterpart elsewhere in the Internal Revenue Code.

If there is a complaint there has been an overallocation of dollars to a player contract, we have seen in a recent court case that the courts do make independent examinations and require that the taxpayer carry his full burden of proof and come up with reasonable allocations. I think the committee is well aware that there is a case now pending in the Fifth Circuit Court of Appeals involving the Atlanta Falcons, which was decided by the district court somewhere in between the contentions of the Internal Revenue Service and the contentions of the taxpayer. That case may not be the last case to be decided, but it will show that the courts are grappling with this problem.

We are heartened in presenting this position by the fact that the Secretary of the Treasury shares these views. He is confident that the present law is entirely adequate to give the Internal Revenue Service the tools it needs to bring taxation of sports enterprises in line with what we all want taxes to do—to work for fair allocation of revenue requirements.

We have suggested in our statement that, indeed, if you were really looking at this problem from the point of view of the tax laws, you might ask why it is that so large an amount of what is invested in the sport franchises has to be put in an account that is not amortizable over any period. Any such account ought to be amortizable over, let us say, an arbitrary period of 20 or 30 years. If you rectify that, you might get rid of a lot of revenue disputes. So we suggest and outline that in our presentation.

I will conclude by pointing out that in our view, the effect of what the House has done is to make it harder for sport leagues to expand,

has a tendency to lock in ineffective owners, owners who have lost interest in sports, and causes transfers of franchises of people who have to move to another city to get the advantage of novelty.

We do not object to the provisions which were originally included in the bill that Chairman Ullman suggested. One codifies the rule of recapture on depreciation of players and the other would require the buyer and the seller to agree on allocation of the amount to player contracts.

Thank you very much, Mr. Chairman.

Mr. SWADOS. Mr. Chairman and Senators, I am Robert O. Swados of Buffalo, N.Y., special tax counsel to the National Hockey League. I am also a vice president, director, and one of the owners of the Buffalo Sabres of the National Hockey League.

I have been in hockey since 1968, as have all of the owners of our club. I have been involved directly in the projections and analysis of the sport that leads to one's entering the league. I participated in the deliberations of another finance committee, the finance committee of the National Hockey League and, indeed, that is where the concern ripened which brings me to this forum today.

Some of you may have seen the article in last night's Star about the troubles of the Kansas City Club in our league. This is a condition with which we must all be concerned. I would say that our principal concern here, is that these provisions, which we do not feel are justified in terms of the experience of our sport or any sport, would have a very adverse effect on the possibility of solving the problems, such as the Kansas City problem, solving problems such as have occurred in Pittsburgh last year of bringing in new owners, as we did in Oakland, of carrying out the policy of our league, which is not to permit or encourage the sudden entry or departure of owners as their tax deductions run out, but to provide a permanent and continuous and growing franchise in the cities that we choose for the league.

Now, what I was thinking about as this problem came up in our finance committee, what is the investor confronted with in terms of this bill as we seek to encourage him to come into our league, either in the purchase of an existing franchise or as a recipient of an expansion franchise. If he seeks an expansion franchise, he knows that the largest part of his cost in major asset will be player contracts; yet, the bill would tell him that he has a very difficult burden to sustain before he can amortize more than half of his purchase price, even though he knows that his players will have limited useful playing lives.

If he cannot bargain successfully with the seller, he must accept the seller's allocation of the cost. He knows—and in our league we tell everybody very clearly—he knows that as a new franchise he must expect losses, and I am not talking about book losses, I am talking about out-of-pocket losses in the development years of the franchise. We insist that people show the financial capacity to stand those get-going costs.

But he also knows that if this bill ever becomes law that if he desires to use his income from another business to fund hockey operations during those rough years, he will have restrictions to the extent to which he can use the hockey losses against his other income.

If he or his general manager seeks to sell a player or make him available in the expansion or interleague draft, he faces the risk of transactions that will trigger unexpected ordinary income tax arising from the depreciation taken on an unrelated player who is not even disposed of.

Now, I may say, after Sunday's night game, I went down to talk to our general manager, Punch Imlach, some of you may know of him, but I will say that he is a very tough-minded fellow. During the course of the conversation, I said to Punch: "Do you know if this bill is going to be enacted, you are going to have to consult tax counsel every time you want to sell, draft, or make available players in the draft," and his answer was in cryptic fashion, "No way." And that is really a realistic problem, what we call the lump recapture provision of the bill.

Now, I am, by what I hope is a fortuitous confluence of experience, also a tax lawyer, but I am trying to talk as an owner. Therefore, I will try to stress the particular facts which seems to me in part what Mr. Kuhn and Mr. Jones have said, to indicate that this bill is too broad a brush, that it does not really appreciate the differences between sports, and that in fact its impact would be much harsher on some and would not make sense in terms of other sports.

For example, we think that one of the main impulses behind the bill's approach to the amortization of player contracts is the theory that sports franchises have a big fat television contract somewhere which generates large amounts of income, and that when you acquire a franchise, either an expansion or from another person, that what you are really getting for your money is the right to get that television money and that therefore these large amounts that are allocated to the player agreements do not make factual sense.

Well, I have to say regretfully that in the National Hockey League they do make an awful lot of sense, because we are sitting here at this very moment with no national television contract and we have not had a television contract on a national basis that amounts in aggregate or in relative terms to anything like what the other three major sports have. In our best years, hockey had dollar-per-club from national television which was about a third of basketball and maybe one-seventh to one-twentieth of what the other sports got.

But here we are today with no television contract. Now, when one looks at it on a local level, the television revenues are all over the lot. There is one club that has zero local television revenue and some clubs have very high television revenue, but that seems to us itself speaks for the fact that the anaylsis of this allocation problem has got to be a case-by-case basis.

Mr. Alexander and his troops have always had a good success in their administrative procedures for handling it, with legal appeals available for it and where there are perfectly rational and fair ways of solving the problem.

Now, it seems to me, the second thing—and this confirms what Mr. Kuhn said—the second thing to realize is that there is a notion that the player contract is nothing but a piece of paper that gives you a temporary right to that player's service. In fact, it has built behind it very substantial development costs because in hockey, and I am in

hockey, we have to develop our talent from the Canadian junior and amateur leagues and from the United States the amateur leagues.

Then we have to take most of these players and find a place for them in the minor leagues and we have to subsidize the minor leagues. For the last 5 years, the aggregate amount paid to junior hockey, to amateur hockey, was $5 million, which is a large number in our league, though that number is smaller than some of these giants here. In addition, the average subsidy to a minor professional league club was $300,000 per NHL club. So that means when you lose a player, he jumps to another league, or for whatever reason you lose a player, that is a real loss, not an artificial loss.

That is something which represents a long period of investment in the player's training, expertise, and promotion.

Now, in the time I have in concluding, I would again like to stress the things that we think are directly referable to hockey so that you will understand that this bill has to be considered in terms of the facts as they differ in the different league situations.

Like baseball, we have stability in our league. We have very few instances in which there have been transfers. There has never been a transfer of geographical location in the National Hockey League. It has been against our policy. I look at those instances where there have been transfers of ownership. One case involved the death of the principal owner and the two other cases involved a serious continuing financial problem, which we dealt with as I have described it, by trying to find ultimately after strenuous efforts and loaning sums and bringing in other owners.

It is this ability, again, to solve those problems which it seems to us this bill would chill. I think, finally, I would also point out that we do not have the characteristics of a tax shelter. I have already mentioned that we do not have a sudden entering into and departure. It ought to be pointed out that normally tax shelters arise because there is an accelerated depreciation. You use sum-of-the-years digits or you use a double declining balance or just push the cost up front in the earlier years. We do not have any such rights.

When we amortize the cost of players' contracts, we are limited to the straight line. We figure what the player expectency is, which can be determined from publications like this, divided by the number of years and arrive at the amortization amount. We do not countenance a high leverage situation. We normally require not less than $1,500,000 of working capital for new franchises and substantial equity, and in every instance where the credit liquidity, or the financing suggests it, we have also required individual guarantees.

Of our franchises, very few use limited partnership vehicles.

Finally, and this is where I can say from my own experience, there is direct and personal involvement by owners in the full range of the operations of the sports business. It is nothing like the indirect ownership of an oil payment or an indirect interest in a Broadway show or whatever it is you want to talk about. As you look at the history of sports generally and particularly in hockey, it looks nothing like a tax shelter, and it is not a tax shelter.

So, in summary, I would concur with Mr. Jones and Mr. Kuhn. As they said before, we do not object to those provisions which would require some conformance between buyer and seller as to the handling

of allocations. We do not object to the rule that the amortization of players' contracts should be subject to the normal recapture rule, but we do not feel that with the economic conditions that exist in hockey today, with the other assaults that have been on us from every side, and owners are getting a little paranoid because nobody says anything good about them, we deserve not to be treated in a discriminatory manner.

We are perfectly willing to be bound by the same general principles of tax accounting applicable to other businesses, and we suggest that those provisions of this bill which would depart for that be rejected.

Mr. SCHACHT. Mr. Chairman and Senators, I am Ronald S. Schacht, and I am an attorney representing the National Basketball Association.

I will try to limit my remarks to just a few points, since the three prior speakers have covered all of the principal points, and because of the short amount of time that we have left.

I would like to reemphasize the fact that we do not believe that there is any reason to treat the owners of sport franchises in a more adverse manner than the owners of any other business enterprise.

Basketball, in particular, is a very speculative, risky operation. Many basketball teams incur substantial dollar losses each year and, as we have recently seen in the American Basketball Association, many of those teams have demonstrated the inability to continue in business because of these losses.

For these reasons, we do not believe that it is justified or warranted to treat a sports team as a tax shelter. To do so, I think, is to completely ignore the reality of the situation.

The proposed provisions with respect to recapture, we believe, are also unwarranted. This provision would apply to an isolated sale of a player contract as well as to the sale of an entire team. To tax recapture of depreciation on a contract, other than the contract being sold, is a very unique concept, and we believe that this will cause a substantial limitation on the ability of players to move from one team to another. The existing recapture rules and proposed codifications of those rules are certainly sufficient to prevent any abuse in this area.

As I stated, a substantial number of basketball teams lose money each year. This proposed legislation would necessarily have an adverse effect on most people who are now willing to operate or who will be willing to acquire teams in the future. There should not be, and we do not believe that there is, any reason for Congress to discourage the continued operation of existing sports teams.

The provision creating a presumption with respect to 50 percent of the purchase price, we believe, is similarly unjustified. This provision would not give any consideration to the differences that, in fact, exist between leagues and between teams in each league. In allocating the purchase price among assets, it is necessary to give consideration to such things as the fact that basketball realizes a very small portion of its revenues from national TV as compared to some of the other sport leagues.

Similarly, it is necessary to give consideration to the area in which the franchise plays their games and to the degree of fan interest in

that area. Consideration should also be given to the size of the arena and to the fact that values of player contracts also varies depending on the ability of the player involved and depending upon that player's appeal to the fans.

To ignore these considerations, by creating arbitrary presumption, we again believe, is unwarranted.

In conclusion, I will just state that the National Basketball Association joins the other speakers in urging that these provisions be deleted from the bill.

Thank you, sir.

The CHAIRMAN. By seniority rule, which applies on this committee, the first Senator here asks the first question, and I believe I was the first one here. So I will avail myself of the benefit of my seniority.

I would like to ask you tax lawyers, have you seen the statement of Peter Fabner before the Senate Finance Committee? If you did, I think you might as well laugh about these things as cry about them. I have done some of this type exercise in trying to figure out what a section is supposed to mean, and I find that I just had to give up and conclude—even though I have been a law school graduate with a good law school record—that it is just beyond my capacity to figure out what that section means, because this man gives an example where a client goes to his lawyer to try to find out whether or not he should make an investment and if he can deduct some of the expenses against income.

Otherwise, it would not be worth making the investment. He showed how the lawyer read all these various sections that make it necessary to read another section, each one referring to three or four other sections. By the time he got through with all this, when he planned to call the client before the day was out, he had to call him to say that he would call him back the following day.

So he then spent all the next day studying, running from one cross-reference to another and then studying all these things out and, finally, he had to call the man and tell him: "To tell you the truth, I cannot really tell you whether, for sure, you can deduct that loss or not."

That is to deduct expenses.

In any event, finally, he winds up saying this, having completed the research—after 2 days—he calls the client and tells him he is not absolutely sure, but thinks there may be a problem. He discusses some of the principles involved, including the additional recordkeeping expenses, at which point the 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 point, the lawyer shouts in the telephone: "How should I know? Ask your Congressman," and hangs up.

Senator CURTIS. May I ask: Is the lawyer studying the House bill or the current law? I think it is the House bill.

The CHAIRMAN. He is studying the LAL, just one section of the LAL. I have had some experience with some things that are in the law now, such as this man points out, that we have succeeded in putting sections in the tax law where a single sentence is 2½ times as long as the Gettysburg Address.

People should be able to have some idea whether they are going to have a chance to make money or keep some of it if they do make it, or if they lose money, they can deduct the loss, and the businessman needs to know about some of that to know where to invest his money, which puts people to work or not. When one puts forth a franchise, somewhere along the line it brings all sorts of jobs. I do not know whether it will ever succeed in paying for the Dome in New Orleans, but it provided a tremendous number of jobs, construction jobs and service jobs, and all sorts of other things.

Now, none of that would have happened if we had not been awarded a football franchise to begin with.

Now, we need to find some way where a businessman can make a decision with the hope that if it goes well, he will make some money and be able to keep some money. One of the suggestions that has been made has been made by Secretary Simon, that you ought to just have a simple system where you have very few deductions and pay a relatively low rate. I do not know if the taxpayers will settle for that.

Now, it occurs to me that while that is not in the offering, it cannot be done any time soon, and Secretary Simon would be the first to admit that you cannot do it now, perhaps we could think of something along that line. Instead of passing something like we did with the Tax Reform Act, pass something that repeals everything in that as well as if you should pass these LAL provisions and all these things in the House bill.

Goodness only knows how much money the Treasury is losing and how many jobs we are losing for this country because a businessman cannot make an investment with any degree of certainty or knowing where he will stand, whether he will be permitted to keep some of what he earned after taxes. It is enough of a risk that the investment might be a failure, much less than the prospect in the event that it does succeed, he cannot keep enough of it to make it worth his while, and I think one of you tax lawyers can give me your reaction to that.

Mr. JONES. Well, I think that one analysis of tax lawyers' would be that the provisions that you talk about take a more simplified structure that would appeal to owners in professional sports as well as anywhere else. The real complaint that we have is that in the determination of income, we feel that under this legislation we are being deprived of deductions which any other business could get in determining what that income is.

So, even if you were to adopt a sound and simplified tax structure which would just be a tremendous improvement in what we have today, it would still have to take this legislation back until we can get an accurate measure. That is our objection here.

The CHAIRMAN. Well, I hope that tax lawyers, so like the firm that you represent, Mr. Jones, can help us to show us some simplified alternatives that would cause the law to be simpler by the time we get through, rather than more complicated.

Now, the testimony against this House bill—and I think I have heard more than anybody—has been devastating. We have had studies to indicate that where we thought they were going to make money, they would lose millions of dollars. It was just because they forgot

to take into account the fact that a man who cannot make a decent profit going into a venture is not going to put his money into it to begin with. So the House bill too often proceeds on the assumption that the man is going to do something where he cannot keep any money if he did make it. Most people know that is an unsafe assumption.

Also, when you look at the secondary and tertiary effects of some of these things, you do something that causes the businessman not to go into the very thing that he would have gone into, and that in turn causes other things to fail to happen that would have been good for the economy, and in analyzing it on through we can see, in my belief I can see, a compelling need to work out something that would be somewhat uniform and that would be rather simple that would assure that if someone in an economic sense makes a lot of income, he may assume a reasonable income tax.

So we do not want to project the man making in economic terms millions of dollars and paying no taxes, but we do not have that right away to contend with. Well, some who made half a million dollars and paid no tax dollars in the economic sense, maybe we can meet those problems and at the same time simplify those codes.

Mr. JONES. I did not consult with the league co-owners on getting their authority to speak on this generalized subject of taxation, but speaking for myself, I very much appreciate the efforts and thoughts of something such as a simplified tax code. I think it is a valid approach. I would say, with that in mind, that the testimony you have heard this morning is that in the present tax law it is contrary to the representations that have been made. There is no special treatment for baseball, for football or any professional sport. They want the same tax law applicable to them as to other businesses.

If the House law is adopted, we are buying a tremendous complication, a whole new unique tax law only applicable to professional sports, and I think we are moving in exactly the wrong direction from the goal you have in mind.

The CHAIRMAN. Thank you very much, gentlemen.

Senator Byrd?

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

Did any of you gentlemen or counterparts have an opportunity to testify before the House Ways and Means Committee?

Mr SWADOS. I did not.

Mr. KUHN. We did not.

Senator HARRY F. BYRD, Jr. As I have gathered, then, these provisions were put in the House bill without getting the input from the businesses being affected?

Mr. KUHN. That is correct.

Mr. SWADOS. Correct.

Mr. JONES. Does the Senator understand how it came about that we did not testify?

There were two provisions, largely declaratory, of the existing law. Given limited time, we felt that it was not necessary to take the committee's time for further discussion since the proposals were reasonable ones. It was only after the hearings that these proposals came to the floor. Thus, if we may use the term, we were "mousetrapped" into not appearing before the Ways and Means Committee.

Senator CURTIS. Mr. Chairman?
The CHAIRMAN. Yes, Senator Curtis.
Senator CURTIS. Mr. Chairman, I would like to ask Mr. Jones—maybe you can help me better understand this problem, referring to what the House bill does.
Would you give me an actual or a hypothetical transaction or transactions that illustrate what the tax consequences are now under the existing law and what the House does to it?
Mr. JONES. Well, we will have to take a series of examples.
Senator CURTIS. That is what I mean.
Mr. JONES. Because there are different kinds of transactions.
Let me take one that I find is the easiest. It is the recapture rule. Under the present law, if I buy a player's contract for $100,000 and depreciate it down to $50,000, because he plays with me for 2 years, and then I sell that contract for, let's say, a figure of $300,000, there is a recapture of the $50,000 depreciation, which I originally took.
Senator CURTIS. Recaptured as ordinary income?
Mr. JONES. Yes, because I took the deduction against ordinary income, and that, we understand under the present law, would be reinforced by one of the provisions they have in this bill.
Senator CURTIS. Now, that is in the present law.
Mr. JONES. Under the present law, most people agree that there is recapture. Under the new law, if you get $300,000 for a player's contract, you would find out if there was any other depreciation on any other player at any time after passage of the act, and you would recapture all of that again, as ordinary income, without any relation to what the particular contract was that changed hands. That is what we object to.
There is no other place, in our view of the law, where you get that kind of pickup for all other depreciation on any similar asset.
Senator CURTIS. The House bill would pick up depreciation that had been taken on all other players?
Mr. SWADOS. Yes.
Mr. JONES. That is right.
Senator CURTIS. How about our physical property?
Mr. JONES. You see what happens, you go through generations of players. You go through a generation of players in 4 years. So, if a future George Halas were to sell out in 40 years, he would have eight generations.
Senator CURTIS. That is very helpful. I like the way you boil that down. Now, give me some other examples of what they do to it.
Mr. JONES. There is the arbitrary rule that we have heard from the baseball on what the allocation of a franchise might be today if a league or if two owners got together, an older owner and somebody who wanted to be an owner, sat down and discussed how much this player is worth. They put that in their contract. That is binding on both parties. Now, the new law would create a presumption that not more than 50 percent of the value could go to the players' contracts, even if a businessman sitting in there had his best judgment and said it was 80 or 90 percent. You still would have that presumption going against you in the new law.
Senator CURTIS. Is there anything else?
Mr. JONES. Yes; yes.

Senator CURTIS. But your concise statement has given me an understanding.

Mr. JONES. We have minimum tax provisions which are supposed to be on items of tax preferences. You look anywhere else for items of tax preference, you find accelerated deductions or early type deductions, something that is privileged under the tax laws. Nowhere else is minimum tax applicable to straight-line depreciation, just recovery of purchase cost. Under the new law, everybody gets taxed as an item of preference on accelerated depreciation. Professional sports are going to be taxed on all depreciation, and that is much more of a severe penalty.

Senator CURTIS. Are those the principal illustrations?

Mr. JONES. Well, the LAL provision, very much what we have said on the minimum tax, where football is treated much less fairly than anybody else. It includes, if I may say so, an absolutely unprecedented provision which has the buyer's basis in the contract being determined by references to what the seller's basis is, which is completely irrelevant.

Senator CURTIS. Could you illustrate that?

Mr. SINGER. Well, if you take a player who is acquired for, say, $10,000, and, say, he comes up in 5 years into a superstar, he may be worth $1 million. Well, if I go buy that player now for $1 million, the LAL provision would say that I can only depreciate on $10,000, because that is what my seller paid for it.

Senator CURTIS. In other words, the buyer takes the base of the seller.

Mr. SCHACHT. Yes; the buyer has to disregard his cost and use his seller's cost.

Mr. SWADOS. For the purposes of LAL, trying to offset any other income with this type of deduction.

Mr. SCHACHT. The depreciation attributable to that excess amount paid could not be deducted against any other income.

Senator CURTIS. Did this happen in the Ways and Means Committee or on the floor of the House?

Mr. ROCKLER. LAL came in at the very end. The minimum tax came in on the floor. It is interesting to look at the interaction of LAL provisions and the minimum tax, because LAL says that the amount of the basis which the buyer has in the contract in excess of the seller's basis is disallowable, and as to that remaining portion, which derives from his seller's basis, which you amortize straight-line, that is treated as a preference item which you must pay minimum tax on. So you are caught coming and going.

The CHAIRMAN. That comes over here under the label of "Reform."

Senator CURTIS. If you would submit for the record some examples that will illustrate what the present law is, what this would do, so we understand that in the practicalities of it, because the testimony of the whole panel today is very good and you are learned men in that field, but these illustrations will help us and will help the staff, too, I am sure.

[The examples requested above follow:]

DEPRECIATION RECAPTURE—(SECTION 209(B))

Example 1.—A club sells in 1977 for $500,000 the contract of a star player acquired in 1967 at a cost of $25,000. Present law: proceeds in excess of $25,000

are capital gain. H.R. 10612: the entire proceeds are treated as ordinary income to extent of depreciation taken on other players 1975.

Example 2.—In 1995, an owner who has owned his club for 40 years retires and sells his team. Seventy-five percent of the consideration received is attributable to the 30 player contracts the club owns. Present law: only depreciation on these 30 contracts is recaptured as ordinary income. H.R. 10612: an amount equal to all depreciation ever taken on these 30 contracts plus the 100 other player contracts which he has owned since 1975 is treated as ordinary income.

LIMITATION ON ARTIFICIAL LOSSES—(SECTION 101(A))

Example 3.—In 1976 a new owner acquires all the player contracts of an old club for $10,000,000. The old club's bases in the contracts totaled $2,000,000 and there was $1,000,000 depreciation recapture. Present law: no restriction on recovery of cost through depreciation. H.R. 10612: new owner cannot deduct any depreciation on $7,000,000 of player contracts against other income he may have. (If he had purchased depreciable real estate, the disallowed depreciation under LAL would be only the excess of accelerated depreciation over straight-line.)

Example 4.—H.R. 10612: if the new owner in Example 2 sells one of the contracts acquired in the transaction, he may be required to report as ordinary income recovery of the depreciation which was disallowed, a double penalty unprecedented in tax law.

MINIMUM TAX (SECTION 301(A))

Example 5.—The new owner in Example 3 allocates $3,000,000 to his contracts (an amount equal to the prior owner's bases plus depreciation recapture). Present law: straight-line depreciaton allowed. H.R. 10612: the entire amount of the new owner's straight-line depreciation is subject to minimium tax of 14 percent.

COMBINED EFFECT

Example 6.—After the effective date of H.R. 10612, Team A purchases a player's contract for $10,000 and sells it to Team B for $10,000. Team C purchases the contract from Team B for $100,000 and sells it to Team D for $250,000. Team D holds the contract until it expires and the player retires.

Item	Team A	Team B	Team C	Team D
Purchase price of contract	$10,000	$10,000	$100,000	$250,000
Depreciation on this contract	0	1,000	20,000	250,000
Depreciation on other player contracts	0	25,000	300,000	1,000,000
Economic gain on purchase and sale of this contract	0	90,000	150,000	0
Present law:				
Ordinary income	0	1,000	20,000	0
Capital gain	0	89,000	130,000	0
H.R. 10612:				
Ordinary income	0	[1] 26,000	[1] 150,000	0
Capital gain	0	64,000	0	0
Amount subject to minimum tax of 14 percent	0	[2] 1,000	[2] 2,000	[2] 100,000
Amount subject to LAL	0	0	[3] 18,000	[3] 150,000

[1] This amount will constitute ordinary income without regard to whether all or part of the depreciation was deferred under LAL.

[2] This amount represents the depreciation allocable to the seller's original basis in the contract.

[3] This amount represents the depreciation allocable to the amount paid for the contract in excess of the seller's original basis.

PRESUMPTION OF VALUE—(SECTION 209(C))

Example 7.—The aggregate price of an expansion franchise, player contracts, and other assets to be acquired is $6,000,000 payable over a five-year period. Buyer and seller agree at arm's length that the aggregate market value allocable to (and cost of) player contracts acquired is $5,400,000. Present law: despite lack of directly comparable sales, expert testimony and appraisal will be accepted to support assigned value and thus permit amortization of the cost of player contracts over five years at the approximate rate of $1,080,000

per year. H.R. 10612: in the absence of directly comparable sales, agreement of parties and expert appraisal may not be enough to overcome the presumption that new owner paid no more than 50 percent of his purchase price for the player contracts in which case his depreciation will be cut from $1,080,000 per year to $600,000. This reduction of $480,000 could prevent him from obtaining sufficient cash flow in the last years of the five-year purchase period to meet his purchase payments, or to support bank loans for that purpose, and thus discourage his acquiring the expansion franchise at all.

Senator CURTIS. I would like to ask a general question. Will the enactment of the House provisions, as it relates to your business, increase business and employment and revenue to the Treasury?

Mr. SWADOS. Absolutely not; it will have the opposite effect.

Mr. SCHACHT. The opposite effect.

Senator CURTIS. That qualifies it for a great many people's definition of tax reform, just some hell-raising notion of theirs.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. What they are doing is forcing you into a position of paying ordinary income tax on all of this.

If I understand, you would have an inhibition, really, on transferring players and you might get locked in.

To go back in a retroactive way and lump together all depreciation, as I understand it, it is straight-line depreciation?

Mr. JONES. That is correct.

Senator BENTSEN. No accelerated depreciation?

Mr. JONES. No. No investment credit; nothing.

The CHAIRMAN. Senator Hathaway.

Senator HATHAWAY. Thank you, Mr. Chairman.

On the example that you gave with regard to the $10,000 player who became a $1 million player, even though you could only limit your losses on your other income, you could still take the balance of the $1 million against the income you get from the franchise. It is not a complete loss.

Mr. JONES. But if you had a new franchise or a new situation where it was producing a loss, if you were in any other business, you could deduct that loss against your other income. This would be the only situation where you could not.

Senator HATHAWAY. When you purchase a franchise now, with the evaluation of player contracts as such, is it determined for tax purposes? Say, you buy a franchise for $10 million, is it in the contract itself that you are paying *x* number of dollars of that $10 million for player contracts?

Mr. SWADOS. Usually is. I suppose the practice is not uniform but usually there are specifications in the sale that exist. There is usually a list of players or contracts referred to.

In an expansion, the practice may be to say that the purchaser of the expansion franchise is going to get *x* number of players to be designated in a draft.

Senator HATHAWAY. Would evaluations be very difficult to come by? That is what I am trying to get at.

Mr. SWADOS. It is not very difficult, because you sit down with a general manager who knows these players, has these records, has their potential, and he makes the evaluation. You may bring in an outside appraiser to make that evaluation. There are enough player transactions in the league so that the evaluations are pretty objective.

Senator HATHAWAY. What are some of the other items going into the franchised television rates?

What about physical property? Aren't there an awful lot of things going into it?

Mr. SWADOS. Yes, but not very much in physical property, because most clubs in the sports rent their facilities. Some do not; most in the National Hockey League own their own facilities, but there are the television rights which I have described of differing value and amount. There are concession rights; there are rights to sell novelties; there are sometimes special rights to promote events within the arena. There are various possibilities but the main asset that you are acquiring are the players.

Mr. JONES. We feel that this is a difficult problem that runs through the tax law—allocation of purchase price. If you buy somebody's amusement park, you are going to have allocation problems. The problem here is not more difficult or different in kind from the purchase of any other business. It is subjective judgment and there is no absolute right answer, but it is something we have been able to deal with elsewhere in the Internal Revenue Code.

The Secretary of the Treasury thinks the sports problem is being dealt with under the present law.

Senator HATHAWAY. And player contracts are simply amortized over a 5-year period?

Mr. JONES. It varies from sport to sport.

Senator HATHAWAY. In baseball?

Mr. SINGER. Approximately.

Senator HATHAWAY. In the IRS, they are all lumped together; right?

Mr. JONES. Sometimes that has been voiced. I do not know that that is their official position, because after all, they have——

Senator HATHAWAY. What if every business had to allocate its expenses against only its own income. Would you object to that? If a trucking firm buys a baseball franchise, it couldn't allocate the baseball losses against the trucking income and the same would be true for the guy who owns a gas station and a laundry business. He couldn't allocate the laundry losses against the gas station.

If we did it for everybody, everybody would be limited.

What would you think of that?

Mr. JONES. It seems to be much easier to state than to implement. When an existing company goes into a new line of business, when is it presumable that it would be subject to the new rule? When it goes into a new city to conduct business it has been conducting in another city? The ramifications are not at all easy to simplify. I guess our answer is that if you work that out and thought that was a good tax law and did that for every business, certainly professional sports would not be entitled to more privileged treatment than other businesses are getting.

Senator HATHAWAY. Wouldn't that be a better tax system, doing it that way? Because the effect of what you are doing now, you are forcing other taxpayers to pay—you name the loophole—for the deductions of somebody else. You are saying to the American public that whether they like it or not, their money is going to be spent for subsidizing baseball, movies, or whatever it might be.

If I make charitable deductions to the X, Y, Z, charity and I'm in the 50-percent bracket, that means that the Federal Government is picking up 50 percent of that tab, which means that the American taxpayer is paying 50 percent of my contribution to the X, Y, Z, charity. Even if other taxpayers voted on it, they might not make the contribution.

Mr. JONES. Charities are quite a different thing. There is a presumption that most businesses in this world exist to make money. They do not go on for a long time losing money, and they do not intentionally do this. In any business there is a start-up cost. As you move into a new business, you are not apt to make money. Although business looks for new ways to make money it is proper to offset that against other income as long as it is under regular business motivations.

Our testimony here today has been trying to persuade this committee that investment in sports are motivated, as are other business investments, to make money. They will make money, and there is no reason for giving them the kind of treatment that you might give to a charitable deduction, for example.

Senator HATHAWAY. My point is, we are, in effect, spending taxpayers' money without their really having a vote on whether or not they would spend that money in the various businesses.

Mr. JONES. You are doing that in every deductible expense.

Senator HATHAWAY. But if you had a direct appropriation for it, that is a little bit different situation.

If we are going to give baseball industry $5 million a year, do you think such an appropriation would pass?

Mr. JONES. But if a business here in town puts on an extra janitor to make its business clean and charges that as an expense, I do not think anybody really believes that that is an appropriation. It is a business decision to incur this expense.

In my experience of sport owners, they do not like to spend money any more than anybody else. The fact that it is a deductible dollar makes it more palatable, but it is still their dollar being spent.

Senator HATHAWAY. Mr. Chairman, if I could have 30 seconds more.

The CHAIRMAN. Agreed.

Senator HATHAWAY. A man in the trucking business who decides to buy a baseball franchise and deducts from his trucking income for losses incurred in his baseball franchise, he pays less income tax to the Federal Government, which means that somebody else picks up the tab for what he did not pay. And one who picks up the tab for what the trucking company did not pay, is the other taxpayer, who is subsidizing the baseball franchise. If you put that subsidy in on the floor for a direct appropriation for that amount of money the taxpayer has to make up for by the trucking company not paying as much taxes as it otherwise would, that subsidy would probably fail.

We do it in an indirect way, and the general taxpayer does not realize what is happening. My point is that we ought to eliminate all of them, not just yours.

Mr. SWADOS. You mean to not let the business that loses deduct that loss from any other business. If that is what the rule was, all we are saying, let us be included in the same rule. I am saying that we could not make an argument here today.

Mr. JONES. For it is also true——

Senator BENTSEN. Even if they hire a new janitor, it becomes a business judgment.

Mr. JONES. We also have a carryover provision that would be deductible against its own income instead of the trucking income, so we do have to take into consideration the carryover business.

The CHAIRMAN. Mr. Kuhn, my Uncle Earl used to like to refer to the bug under the chip; what the thing was really about. I want to see what your reaction is to this: I have heard a rumor that the whole purpose of all this, some of which makes for ridiculous tax law, is to cause you people to put a baseball team back here in Washington, D.C. Have you heard that? Has that thought ever occurred to you?

Mr. KUHN. I have heard the rumor, and the thought has occurred to me.

The CHAIRMAN. All I can say is, it is one hell of a way to write a tax law.

Senator CURTIS. I do not believe that. I believe that the sports lovers are high-class citizens, and it is impossible for something like this to come out of their minds and hearts.

The CHAIRMAN. Thank you very much, gentlemen.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 661.]

BASEBALL'S OPPOSITION TO PROVISIONS OF H.R. 10612 AFFECTING PROFESSIONAL SPORTS

SUMMARY

Baseball strongly opposes the provisions of H.R. 10612 affecting professional sports. (Sections 101(a), 209(b), 209(c), and 301(a) and (c)). These provisions are unjustified because Baseball is not a "tax shelter." In Baseball, the cost of player contracts is capitalized and depreciation is taken on a straight-line basis. These deductions, firmly engrained in the tax laws, are available to all taxpayers in all businesses. Baseball depreciation is not inflated; players' contracts are of substantial value to the clubs.

The proposed measures are not justified by tax policy, nor are they appropriate to the economics of Baseball. Moreover, legislation is unnecessary. Any problems that may arise in the transfer of a baseball club can be readily handled by the IRS and the courts. Secretary Simon has testified to the Finance Committee in opposition; sports presents no "abuse" warranting singularly unfavorable legislation.

These measures can damage Baseball without commensurate gain. They should be stricken from the bill.

STATEMENT OF BOWIE K. KUHN, COMMISSIONER OF BASEBALL

I appear here today to state our opposition to certain provisions of H.R. 10612 affecting Baseball, all of which are based on the false premise that Baseball is a tax shelter. Baseball strongly objects to those measures which would subject sports to LAL and to the minimum tax (Sections 101(a) and 301(a) and (c)); which would impose a unique and adverse depreciation recapture rule (Section 209(b)); and which would establish the presumption that no

more than 50 percent of the purchase price for a team can be allocated to player contracts (Section 209(c)).[1]

As we detail in the attached memorandum, which we ask be included in the record, these provisions are unnecessary, unfair, and would be most damaging to Baseball. Significantly, the Administration squarely opposes them. As the Secretary of the Treasury testified:

"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 which may be 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."

1. *Baseball is not a "tax shelter".*—In the first place, Baseball possesses none of the attributes of a tax shelter which would justify the imposition of the harsh provisions which we and the Secretary oppose. A tax shelter is, in general, a marketed promotion, in which individuals invest for the principal purpose of saving taxes on income from other sources. As passive investors, they withdraw from a venture once all tax benefits have been obtained.

Investment in a baseball club is wholly different in character. Baseball owners do not hold teams for tax reasons; rather they seek an economic return on their investment and the enjoyment and excitement that accompany active involvement in the sport. A Baseball owner's participation is active and long-standing. Our average Baseball owner has held his club for about 18 years, and some for a great deal longer. For example, Phil Wrigley has owned the Chicago Cubs for 44 years and Tom Yawkey has owned the Boston Red Sox for 42 years.

In addition, the purchase and operation of a Baseball club are based on ordinary business practices, not tax manipulation. Purchases are financed by hard cash rather than leveraged by non-recourse loans. Prior to approving the purchase of a team, a prospective buyer's proposed capitalization is examined and a substantial equity investment is required in order to insure proper operation of the club. In recent Baseball transfers equity financing has constituted about 70 percent of the purchase price.

Similarly, purchasers do not select a form of ownership solely for tax reasons. Fourteen of the 24 teams do business as ordinary corporations. Corporate ownership and operation are inconsistent with a team's being held as a tax shelter, since losses do not flow through to individuals and therefore are not available to shelter high-bracket income from other sources.

2. *Players' contracts have substantial value.*—Some have suggested that purchasers of sports teams, in order to inflate amortization deductions, arbi-

[1] Although we feel that no legislation is required, Baseball is less troubled by two additional provisions affecting sports which were proposed by Chairman Ullman, one codifying the present IRS practice which subjects player contracts to the ordinary rules of depreciation recapture (Section 209(a)), and the second requiring the buyer and seller of a sports team to specify the portion of the price to be allocated to player contracts in a manner binding on both parties (Section 209(c)).

trarily over-allocate the value of player contracts, and under-allocate the non-depreciable franchise. In Baseball, this clearly is not the case. In the first place, allocations to contracts are not arbitrary. The normal procedure is that, shortly after a team is purchased, the club's executive personnel, often with outside consulting advice, value each of the purchased contracts separately for depreciation purposes. The value assigned to each is the price that they believe would be paid for the exclusive contract right to that player's services, assuming that such a right were available on the market.

Second, these values are not inflated. In Baseball, historically the rights to players' services are seldom sold, but the current collective bargaining procedure will likely lead to greater bargaining for contracts in the market. One example of the value of a contract is reflected in the bidding which took place over the right to the services of Jim "Catfish" Hunter and the extraordinarily high consideration paid by the New York Yankees to acquire rights to his services.

Also, a purchaser acquires proven Major League players, which cost the previous owner substantial amounts to acquire and train. Unlike other sports, Baseball owners make substantial expenditures—over $160 million in the years 1969 through 1973—to train players in the Minor League system. We estimate that it costs $500,000 to bring a player up to a Major League team.

Finally, in Baseball the quality and abilities of the players generally determine a club's profit or loss. Therefore, it is appropriate to value the player roster highly in a franchise transfer. Eighty-four percent of a club's revenue is derived from gate receipts, from concessions, parking, and advertising, and from radio and television contracts with local stations, with additional revenue realized from participation in the League Championship Series and the World Series. All of these receipts depend on player quality. In Baseball, more people come to see the better teams. Similarly, since greater community interest is generated when the team is a contender, the better teams will tend to realize more from the sale of the rights to broadcast and televise their games locally. locally.

3. *No legislation is necessary; administrative review by IRS is adequate.*—Of course, a purchaser's allocation of price to player contracts must be fully justified by the facts. The IRS necessarily reviews Baseball club transfers; it has accepted allocations which it found warranted and set aside those of which it did not approve. The burden of proving a reasonable allocation is on the taxpayer. Should the IRS and the taxpayer disagree, the matter will be decided by the courts, as the Atlanta Falcons case demonstrates.

Accordingly, as the Secretary of the Treasury. has noted, legislation on allocations is unnecessary and inappropriate; disputes "can be dealt with adequately by the Internal Revenue Service" and the courts.

4. *The proposed measures can be damaging to Baseball.*—The proposed measures may be potentially harmful to Baseball. First, they will tend to make the sale of exsting teams more difficult. At present some Baseball clubs operate at a loss and new owners or additional investors may be required. If a distressed owner cannot find a buyer because of unwarranted tax provisions, there will be unnecessary pressure to move the franchise to a new city, hoping to find a buyer there.

Second, the proposed measures may inhibit the establishment of expansion clubs, a matter which has been under consideration in Baseball. Expansion teams generally operate at a loss in their early years. We are concerned that potential investors in an expansion franchise would be discouraged if the losses that will almost inevitably ensue are disallowed as a deduction for tax purposes.

The proposed provisions can thus make desirable expansion difficult. They can also cause the shifting of existing franchises, damaging all who participate in the present system. These include the cities in which teams are located, the Minor leagues and their cities, television, radio, and, most of all, the millions of Baseball fans who enjoy the wholesome entertainment that Baseball provides.

The benefits of the proposed provisions on federal revenue would be minimal; they are estimated to generate only 7 million in the first year from all sports—less than one percent of the tax revenue to be raised by the reform provisions of the House Bill. In contrast, the detriment resulting from these

inappropriate and unnecessary measures to Baseball and those who enjoy it would be very considerablly greater.

In conclusion, we ask that this Committee exercise its taxing power carefully and fairly. On behalf of Baseball, we request that the provisions of H.R. 10612 adversely affecting sports be stricken from the bill.

ADDENDUM

MEMORANDUM OF BASEBALL IN OPPOSITION TO PROVISIONS OF H.R. 10612 AFFECTING PROFESSIONAL SPORTS

INTRODUCTION

The tax bill (H.R. 10612) which was recently passed by the House of Representatives includes six provisions affecting the owners of sports teams. All of these provisions appear to be based upon the premise that the ownership of a professional sports team is a "tax shelter". Two of the provisions were proposed by Chairman Ullman, one codifying the present IRS practice which subject player contracts to the ordinary rules of depreciation recapture,[1] and the second requiring the buyer and seller of a sports team to specify the portion of the price to be allocated to player contracts in a manner binding on both parties.[2] Four other, more damaging provisions (i) establish a presumption that a purchaser can allocate no more than 50 percent of his purchase price to player contracts;[3] (ii) require recapture of depreciation taken on all player contracts after December 31, 1975 and all losses incurred on the disposition of player contracts after this date;[4] (iii) prohibit a purchaser from applying against other income losses attributable to depreciation deductions taken on the purchased player contracts (LAL);[5] and (iv) subject to the 14 percent minimum tax depreciation deductions taken on purchased player contracts which are not disallowed under LAL.[6]

Baseball feels that there is no need for any legislation whatever in this area, but it is most strongly opposed to the latter four provisions of this bill which were added in Executive Session or on the floor. These measures are particularly discriminatory and unjustified by the economic realities of Baseball. Baseball is not a "tax shelter" in any sense of that term; owners enjoy no special tax benefits which would warrant their being singled out for this unfavorable and inappropriate legislation. The Secretary of the Treasury has opposed these proposals; he testified that these measures are unnecessary since the IRS and the courts have complete power to resolve any differences and restrict any debatable practices that may arise in the transfer of a sports team.

I. BASEBALL IS NOT A "TAX SHELTER"; THIS CHARACTERIZATION IS BASED ON A SERIOUS MISUNDERSTANDING OF THE NATURE OF BASEBALL OPERATIONS AND DISREGARDS THE BASIC ROLE OF AMORTIZATION DEDUCTIONS IN THE TAX LAW.

A. Overview

The sports provisions were included in the bill as part of the Ways and Means Committee's attempt to curb "tax shelters". Well-recognized "tax shelters" have included real estate ventures, farm operations, film productions, equipment leasing, and oil and gas ventures. Apparently, the Committee equated them with a Baseball owner's amortization of purchased player contracts and the possible sale of player contracts at capital gains rates.[7] However, the view

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[1] H.R. 10612, 94th Con., 1st Sess., § 209(a) (1975) (hereinafter H.R. 10612), amending Int. Rev. Code of 1954 (hereinafter "Code") §§ 1245(a)(2) and 1245(a)(3).
[2] H.R. 10612, § 209(c), adding Code §§ 1056(a), (b) and (c).
[3] H.R. 10612, § 209(c), adding Code § 1056(d).
[4] H.R. 10612, § 209(b), adding Code § 1245(a)(4).
[5] H.R. 10612, § 101(a), adding Code §§ 466, 467(a)(6), 468(f). More precisely, a deduction subject to LAL disallowance consists of amortization of the excess of the amount allocated to player contracts over the sum of the aggregate adjusted bases of player contracts in the hands of the seller immediately before the sale, plus the ordinary income, if any, recognized by the seller on the sale.
[6] H.R. 10612, §§ 301(a) and (c), adding Code §§ 55, 57(a)(15).
[7] *See* Staff of Joint Comm. on Int. Rev. Taxation, 94th Cong., 1st Sess., tax Shelters: Professional Sports Franchises 1–2, 5–8 (Comm. Print 1975) (hereinafter "Sports Franchises").

of a baseball club as a "tax shelter" is founded on a complete misconception, which ignores the realities of Baseball operations and the role of amortization or depreciation deductions in the tax law. Briefly to summarize, the facts with respect to Baseball are as follows:

1. Persons invest in, and retain ownership of, Baseball clubs with a view to economic profit and also for love of the sport. The average length of ownership today is eighteen years.
2. Baseball enjoys no special statutory or regulations tax advantages, such as deductions for accelerated depreciation, prepayment of expenses (e.g., construction loan interest and points), or intangible drilling expenses which are characteristic of a "tax shelter".
3. Player contracts are the most valuable assets owned by any club; the costs of acquiring or developing a player roster are real and substantial.
4. The amortization of the cost of player contracts is consistent with general tax principles applicable to any business. Such amortization has long been recognized as appropriatt by the Internal Revenue Service and by the courts, both in the sports area and in analogous contexts.

B. Baseball Possesses None of the Attributes of a "Tax Shelter"

As defined by the Staff of the Joint Committee on Internal Revenue Taxation, "tax shelters" share certain characteristics. They are, in general, investments in which losses flow from special deductions allowed specifically by statute or by regulations—losses taken before realization of matching income. Such investments are held in forms (limited partnerships or Subchapter S corporations) that permit the losses to pass through to individuals to be used to offset income from other sources. The investments are generally financed through non-recourse loans, which allow the investor to amplify deductions of interest, depreciation, and other expenditures. Finally, the investors' primary concern is a tax benefit rather than economic gain from the activity.[8]

An examination of these elements will show that they are not applicable to Baseball.

1. Alleged Creation of Artificial Losses

(a) *In fact, depreciation is taken on a straight-line basis; deductions are matched with related income.*—The labeling of Baseball as a "tax shelter" assumes that amortization of player contracts generates an artificial loss.[9] Yet, in contrast to the other investments subject to H.R. 10612, contract costs in Baseball are capitalized and depreciation is taken on a straight-line, rather than on an accelerated, basis.[10] Further, in contrast to "shelter" investments, these Baseball deductions are not taken in years before the related income is earned.[11] The income derived from player contracts is earned immediately and

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[8] *See* Staff of Joint Comm. on Int. Rev. Taxation, 94th Cong., 1st Sess., Overview of Tax Shelters 1–7 (Comm. Print 1975) (hereinafter "Overview").

[9] Sports Franchises at 1–7, 5–8. As to subsequent gain on the sale of contracts, to the extent that the portion of gain which reflects a recoupment of depreciation is subject to ordinary "recapture" rules, there is no problem. Any gain beyond the recaptured amount is legitimately entitled to capital gain treatment, as in the case of the sale of contract rights or of any other asset of a trade, business or investment.

[10] In the case of real estate, a buyer-owner is permitted accelerated depreciation without regard to the actual decline in the value of the assets during the depreciation period. See I.R.C. §§ 167(b), (c). In the case of farm operations, the owner is entitled to a current deduction for the costs of developing farm properties and animals, thus putting his inventory costs on a prepaid cash basis. Sec.-Treas. Regs. §§ 1.61–4, 1.162–12. In addition, farm investors are permitted accelerated depreceation of the purchase price of animals and farm buildings. In the case of oil ventures, the owner may current deduct intangible drilling expenses at the outset. *See* I.R.C. § 263(c). In the case of equipment leasing the owner is permitted accelerated depreceation as in the case of real estate. In addition, under the ADR rules, the owner may claim a very short life for the leased assets. Under Section 179 of the Code, the owner is permitted accelerated first year depreciation, and under special provisions (*see* I.R.C. § 169) is permitted rapid amortization of certain types of equipment (for example, pollution control equipment). In the case of movie films, financing through non-recourse loans is common. The depreciable asset acquired thereby at a high price may then be amortized on an accelerated basis. Cf. Joint Comm. on Int. Rev. Taxation, 94th Cong., 1st Sess., Tax Shelters: Movie Films 2–3 (Comm. Print 1975), which shows 75 percent of the basis of a film being amortized in the first year.

[11] In real estate, deductions for interest and taxes are taken during the construction period before any income is generated from the property. In farm operations, deductions are taken for feed and other expenses before realization of matching income. In oil ventures, current deduction for intangible drilling costs is permitted, although income from the well, if any, is realized over several subsequent years. In film productions the current deduction of production expenses is permitted although income from the film is generated over several years thereafter. *See* H.R. Rep. No. 94–658, 94th Cong., 1st Sess. 28–29 (1975).

for each year over the players' professional lives. Accordingly, in distinction to losses in "shelter" investments which are generated by "accelerated" deductions, in Baseball, any losses which may be generated by depreciation deductions are by no means "artificial".

(b) *Player contracts have substantial value; allocations to contracts are not arbitrary or inflated.*—It has also been suggested that artificial losses are created by allocating more of the purchase price for a club to player contracts than is warranted. This would have the effect of overstating the depreciable assets, player contracts, and understating the non-depreciable assets, the franchise itself.

In Baseball, player contracts are quite valuable and their worth is not overstated. Contrary to uninformed belief, when a team is purchased the buyer does not allocate an arbitrary sum to the aggregate players' contracts that he buys. As a matter of normal practice, the team's executive officials, often with expert advice, value each contract separately. The amount assigned to each is the price that they believe would be paid for the exclusive right to that player's services, assuming that such a right were available on the market. Although such rights are seldom sold, the price can be very high in an arm's length negotiation.[12]

In overall terms, when a purchaser buys a player roster he is buying proven Major League Baseball players. The previous owner has spent a substantial amount of money to acquire, train, and develop this roster. It is estimated that an average of $10,000 is paid as a signing bonus to each player drafted by a Major League club. Since on the average, only one in every ten players signed up makes the Major Leagues, the signing bonus invested in each Major League player is $100,000, or $4 million per 40-player roster. In addition, the teams spend a substantial amount of money in the form of scouting expenses and on the maintenance and operation of minor league affiliates. In the years 1969–73, these expenses amounted to $162 million for all Major League clubs, or 23 percent of their total expenses. Economic research has indicated that it costs $500,000 to bring a player up to a Major League team.

Most importantly, in Baseball the quality and abilities of the players directly determines a club's profit or loss. Eighty-four percent of an average team's revenue is derived from gate receipts (59 percent), radio and television contracts with local stations (14 percent), and concessions, parking, and advertising (11 percent),[13] all of which depend largely on player quality. It is noteworthy that the amortization of player contracts accounts for only 6.7 percent of average expenses of a Baseball team. See Table II in Appendix A.

One example plainly demonstrates that in Baseball more people come to see better teams. In 1966, when the Boston Red Sox finished next to last, the team drew 811,172 fans. The following season, when the Red Sox won the American League championship, the team drew 1,727,832 fans, an increase in attendance of more than 100 percent.

Aside from affecting gate receipts, attendance also affects concession and similar revenues. Baseball's experience has been that these revenues vary almost proportionately with attendance.[14]

Teams with better players also generally command more revenue from local radio and television contracts. For example, the Pittsburgh Pirates sold broadcast rights for the 1974 season for $1.2 million, while Cleveland, a team representing a city of approximately the same size, sold its 1974 rights for $800,000, or two-thirds of what the Pirates received.[15] The Pirates had won their divi-

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[12] For example, at the end of the 1974 season, the famous pitcher, Jim ("Catfish") Hunter was declared a "free agent". As a result, he had the right to negotiate his own contract which he sold to the highest bidder, the New York Yankees. The Yankees undertook to pay Hunter a bonus, a salary for his services for five years, and certain deferred payments extended over a substantial period thereafter. The total package came to approximately $3 million. Since Hunter's salary amounted to $150,000 yearly, the straight compensation portion of this package was $750,000, the other $2.25 million was the cost to the Yankees of acquiring the exclusive right to Hunter's services. Because this amount was to be paid over a number of years, the contract cost, discounted to present values, was approximately $1.75 million.

[13] See Table II in Appendix A.

[14] For example, in 1972, gate receipts for the Baseball industry were $80.8 million, and the net revenue from advertising, concessions, and parking was $15.4 million. In 1973, gate receipts increased to 90.5 million and advertising, concessions and parking revenues increased to $18.5 million. See Table II in Appendix A.

[15] These figures are taken from a schedule compiled by Broadcast Magazine, March 3, 1975, pp. 38–39.

sion's championship in three of the four years prior to the 1974 season, winning the World Series in 1971. Cleveland, in these years, finished last twice and next to last twice.

Finally, since participation in the League Championship Series and in the World Series brings a team substantial additional revenue, players can contribute even more directly to the club's profits. For example, in every year for the five-year period between 1970 and 1974, the Baltimore Orioles had an operating loss prior to, but had net profits after, the inclusion of income from post-season competition. Thus, all of the Orioles' profits in these years flowed directly from the quality of its players.

Since the purchase price of a team is based on an expectation of net earnings, and since, in Baseball, earnings depend primarily on the quality of the players, there is nothing unrealistic in allocating a very large part of the purchase price of a team to player contracts.

(c) *Theory of depreciation.*—The notion that the straight-line amortization of the cost of a player's contract over his useful life creates an 'artificial" loss disregards the basic role of amortization or depreciation deductions in Federal income taxation. In determining income subject to tax, a taxpayer is permitted to deduct the costs of producing his income. However, when an asset is purchased that will generate income over a number of years, the taxpayer recovers its cost through amortization or depreciation deductions as that asset is used up in the operations, representing dollars spent years earlier for which no immediate deduction was available.

Thus, the depreciation of purchased Baseball player contracts represents nothing more than the buyer's recovering the dollars he paid for these contracts as their value is exhausted. Any losses flowing from such depreciation are real economic losses, not the artificial benefits of which "tax shelters" are made.

Significantly, the IRS has long recognized the propriety of capitalizing and depreciating player contracts in professional sports. *See* Rev. Rul. 54–441, 1954–2 Cum. Bull. 101; Rev. Rul. 67–379, 1967–2 Cum. Bull. 127; Rev. Rul. 71–137, 1971–1 Cum. Bull. 104. This principle has been recently reaffirmed in the courts. See *Laird* v. *United States*, 391 F. Supp. 656 (N.D. Ga. 1975), appeal pending, involving the contract allocation of the Atlanta Falcons.

2. Use of Special Statutory or Regulations Provisions

In each of the "tax shelters", losses are generated by special deductions, allowed specifically to such activity by statute or regulations and not generally available to all taxpayers in all businesses.[16] In contrast, as described above, the capitalization and depreciation of the cost of player contracts are founded on the general principles of the tax laws, with no special benefits being made available to sports. As Secretary Simon has testified to the Finance Committee:

"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 which may be amortized or depreciated. These abuses can be dealt with adequately by the Internal Revenue Service."

Thus, the tax consequences for the buyer of a baseball team are applicable to any taxpayer upon the purchase of any business. The buyer of any business must allocate his purchase price to the various assets purchased in proportion to their respective fair market values. Upon the purchase of any business, some of the assets acquired may consist of supply contracts, personal service contracts, or customer contracts, and the buyer may properly allocate some part of his purchase price to such contracts and amortize the allocable cost over their useful lives. See *KFOX, Inc.* v. *United States*, 510 F.2d 1365 (Ct. Cl. 1975) (recognizing the right to allocate and amortize a substantial part of the purchase price of a radio station to contracts for the services of four disc jockeys and the station manager).

3. Form of Investment

Unless the investment is held in a form that allows the losses to flow to an individual so as to offset his income from other sources, it will provide little "shelter". Baseball lacks this characteristic of a "tax shelter" as well. Of the

[16] *See* n. 8 on p. 4, *supra*.

23 Major League teams subject to the United States tax laws (excluding Montreal), only four are operated as limited partnerships, four as Subchapter S corporations, and one as a sole proprietorship. Four clubs do business as ordinary corporations.[17]

4. Use of Non-Recourse Loans

In several tax shelters the purchase is highly leveraged through the use of non-recourse loans, which allow the investor to minimize his risk and amplify deductions of interest, depreciation and other expenditures. In Baseball, by way of contrast, purchasers pay hard cash for their teams. In the last six years, seven teams have been sold.[18] The average purchase price was $10 million, of which about $7 million was paid in cash and $3 million took the form of debt (including the assumption of liabilities). Thus, instead of debt exceeding equity financing by ratio of nine to one as in real estate shelters,[19] in the purchase of Baseball teams equity exceeds debt by a ratio of almost two and one-half to one.

5. Motivation for Investment—Length of Ownership

Since people invest in "shelters" primarily for tax savings, they generally withdraw once all benefits have been obtained. A taxpayer using his investment as a "shelter" has no interest in being a farmer or a movie producer. If the ownership of a Baseball team were undertaken for tax purposes only, the average length of ownership would presumably be equivalent to the depreciation period for purchased contracts (from four to six years). At that point, the owner would have derived his maximum tax benefits and have the opportunity to sell at a gain.

In Baseball, the average franchise owner holds his team for well beyond the depreciation period, since he is not a passive investor interested only in deductions. Baseball owners operate clubs as a major source of income or as a secondary business venture, and also for love of the sport. The average Baseball owner has held his club for about eighteen years.[20] The average realistically is much higher, taking into account the fact that four of the 24 teams were created only seven years ago, two others 14 years ago, and two others 15 years ago.

6. Particular Examples

In Appendix B, two specific Baseball transactions, Bob Short's purchase, operation, and sale of the Washington-Texas club (a transaction widely, and erroneously, thought to reflect some kind of tax "abuse"), and Bill Veeck's purchase of the Chicago White Sox (a recent transfer of a Major League club), are summarized. These transactions support the view that Baseball is not a "tax shelter".

II. THE HOUSE PROVISIONS ADOPTED TO CURB THE ALLEGED ABUSE WERE INADEQUATELY CONSIDERED AND ARE DISCRIMINATORY, UNJUSTIFIED AND INAPPROPRIATE TO THE ECONOMIC REALITIES OF BASEBALL

Although Baseball does not present a tax "abuse" warranting remedial legislation, the measures adopted by the House single out sports for unique tax treatment which is neither justified as a matter of tax policy nor appropriate to the economic realities of Baseball.

1. Presumption That Value of Players Does Not Exceed 50 Percent of Purchase Price

Prior to the Committee's consideration of a fixed percentage presumption for player contract depreciation, it had given no notice that it would take up any such proposal. Rather, the advance Committee documents indicated that only Chairman Ullman's two, relatively non-controversial, proposals (described on page one) would be considered.[21]

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[17] See Table I in Appendix A.

[18] Seattle in 1970, Cleveland in 1972, New York Yankees in 1973, San Diego and Texas in 1974, and Chicago and Atlanta in 1975. Figures on the Atlanta sale are not yet available. See *generally* Table IV in Appendix A.

[19] See Joint Comm. on Int. Rev. Taxation, 94th Cong., 1st Sess., Tax Shelters: Real Estate 2 (Comm. Print 1975).

[20] See Table I in Appendix A.

[21] See Joint Comm. on Int. Rev. Taxation, 94th Cong., 1st Sess., Committee Member Selection of Proposals for Consideration in First Phase of Tax Reform 8 (Comm. Print 1975) (hereinafter "Proposals").

In addition, no economic data were presented in any hearings to support the presumption that the value of players is no more than 50 percent of the purchase price for a club—and that the fixed presumption is fair for all sports. In fact, the presumption bears no relation to the economic realities of Baseball where the value of player contracts has consistently run above 50 percent and often run above 80 percent.

The purchase price of a baseball team is based upon its projected net earnings. As set forth above, a team's earnings in terms of gate receipts, local television and radio revenues, concession income, and postseason revenues depend directly on the quality of the players. In addition, the purchaser acquires a proven Major League roster for which his predecessor had incurred very substantial costs. Thus, if any presumption is economically justified in Baseball, it would appear to be the opposite one—that upon the purchase of a team the value of the players is greater than 50 percent of the purchase price. Indeed, in previous Baseball transfers the IRS after full investigation agreed that the facts warranted allocations to player contracts in excess of 50 percent.[22]

Actually, no statutory presumption whatsoever is appropriate or necessary. The quality of baseball players varies, of course, from team to team and from time to time with any one team. Similarly, the value of a franchise varies from city to city and from time to time. Moreover, there are intrinsic differences between sports that affect the value of the players in relation to the value of the franchise.[23] Therefore, the establishment of a mechanical presumption, whichever way it goes, applicable to any purchase at any time in any sport, is arbitrary and unwarranted.

As far as we know, Congress has never before legislated a limitation on the market value of an asset; no reason is apparent why a statutory limitation is now necessary for sports teams. The IRS currently audits every transfer of a sports team, requiring the parties to justify the allocations to player contracts. When the IRS and club owners do not agree on such allocations, the dispute will be decided by the courts, as the Atlanta Falcons case demonstrates.[24] The present process of administrative review and judicial determination is not particularly burdensome to the IRS or to the courts. In Baseball, there have been only a dozen sales in the past decade.[25]

Sports owners are proposed to be made the subject of special legislation with no showing of a need therefor. The presumption should be eliminated.

2. Depreciation Recapture

H.R. 10612 has two recapture provisions applicable to sports. The first expressly applies Code Section 1245 to player contracts (Section 209(a)). The second requires that, on the sale of a player contract or of the player roster, gain must be recaptured as ordinary income, not only to the extent of the depreciation reflected in the basis of the contract or contracts sold, but also to the extent of the depreciation taken on all contracts after December 31, 1975, plus all losess incurred after this date on the disposition of all contracts, less any ordinary income previously recaptured (Section 209(b)).

The first depreciation recapture provision merely codifies existing IRS practice. It was subject to hearings. There is relatively little controversy over this provision.

In contrast, the second provision was suddenly and unexpectedly considered and approved, without any hearings. The advance Ways and Means Committee

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[22] The IRS has set aside Baseball contract allocations of 98.5 percent and 98.4 percent, settling with the taxpayers on allocations of 91.4 percent and 79.4 percent expectancy. The IRS has also reviewed allocations in all recent Baseball transfers, but has withheld action pending outcome of the Atlanta Falcons case.

[23] For example, in Football, all owners share equally in a large national television contract which accounts for about 34 percent of a team's revenues. In addition, in Football, gate receipts (which account for about 55 percent of a team's revenues) only vary on the average about 6.5 percent from team to team regardless of quality. In fact, one of the expansion teams has sold 59,000 season tickets for revenues of $2.95 million, even though it has few players under contract. See *Washington Post*, February 22, 1973, C6, Col. 3. Also, Football owners do not have the same costs for players as do Baseball owners; players are trained without cost in the college ranks. In contract Baseball spent over $160 million in player development costs over the five year period from 1969 through 1973. Thus, in the sale of a football team, the portion of the total price attributable to the franchise is apparently far greater than in the case of Baseball. For a comparison of Football and Baseball revenues, *see* Table III in Appendix A.

[24] *Laird v. United States*, 391 F. Supp. 656 (N.D. Ga. 1975). In this case, the taxpayer allocated $7.7 million to his $8.5 million purchase price to player contracts (90.5 percent). On audit the IRS reduced the allocation to $1.05 million (12.3 percent). The court fixed the allocation at $3,035 million (35.6 percent).

[25] See Table IV in Appendix A.

documents expressly stated that the depreciation recapture proposal to be considered was the provision of the tax legislation which the Committee considered in 1974,[26] which codified IRS practice by expressly bringing player contracts within the operation of Section 1245.[27] Similarly, when the Committee accepted depreciation recapture in principle on September 17, 1975, at no time in its deliberations did it indicate that it was adopting or even considering going beyond codification of current administrative practice. In fact, the Committee's release plainly stated that it had only clarified present law.[28] It was not until the first copy of the House Bill was made public on October 20, 1975 that sports was informed of Section 209(b) which had a far wider scope than Section 1245.

In fact, Section 209(b) not only goes well beyond present law, but imposes on sports owners unfavorable and discriminatory tax treatment which has no basis in principle, policy or practice. Under present law, gain realized on the sale of players' contracts is taxed as ordinary income to the extent of the depreciation taken and reflected in the basis of the contract or contracts sold. Recapture of depreciation taken on other contracts,[29] or of losses incurred on the disposition of other contracts, is not required.

Nor is such treatment required in any other business context. The seller of any other asset need recapture only the depreciation reflected in the reduction of basis of the sset which is sold. In no other case is a seller required to recapture depreciation or loss deductions attributable to other assets which are *not* sold. There is no justification to apply this unique and burdensome theory to Baseball. The Secretary of the Treasury is correct in labeling this rule as "arbitrary".

3. LAL

The application of LAL to sports was also a last-minute measure, adopted by the Committee on November 4, 1975. Here, too, there was no opportunity for full consideration of the propriety of LAL treatment.

In addition, the degree of support for this measure is questionable. The Committee adopted the provision by a single vote; its principle sponsor was the major opponent of LAL treatment for any activity. In fact, press reports indicated that the proposal was made as an effort to embarrass LAL proponents by extending LAL to activities where there was no justification.[30]

Like the other proposals, the LAL provisions are discriminatorily applied to sports and unjustified as a matter of policy. As the Secretary of the Treasury has testified:

"While LAL is a sound concept, [application to sports franchises] is an unwarranted extension of the rules of the Administration proposed in 1973."

In other investments LAL is applied to accelerated deductions, taken before the realization of matching income.[31] In sports, LAL is applied to deductions for straight-line amortization which are taken in the years in which the related income is earned. In other investments, these accelerated deductions are allowed specifically by statute or regulations and are not generally available to taxpayers in all businesses. In sports, the LAL provisions would prevent owners from utilizing general tax provisions, applicable to all taxpayers, which repre-

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[26] Proposals at 8.

[27] Tax Reform Act of 1974, Section 293(a).

[28] "In the case of player contracts of sports franchises the Committee agreed to clarify present law by providing that there would be a complete recapture of all depreciation to the extent of any gain involved at the time of the sale of the player contract or of the sports enterprise." Committee on Ways and Means, Tax Reform Legislation, Tentative Decisions for Drafting Purposes Only, Release No. 5, Wednesday, September 17, 1975. (Emphasis added.)

[29] For example, no recapture is required on a contract for the services of a player who retired, since this contract would be extinct, and not the subject of sale.

[30] The November 5, 1975 edition of the Washington Post reported: "He [the sponsor] hadn't meant for the amendment to pass, he said a little sheepishly afterward. He had just been trying to show that 'some people change their feet when they change their shoes.' "

[31] In real estate, LAL applies to accelerated depreciation (Code § 468(a)(2)) and construction period interest and taxes (§ 468(a)(1)), taken in years before any matching income is realized. In equipment leasing, LAL applies to accelerated depreciation, including the effect of the ADR rules (§ 468(b)). In farm operations, LAL applies to accelerated, depreciation of animals and trees (§ 468(c)(3)) and certain prepaid expenses (§ 468(c)(1) and (c)(2), taken before the matching income is realized. In oil and gas ventures, LAL is applied to the accelerated deduction of intangible drilling expenses, (§ 468(e). In film productions, LAL is applied to deductions for depreciation and production expenses (§ 468(d)) as such deductions are accelerated. See H.R. Rep. No. 94-658, 94th Cong., 1st Sess., 61-69 (1975).

sent nothing more than the recovery of the cost of an income-producing asset over its useful life. Other taxpayers are permitted this deduction in full; only for sports owners would it be conditioned on the extent of the income from the activity.

Furthermore, LAL is meaningful only for teams that lose money. Profitable teams will be allowed their depreciation deductions in full. It seems arbitrary and unfair to subject owners suffering losses to this tax disadvantage.[82]

Furthermore, LAL as applied to sports would produce little revenue. The Ways and Means Committee has estimated that in 1976 LAL as applied to oil and gas property would raise 207 times as much tax revenue as sports franchises, farm property 100 times as much, and real property 84 times a much.[83]

4. Minimum Tax

This provision is also discriminatory and inappropriate. The bill as reported did not extend the minimum tax to sports; the provision was part of a floor amendment which generally broadened the application of the minimum tax. The sponsor of the amendment conceded in House debate that the sports portion received little consideration in Committee.[84] In addition, the sports provision was not voted on separately. In fact, criticism of the inclusion of player contracts under this amendment was voiced during the debate by Representatives who supported the amendment generally.[85]

This amendment is also discriminatory in its application. The sports deductions made subject to the minimum tax are those amortization deductions taken on purchased player contracts which are not disallowed under LAL. First, it should be noted that in no other case is straight-line depreciation made a tax preference item. Moreover, the deductions on which this tax is levied are available to all taxpayers in all other businesses. Therefore, not only is the sports owner put in the singular position of having his depreciation deductions contingent on income from the activity (LAL), but he alone is subject to a 14 percent tax on such deductions when they are allowed.

By subjecting these deductions to LAL and to the minimum tax, sports owners would, to a large extent, be denied the opportunity to recover the cost of their income-producing assets. No reason has been advanced why sports owners should be singled out for this treatment.

III. THE LEGISLATION IS UNNECESSARY; DISPUTES MAY BE READILY RESOLVED BY THE IRS AND THE COURTS

The root of the alleged problem in the sports area is the view that a purchaser allocates more to contracts than their value warrants.[86] All of the aforementioned provisions are merely overlapping efforts to rectify this alleged problem.[87] Yet, this issue involves nothing more than a matter of the valuation of assets in a transfer of a business. Such valuation is not unique to sports; it arises in a variety of businesses and transactions. The Service and the courts have demonstrated that they are fully capable of curbing "abuse" in the sports area or elsewhere.

A purchaser's allocation of costs to player contracts and the useful lives assigned to these contracts for depreciation purposes are subject to tests of reasonable justification, which the taxpayer must establish by a preponderance

[82] New Code Section 470(d) provides that depreciation deductions not allowed under LAL will nonetheless reduce the basis of a player's contract, thereby increasing potential gain on sale. Under the new recapture provision, in effect, all gain realized on the sale of a player's contract will be ordinary income. The House Report states that no deduction will be allowed for deferred depreciation upon the sale of an individual contract (H.R. Rep. No. 94–658, 94th Cong., 1st Sess. 83 (1975)). Thus, upon the sale of an individual contract, it appears that the owner is put in the anomalous position of having to recapture as ordinary income a deduction which was never allowed—a result which is improper on its face. At the least, deferred depreciation deductions should offset recapture in the year in which the contract is sold.

[83] H.R. Rep. No. 94–658, 94th Cong., 1st Sess. 19 1975).

[84] 121 *Cong. Rec.* H.R. 11834 (daily ed. Dec. 4, 1975) (remarks of Representative Corman.

[85] *Id.* (remarks of Representatives Sisk and Horton).

[86] See Sports Franchises 1–2, 5–8.

[87] The 50 percent presumption directly legislates the value of player contracts. Depreciation recapture penalizes a purchaser for an overallocation and serves to establish an adversity of interests when the purchaser later seeks to sell the team, so as to limit his buyer's allocation to contracts. LAL penalizes the purchaser for allocating to contracts more than his seller's original basis. The minimum tax is a further penalty on overallocation, exacted to discourage abuse.

of proof. Although it is claimed that purchasers overreach in their valuation of player contracts, it has not been suggested why the IRS and the courts cannot deal with such excesses. In truth, unlike true tax shelters, where the tax losses are based on special statutory or regulations provisions that are binding on the IRS and the courts,[38] alleged abuses in the purchase of a sports club are presently subject to effective administrative and judicial controls.

In sports, the IRS has regularly reviewed buyers' allocations to player contracts and has accepted those which it found warranted and set aside those of which it did not approve. Similarly, the courts have determined the value of contracts for personal services in the sports area[39] and in analogous non-sports situations[40] where the IRS and the taxpayer could not agree.

Moreover, the valuation of assets for tax purposes is particularly within the administrative competence of the IRS. Even if the IRS and the taxpayer cannot agree on value, the resolution of their dispute is best handled by the courts, to which all the facts are presented and the issues sharpened in an adversary proceeding. As far as we know, Congress has never before sought to legislate limitations on fair market values of the assets of a business. No reason has been advanced as to why it should do so in the sports area.

IV. THE ADMINISTRATION ALSO BELIEVES THAT THESE PROVISIONS ARE DISCRIMINATORY, UNJUSTIFIED AND UNNECESSARY

Indeed, the Administration is similarly of the view that these provisions are discriminatory and unjustified since sports owners enjoy no special tax benefits warranting singularly unfavorable treatment. Furthermore, the Administration believes, as do we, that these measures are unnecessary since the IRS and the courts can readily handle any "abuse" that may arise in the transfer of a baseball club. As the Secretary of the Treasury noted in his statement delivered to this Committee on March 17, 1976:

"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 franchise.

"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 which may be 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."

V. THESE PROVISIONS CAN HAVE A DESTRUCTIVE IMPACT ON BASEBALL

Not only are the sports provisions of H.R. 10612 discriminatory, inappropriate and unnecessary, but they could harm the sport of Baseball and all who enjoy it without commensurate revenue gain.

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[38] *See* notes on pp. 4 and 10 and accompanying text.

[39] In the Atlanta Falcons case, the court fixed the value of player contracts at $3.035 million. *Laird* v. *United States*, 391 F. Supp. 656 (N.D. Ga. 1975).

[40] See *KFOX, Inc.* v. *United States*, 510 F. 2d 1365 (Ct. Cl. 1975) In this case, the buyer of a radio station allocated $400,000 of the $878,666 purchase price to contracts for the services of four disc jockeys and the station manager. The IRS lowered the amount allocated to $109,091. The Court of Claims determined the value of the contracts to be $400.000.

The Ways and Means Committee estimates that of the more than $1 billion of tax revenues to be raised in 1976 by the reform provisions of H.R. 10612, $7 million—less than one percent—will be generated by applying the new sports provisions to all professional sports.[41] However, the immediate impact of these measures will be to deflate significantly the value of existing teams. It would seem highly unfair to exact a penalty from individual taxpayers without a showing either of abuse, or necessity, or promotion of the general good.

In addition, these measures could severely damage Baseball by making the transfer of a club more difficult and inhibiting expansion.

It is well known that in recent years, some Baseball owners have encountered substantial difficulty finding buyers despite the alleged tax benefits and advantages to purchasers. In penalizing sports club owners, as the House Bill does, the proposed measures would encourage franchise shifts. Many Baseball teams now operate at substantial loss. No owner can afford to lose money indefinitely. If a distressed owner cannot find a buyer, he may have no alternative but move the team, hoping to realize on its novelty in another setting.

The House provisions may also inhibit the establishment of new clubs, a matter currently under consideration in Baseball. Expansion teams generally operate at a loss in their early years. We are concerned that potential investors in an expansion franchise would be discouraged if the losses that will almost inevitably ensue are not allowed as a deduction for tax purposes.

Thus, these provisions are not neutral; they discourage professional sports as they now exist. They certainly will cause the shifting of franchises. The result will be to damage all those who participate in the present system. These include not only the team owners and players, but also the many others who make a living, and pay taxes, out of activities related to Baseball, *i.e.*, media, announcers, concessionnaires, etc. They also include the cities that profit from favorable stadium lease arrangements and from the increased economic activity that a team generates. Most of all, however, they include the millions of Baseball fans who enjoy the many hours of inexpensive entertainment that Baseball provides.

It must be questioned what, if anything, would be gained by removing these benefits. As noted, the impact of these measures on the Federal Treasury will be minimal.[42] We have heard no suggestion of the other benefits that will accrue to the nation from discouraging sports through special, unfavorable tax provisions.

CONCLUSION

Baseball is not a "tax shelter" in any sense. It is a sport and also a business like other businesses, presenting more risk than most. There is no reason to isolate it for specially unfavorable tax treatment.

The allocation of value to, and depreciation of, player contracts does not constitute a tax "abuse" or loophole". The treatment of player contracts does not constitute a tax "abuse" or 'loophole". The treatment of player contracts is not a case of a special tax privilege. Rather, it reflects the realities of cost and value exhausted over the terms of the contracts, i.e., useful professional lives. Furthermore, it is a recognized application of general and sound tax principles.

The provisions of H.R. 10612 discussed in this memorandum are wholly inappropriate to Baseball and are unjustified as a matter of policy. Moreover, these provisions are unnecessary. To the extent that excessive allocations and depreciation may be claimed in franchise transactions, the Internal Revenue Service and the courts have full power now to challenge them. The taxpayer may be put to his proof, with the general presumption of correctness running in favor of the Internal Revenue Service. The situation is no different than in the case of any other allocation of a purchase price to a package of assets.

The Administration shares the belief that these provisions are discriminatory, unjustified and unnecessary.

Moreover, these measures could have a destructive impact on Baseball, which could radiate beyond the immediate confines of the sport. No suggestion has been made of any commensurate benefit that would be advanced by damaging Baseball.

The Congress has a broad power to impose different tax treatment on various taxpayers. We ask that it exercise its taxing power carefully and fairly. The

[41] H.R. Rep. No. 94-658, 94th Con., 1st Sess. 19 (1975).
[42] H.R. Rep. No. 95-658, 94th Cong., 1st Sess. 19 (1975).

case for special, unfavorable treatment of Baseball has not been made and, we believe, cannot be made. We ask that the provisions of H.R. 10612 adversely and discriminatorily affecting sports be stricken from any legislation finally enacted.

Appendix

TABLE I.—LENGTH AND FORM OF OWNERSHIP OF MAJOR LEAGUE BASEBALL CLUBS, JANUARY 1, 1976

Club	Form of ownership	Date present ownership took control	Length of ownership (years)
National League:			
San Francisco Giants	Ordinary corporation	1919	57
Chicago Cubs	do	1932	44
Philadelphia Phillies	do	1943	33
Los Angeles Dodgers	do	1950	26
Pittsburgh Pirates	do	1950	26
St. Louis Cardinals	do	1953	23
New York Mets [1]	Subchapter S corporation	1962	14
Houston Astros [1]	Ordinary corporation	1965	11
Cincinnati Reds	do	1967	9
Montreal Expos [2]	Canadian partnership	1969	7
San Diego Padres [2]	Subchapter S corporation	1974	2
Atlanta Braves	Ordinary corporation	1975	1
American League:			
Minnesota Twins	do	1920	56
Boston Red Sox	Sole proprietorship	1934	42
Oakland Athletics	Ordinary corporation	1961	15
Detroit Tigers	Subchapter S corporation	1961	15
California Angels [3]	Ordinary corporation	1961	15
Baltimore Orioles	do	1965	11
Kansas City Royals [2]	Subchapter S corporation	1969	7
Milwaukee Brewers [2]	Limited partnership	1970	6
Cleveland Indians	do	1972	4
New York Yankees	do	1973	3
Texas Rangers [3]	do	1974	2
Chicago White Sox	Ordinary corporation	1975	1

[1] Expansion team created in 1962.
[2] Expansion team created in 1969.
[3] Expansion team created in 1961.

TABLE II.—COMBINED STATEMENT OF INCOME AND EXPENSES FOR MAJOR LEAGUE BASEBALL TEAMS FOR YEARS 1969-1973 INCLUSIVE (DOLLARS IN THOUSANDS)

	1969	1970	1971	1972	1973	Totals	Percentage of total
				Income			
Gate receipts	$75,346	$79,996	$83,730	$80,785	$90,492	$410,349	59.37
Local television and radio contracts	17,970	19,452	19,864	20,468	19,086	96,840	14.01
National network contracts	15,529	16,648	18,963	16,875	17,862	85,877	12.43
Concessions, parking, and advertising	14,335	15,327	15,698	15,443	18,482	79,285	11.47
Other (investments, rental of stadium for nonbaseball activities, stadium clubs and miscellaneous)	3,075	5,450	5,970	1,743	2,531	18,769	2.72
Total income	126,255	136,873	144,225	135,314	148,453	691,120	100
				Expenses			
Team operations	$33,773	$36,314	$38,393	$39,171	$43,216	$190,867	27.21
Player development (including scouting and spring training expenses)	33,154	31,568	32,315	32,729	32,569	162,335	23.14
Stadium expenses	18,824	24,472	25,504	22,616	24,841	116,257	16.57
General and administrative expenses	16,823	17,318	18,095	19,390	20,636	92,262	13.15
Game and ticket expenses, publicity, and promotion	16,002	10,557	10,903	10,886	11,248	59,596	8.50
Contract depreciation	10,677	9,117	9,494	8,070	9,568	46,926	6.69
Other expenses		10,534	9,539	7,221	5,927	33,221	4.74
Total expenses	129,253	139,880	144,243	140,083	148,005	701,464	100

TABLE III.—COMPARISON OF BASEBALL AND FOOTBALL REVENUES

[Dollars in thousands]

	Baseball [1]		Football [2]	
	Amount	Percent	Amount	Percent
Total income	$148,453		$171,776	
Gate receipts	90,492	60.96	94,197	54.84
Television contracts with national networks	17,862	12.03	[3] 59,286	34.51
Radio and televison contracts with local stations	19,086	12.86	(4)	(4)
Advertising, concessions and parking	18,482	12.45	3,491	2.03
Other	2,531	1.70	14,802	8.61

[1] Figures are taken from a consolidated schedule prepared by a major public accounting firm for the 1973 season. Figures for 1974 and 1975 have not yet been compiled.
[2] Figures are taken from a consolidated schedule prepared by a major public accounting firm for the 1974 season. Figures for 1975 have not yet been compiled.
[3] Includes revenue from sale of radio broadcast rights to local stations.
[4] See note 3, supra.

TABLE IV.—*Baseball franchise purchases, 1965–75*

1.	Baltimore Orioles	1965
2.	New York Yankees	1966
3.	Cleveland Indians	1966
4.	Cincinnati Reds	1967
5.	Washington Senators (became Texas Rangers)	1969
6.	Seattle Pilots (became Milwaukee Brewers)	1970
7.	Cleveland Indians	1972
8.	New York Yankees	1973
9.	San Diego Padres	1974
10.	Texas Rangers	1974
11.	Chicago White Sox	1975
12.	Atlanta Braves	1975

Appendix B

SPECIFIC BASEBALL TRANSACTIONS

1. BOB SHORT

Although it is thought in some quarters that Bob Short realized large profits from tax manipulations in his ownership and operation of the Washington Senators-Texas Rangers, the facts appear to be otherwise. Short's profits were relatively modest in light of his risk and were the product of Short's business acumen and bargaining ability rather than tax advantage.

A. Facts

The team was purchased prior to the 1969 season by the Washington Senators, Inc. ("WSI"), a corporation of which Robert E. Short Company, a second corporation, was the principal shareholder. The purchase price was approximately $9 million; another million was advanced as working capital during Robert E. Short Company's participation in the venture. Of this $10 million, $5.6 million was contributed by Short or his companies[1] through loans upon which Short was liable either through personal or corporate guarantees or through personal or corporate ownership of collateral (other than the baseball club's assets).[2]

After suffering substantial operating losses in Washington, exclusive of depreciation and interest deductions, WSI moved the team to Texas after the 1971 season.[3] Thereafter, it had operating profits. In addition, upon moving to

[1] From the information that Short purchased and operated the team on a $1,000 investment is without foundation in fact.
[2] The remaining $4.4 million was raised through a $3.3 million purchase money loan from the prior owners, and through the sale of $1.1 million of preferred stock to Mr. James Lemon.
[3] The authority to move the team came only after Short was unable to find a buyer in Washington who would pay the same amount as Short had.

Texas, WSI sold the rights to broadcast and televise its games for the years 1972 through 1981 for $7.5 million in cash, all received in 1971.

After the 1973 season, Robert E. Short Company sold the club for approximately the amount it paid for it. However, the purchasers were not to share in the $6 million ($7.5 million x 8/10) received for the sale of radio and television rights for seasons 1974 through 1981. Robert E. Short Company retained this money, thus constructively increasing the amount received on resale (and consequently the company's profit) by $6 million.

B. Analysis

Short's investment contained no characteristics of a "tax shelter". First, since the team was owned and operated in ordinary corporate form (in fact, there were two corporate layers, WSI and Robert E. Short Company, between the team and Short as an individual), Short could not use any losses generated by the team to offset personal income from other sources.

Secondly, ownership and operations were not financed primarily through nonrecourse loans. Eleven percent of the capital was equity, another 56 percent was debt either guaranteed by Short or his companies or secured by his personal or corporate assets.

The profit realized in this transaction was the product of Short's business acumen and his bargaining ability rather than of tax advantages. Even so, the net profit of the Robert E. Short Company for its five-year investment was about $2 million or $400,000 yearly, a 7 percent return on the $5.6 million risk. This return resulted solely from Short's ability to move the team and presell its radio and television rights, and from his ability to induce the buyers to pay full value for the team even though they would have no local radio and television revenue for the next eight years. Profit did not result from tax manipulations.

2. CHICAGO WHITE SOX

A. Facts

The Chicago White Sox franchise is held by Artnell Company ("Artnell"). On December 2, 1975, the White Sox Baseball Club, Inc. ("White Sox"), a corporation organized for this purpose, purchased 80 percent of Artnell's common and all of its preferred stock for $535,500 in cash and an assignment of Artnell's cash balance and accounts receivable, expected to total from $135,000 to $164,500. In addition, White Sox was to discharge certain of Artnell's debts totaling $7,014,500.

To raise this money plus the working capital required by the American League, the White Sox offered $6,211,700 in common and preferred stock in $110,000 packages to selected investors and received a bank loan of $3.75 million.

B. This Transaction Also Lacks the Characteristics of a "Tax Shelter"

Like the Bob Short transaction, this purchase is in no sense a "tax shelter". First, since the team is held in ordinary corporate form (indeed, there are two corporate lawyers. Artnell and White Sox between the team and the individuals), it is impossible for losses generated by the team to offset individuals' income from other sources.

In addition, this purchase was not highly leveraged. Equity ($6,211,700) exceeds debt $3,750,000) by 1.66 to 1.

Furthermore, any return to shareholders will be in the form of dividends. In addition, the receipt of dividends will depend on the profitable operation of the team. Thus, unlike in "tax shelters", the investors' sole economic concern is the profitability of the activity, which will generate ordinary income to them.

It is unlikely that White Sox will pay dividends in the near future. In addition, restrictions imposed on the transferability of White Sox stock limit the shareholders' ability to realize any appreciation in their investment or to liquidate if it proves unprofitable. Whatever may be the economic merits of their investment, it is difficult to perceive invidious tax motives for it.

STATEMENT OF COMMISSIONER ROZELLE OF THE NATIONAL FOOTBALL LEAGUE

My name is Pete Rozelle. I am Commissioner of the National Football League. I am appearing here today on behalf of the 28 member clubs of the League

in opposition to certain provisions of H.R. 10612 that would deny owners of football and other professional sports teams the right to compute their net income and pay tax on the same basis as other businesses.

THE TAX RULES ON PROFESSIONAL SPORTS IN H.R. 10612 ARE ARBITRARY AND DISCRIMINATORY

The provisions we oppose would apply uniquely onerous rules to investments in player contracts, the principal asset of every sports team.

1. For LAL purposes, the purchaser of a sports team would be required to depreciate player contracts on his seller's basis rather than his own investment, contrary to a basic principle of tax law applicable to all other businesses.

2. Depreciation on player contracts, already limited to the straight-line method by present law, and to the seller's basis by the proposed LAL rules, would be subject to the minimum tax as a "tax preference" item. No other business is required to treat straight-line depreciation as a tax preference item subject to the minimum tax.

3. In most cases, the owner of a sports team would be required to pay ordinary income tax on any gain attributable to the sale of player contracts. In all other businesses, sellers are entitled to capital gains on any appreciation over cost in assets comparably used in their trade or business.

4. A purchaser of a sports team would be subject to a presumption that no more than 50 percent of his purchase price is allocable to player contracts. We know of no similar provision applicable to any other business.

These far-reaching changes in the tax treatment of professional sports would substantially impair the value and marketability of present franchises. This might not be objectionable, at least from the Committee's point of view, if football and other professional sports are receiving special tax breaks which are undeserved or abused. The fact is that sports enjoy no special tax breaks.

FOOTBALL IS NOT A TAX SHELTER

An NFL franchise is not a tax shelter. There is no accelerated depreciation of player contracts, no fast write-offs of capital expenditures, no special tax incentives to encourage investment in professional sports.

Accordingly, every NFL owner must look to economic profit rather than artificial tax losses for a return on his investment. As in most businesses, losses do occur, particularly in the early years of a franchise, but these are real economic losses, not artificial tax losses.

ALLEGED ALLOCATION ABUSES CAN BE ADEQUATELY DEALT WITH BY THE IRS UNDER PRESENT LAW

Critics charge that some purchasers of sports teams allocate too much of the purchase price to depreciable player contracts, and too little to nondepreciable franchise costs. These provisions, however, go far beyond what is needed to deal with any such problem. They penalize the many legitimate owners for the alleged abuses of a few.

As you know, the Secretary of the Treasury testified last week against the same provisions we oppose here. His statement before the Committee points out that the Internal Revenue Service already has the tools to deal adequately with allocations that do not fairly reflect market values. These disputes are common in all types of businesses, and provide no justification for singling out professional sports for discriminatory and arbitrary treatment.

THE HOUSE'S RESPONSE TO ALLEGED ALLOCATION ABUSES MISSES THE REAL PROBLEM

Any objective legislative approach to purchase price allocations in professional sports must deal with the failure of present law to allow owners to amortize their franchise costs against the income generated by the franchise. The theory for disallowing amortization is that the useful life of a franchise is indefinite or indeterminable, but, as the accounting profession has recently come to recognize, this is no excuse for disregarding a real cost of doing business and overstating net income. Correcting this defect in present law would treat the principal cause of allocation disputes in professional sports (owners are understandably reluctant to allocate to a nondepreciable asset), and thereby solve most of the problems.

FOOTBALL DOES NOT OBJECT TO CHAIRMAN ULLMAN'S PROPOSAL FOR MINIMIZING VALUATION DISPUTES

Football has no objection to the sports provisions in H.R. 10612 proposed by Chairman Ullman of the Ways and Means Committee. One change would codify present administrative ruling holding that when a player contract is sold, depreciation claimed on that contract must be recaptured. The other would require both buyer and seller of a sports team to allocate the same amounts to player contracts and franchise costs. This will assure that the Internal Revenue Service is not "whipsawed" and, because of the ordinary income recapture on player contracts, will provide some incentive for the seller to insist on allocating a fair amount to franchise costs.

The other provisions on professional sports are unnecessary, unjustified, and completely arbitrary. We urge the Committee not to include those provisions in its tax bill.

Statement of the National Football League

SUMMARY OF PRINCIPAL POINTS

1. NFL owners oppose provisions of H.R. 10612 that would deny professional sports the benefits of basic depreciation and capital gains rules available to all other businesses.
2. These provisions cannot be justified as a means of eliminating tax shelters in professional sports. There are no special tax provisions or incentives available to professional sports that give rise to "artificial tax losses". Depreciation of player contracts is already limited by present law to the most conservative straight line method.
3. Problems of valuing player contracts and other assets on the purchase of a sports team can be adequately dealt with by the Internal Revenue Service under present law. These are problems common to all businesses and do not justify singling out professional sports for discriminatory and arbitrary treatment.
4. The failure to allow amortization of franchise costs as a cost of doing business is a major defect in present law and a principal cause of valuation disputes between team owners and the Internal Revenue Service. Further study of this area is needed if Congress desire a legislative solution to valuation disputes in professional sports.
5. NFL owners do not oppose Chairman Ullman's proposal that the buyer and seller of a sports team allocate the same amounts to player contracts and franchise costs as a means of minimizing valuation disputes.

I. H.R. 10612 UNFAIRLY DISCRIMINATES AGAINST PROFESSIONAL SPORTS

The member clubs of the National Football League object to those provisions of H.R. 10612 which subject them to a unique set of tax rules that are substantially more onerous than those applicable to any other business. All of these rules relate to player contracts, the principal asset of every sports franchise.

1. Under the Limitation on Artificial Losses (LAL) provisions, the purchaser of a professional sports team could not deduct economic losses from the operation of his team against income from other sources to the extent that such losses were attributable to straight line depreciation on the excess of what he paid for player contracts over his seller's basis in those contracts. See H.R. 10612, Section 101(a), adding Code §§ 466, 467(a)(6) and 468(f). The idea that the buyer in a purchase transaction must use a carryover basis for depreciation purposes is contrary to basic accounting and tax law principles applicable to all other businesses.

Further, this is the only instance in all of the LAL provisions in which straight line depreciation is treated as an "artificial loss." For all other investments to which LAL is applicable, depreciation is considered an "artificial loss" only to the extent that accelerated depreciation exceeds straight line depreciation.

2. The limited amount of straight line depreciation on player contracts to which an owner would be entitled becomes a tax preference item subject to the minimum tax. See H.R. 10612, Sections 301(a) and (c), adding §§ 55, 57(a)(15). In no other business must an owner include depreciation deduc-

tions computed on the straight line method as income subject to the minimum tax.

3. When an owner sells player contracts, he will be required to "recapture" depreciation taken not only on the contracts actually sold (the rule for other depreciable property) but on every other contract on which depreciation has ever been taken since December 31, 1975. See H.R. 10612, Section 209(b), adding Code § 1245(a)(4). The practical effect is to make the entire gain on all sales of player contracts taxable at ordinary income rates. This is contrary to the rule applicable to all other businesses that realized appreciation above cost on assets used in the trade or business is taxable at capital gains rates.

4. The purchaser of a professional sports team is subject to a presumption that no more than 50 percent of his purchase price was paid for player contracts. *See* H.R. 10612, Section 209(c), adding Code § 1056(d). In no other business is a purchaser subject to such a presumption. Further, the value of player contracts as a percentage of the total value of a team varies substantially between sports and between teams in the same sport, making across-the-board presumptions entirely inappropriate.

These arbitrary and discriminatory changes in the tax treatment of professional sports would substantially impair the value and marketability of NFL franchises. As one consequence, sport leagues might have to abandon expansion plans and some leagues could be faced with contractions in the number of franchises.

A professional sports franchise is already one of the least favored forms of investment from a tax standpoint, and certainly one of the most risky from a business standpoint. It will be extremely difficult, if not impossible, to attract new owners if they are unable to deduct real economic losses from operating a sports team against their other income as they could do with any other kind of business.

This might not be objectionable, at least to Congress and this Committee, if sports teams were currently over-valued solely because of artificial tax advantages. But professional sports teams have never enjoyed special tax breaks. The provisions of H.R. 10612 would instead deprive club owners of basic depreciation and capital gains rules that are available to all other businesses.

II. A PROFESSIONAL FOOTBALL FRANCHISE IS NOT A TAX SHELTER

An investment is generally regarded as a "tax shelter" if it enables the investor to take advantage of special tax incentives which generate large "artificial" losses that offset the investor's ordinary income. Typically, the investor is not concerned about the economic soundness of his investment because the tax savings alone substantially exceed his cash outlay.[1]

Professional sports do not enjoy unique tax advantages such as unlimited depletion or immediate write-offs of capital expenditures which are necessary to construct a "tax shelter". The most controversial deduction allowed to a team owner, depreciation of player contracts, is already limited by present law to the basic, conservative straight line method.

An NFL owner does not even enjoy generally available capital incentives such as the investment credit, accelerated methods of depreciation, or the Asset Depreciation Range (ADR) system. These provisions are limited to investments in tangible personal property, and the largest part by far of an NFL owner's capital investment is in "intangibiles" such as player contracts.

An NFL owner therefore must look only to economic profits, not tax shelter profits, for a return on his investment.

In summary, neither Congress nor the Internal Revenue Service has given professional sports any special tax privileges. Unlike other industries singled out for consideration in the LAL provisions, no one has alleged abuses of special tax incentives by owners of professional sports teams, for such special privileges have never been conferred on professional sports.

III. ALLEGED VALUATION ABUSES CAN BE ADEQUATELY DEALT WITH BY THE IRS UNDER PRESENT LAW

Critics of professional sports who profess to see special tax advantages accruing to wealthy owners usually point to large write-offs of player contract costs.

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[1] *See generally* Staff of Joint Comm. on Int. Rev. Taxation 94th Cong., 1st Sess., *Overview of Tax Shelters,* 1–7 (Comm. Print. 1975).

If those write-offs are large. it is because player contracts represent the owner's principal investment in his team. The owner of a laundromat has substantial write-offs from depreciation deductions on his washing machines (which he can take at accelerated rates), but no one complains about that.

Some allege that purchasers of professional sports teams allocate far too much of the purchase price to depreciable player contracts and not nearly enough to non-depreciable franchise costs. As Secretary Simon pointed out in his statement to this Committee, disputes of that kind arise in all types of businesses and can be dealt with adequately by the Internal Revenue Service under present law. There is no justification for singling out professional sports for discriminatory and arbitrary treatment.

The Revenue Service is not bound by the allocation made by a purchaser but may make an independent allocation based on its appraisal of the relative fair market values of the assets. The Service maintains an Engineering and Valuation Branch precisely for this purpose. The Service does not hesitate to exercise this power, as can be seen by its challenge to the allocation made by one of the NFL's expansion clubs, the Atlanta Falcons. See *Laird* v. *United States*, 391 F. Supp. 656 (D.C. G. 1975), on appeal to CA-5. Disputes such as these, which turn upon the particular facts in each case, are uniquely suited to resolution within the Internal Revenue Service or by the courts.

Even if a legislative response to the problem were called for, the approach of H.R. 10612 is inequitable and inadequate. It applies not only to the so called abuse situations but also penalizes the legitimate owner who has been in football for many years and is not looking for tax savings.

The so-called depreciation recapture rules are a good example of the overly broad scope of these provisions. This is really a back door way of imposing ordinary income treatment on all gains from the sale of player contracts. A goal is to give the seller of a sports team an incentive for seeing that the purchaser accepts a greater allocation of the purchase price to franchise costs (taxed as capital gains to the seller but non-depreciable) and less to player contracts (depreciable but, under the proposed rules, taxable as ordinary income to the seller).

The idea of imposing additional tax burdens on an innocent party to police another party to the transaction is one which we hope never gains acceptance in this Committee or the Congress. It does not insure fair allocations, for the party with the greatest bargaining power will obviously hold sway in the allocations. It is also necessary, for the Internal Revenue Service maintains an adult division for the purpose of policing just such abuses as the provision purports to cover.

Consider also the owner who wishes to retire and sell his club after holding it for twenty years. He may well have gone through four generations of players and have a substantive gain, if only because of inflation. Yet he, as well as the sharp operator, will be subject to ordinary income tax on any gain from the sale of player contracts under the rules of H.R. 10612. In any other business. gains from the sale of assets used in the trade or business would be taxable at capital gains rates.

The depreciation recapture provision also fails to distinguish between player contracts purchased as part of the sale of an entire franchise, where amounts assigned for depreciation purposes might be disputed, and contract costs incurred as a result of the payment of signing bonuses to players as part of the normal operations of any sports team. These bonuses are essentially the same as salary and the players of course report them as ordinary income. There is no apparent reason why the cost of these contracts should be subject to specially onerous depreciation recapture rules, yet the broad-brush approach of H.R. 10612 fails to make the distinction.

IV. CONGRESS SHOULD STUDY THE NON-DEPRECIABILITY OF FRANCHISE COSTS, A MAJOR DEFECT OF EXISTING LAW AND PRINCIPLE CAUSE OF VALUATION DISPUTES, BEFORE UNDERTAKING ANY LEGISLATIVE SOLUTION TO ALLOCATION DISPUTES IN PROFESSIONAL SPORTS

If critics of owners' allocations were entirely objective, they would recognize that pressure to maximize allocations to player contracts results from an for franchise costs on the theory that such costs have an "indefinite" useful unrealistic and illogical rule of tax law that denies any amortization whatever

life. We think it plain, for example, that the value of an expansion team's NFL franchise diminishes as the novelty of professional football competition wears off in its home city and the team must attract fans on the basis of success on the field. Yet this diminished value is not recognized through a matching of amortized franchise costs against revenue produced by the franchise, particularly in the initial years.

The accounting profession now recognizes that net income is overstated when it does not reflect amortization of the cost of intangibles, no matter how "indeterminable" the life.[2] Accountants and tax lawyers have developed proposals to change the tax law to conform more closely to accounting theory.[3] Indeed, the Internal Revenue Code already allows elective amortization of certain intangibles with "indeterminate" useful lives.[4]

Congress should not attempt any legislation in the area of valuation disputes, which have as their root cause the failure of present law to deal adequately with franchise costs and other intangibles with "indeterminable" lives, without giving this matter careful study.

V. FOOTBALL DOES NOT OBJECT TO CHAIRMAN ULLMAN'S PROPOSAL FOR MINIMIZING VALUATION DISPUTES

Football has no objection to the sports provisions in H.R. 10612 proposed by Chairman Ullman of the Ways and Means Committee. One change would codify present administrative rulings holding that when a player contract is sold, depreciation claimed on *that* contract must be recaptured.[5] The other would require both buyer and seller of a sports team to allocate the same amounts to player contracts and franchise costs.[6] This will assure that the Internal Revenue Service is not "whipsawed" and, because of the ordinary income recapture on player contracts, will provide some incentive for the seller to insist on allocating a fair amount to franchise costs.

The other provisions on professional sports are unnecessary, unjustified, and completely arbitrary. We urge the Committee not to include those provisions in its tax bill.

STATEMENT OF NATIONAL HOCKEY LEAGUE

I am Robert O. Swados of Buffalo, New York, Special Tax Counsel to the National Hockey League. I am also a Vice President, director and one of the owners of the Buffalo Sabres of the NHL, as well as general counsel to that organization. I have been a practicing tax lawyer for many years with some contribution to the legal literature in that field.

I am here on behalf of the National Hockey League and I will try to resist speaking from the viewpoint of a tax lawyer and instead focus on the difficulties in the proposed bill from the perspective of present and future owners of National Hockey League franchises. We are seriously concerned about Section 209 of the bill dealing with the allocation of the purchase price to player contracts and with depreciation, depreciation recapture, and the basis of such player contracts; and with Section 101 of the bill adding Code Section 467(a)(6)—making a sports franchise "LAL" property. In our view these sections of the proposed bill would have a chilling effect on incentives to invest in professional hockey. The consequence could well be few franchises, with a resultant loss in jobs for players and reduction in badly needed revenue for municipalities where such franchises operate.

The circumstances under which these sports related provisions emerged from the House suggest that they were prompted not by tax considerations, but rather by fallout from public or judicial controversies over antitrust laws, player relationships and collective bargaining disputes. But to the extent that

[2] See American Institute of Certified Public Accountants, Accounting Principles Board Opinion No. 17.

[3] See 136 J. Accountancy 79–80 (August, 1973); 28 The Tax Lawyer 1027 (Summer, 1975; 29 The Tax Lawyer 191 (Fall, 1975).

[4] See § 174 (Current deduction of research and experimental expenditures); § 177 (Amortization of trademark and trade name expenditures over a period of not less than sixty months); § 248 (Amortization of organizational expenditures of a corporation over a period of not less than sixty months).

[5] See H.R. 10612, § 209(a), adding Code § 1245(a)(2) and 1245(a)(3).

[6] H.R. 10612, § 209(c), adding §§ 1056(a), (b) and (c).

such provisions did emanate from tax policy considerations, we think they proceeded on three erroneous premises: (1) an erroneous view that all professional sports are alike and, therefore, the impact of these sections of the bill would be the same for all sports; (2) an erroneous premise—common to all of the sections of the bill we are considering—that the contract with a professional player—although admittedly a very important asset of the franchise—has no real cost behind it, and thus its amortization or depreciation produces an "artificial" deduction; and (3) an erroneous conception of the sports franchise as belonging to the category of "tax shelter".

We in the NHL believe it is unfair and unrealistic to place all professional sports under a single set of arbitrary assumptions, punitive allocation formulas and unprecedented depreciation recapture provisions. There are real and substantial factual differences between hockey and other professional sports. While there are some similarities we believe the differences argue strongly for continuing the case-by-case determination of these issues and against the inflexible and overly broad provisions contained in the House bill. I would like to describe a few of the special characteristics of hockey which indicate that the bill proceeds on erroneous conceptions of the facts and would produce bad legislation.

It is appropriate that my brief remarks follow those of Commissioner Kuhn. Of the four big league sports represented here, baseball and hockey share certain common features. Perhaps the two most significant similarities are in the areas of player development costs and franchise stability.

PLAYER DEVELOPMENT COSTS

Hockey, like baseball, incurs substantial player development costs. The 50% presumption provision makes no sense in the hockey context because of these development costs; we have invested many dollars per player before the typical rookie reports to the NHL. During the period 1971–75, the aggregate payments by the NHL to the amateur leagues exceeded six million dollars. In addition, financial support to the minor professional leagues, usually in the form of subsidies for players' salaries, averaged in excess of $300,000 per NHL Club per year. A typical club owns or has working agreements with two or three minor league clubs and has contractual relationships with as many as 40 players in its farm system, in addition to the 25 to 30 players employed at the major league level. The subsidy of amateur hockey and the prolonged and substantial costs of developing a player through the minor league system mean that when an NHL owner is asked to sell or provide a new expansion franchise or make available for draft a player, that player's contract represents much more than the right to that player's services for a specific period of time; it represents substantial costs and years of effort in developing that player's skill, stamina, expertise and public image. When a player leaves the team, as when he jumps to another league, there is nothing artificial about that loss—it is real indeed. These factors support the appropriateness to hockey of the House Committee report's conclusion that player contracts "represent one of the important costs of acquiring a sports franchise". Under generally accepted accounting principles and tax practice, independent appraisals must be utilized and work very well in allocating the cost of acquisition. In these circumstances, any arbitrary restriction of the amount allocable to player contracts to 50% of the purchase price is wholly unwarranted.

FRANCHISE STABILITY

A second marked similarity between baseball and hockey is the relative stability of franchise ownership and location. Of the 15 U.S.-owned clubs in the League, 12 have their original owners. In recent years, one changed ownership primarily because of the death of the principal shareholder, and two others underwent ownership changes because of persistent financial problems. None of these 15 U.S. franchises has changed its location from one metropolitan area to another. Such stability is strong evidence that hockey is not the type of business that attracts investors interested in the sport only so long as their tax deduction is useful. We neither encourage nor permit the kind of "in and out" shuttle of frequent geographic relocation which might indicate

an intention to seek a temporary tax shelter. Our league constitution and bylaws require unanimous consent for a change of franchise location and, in modern times, no transfer from one metropolitan area to another has taken place. In fact, just the opposite is true. In cities where serious financial problems have confronted the franchise, the League has not acted like a carpetbagger, pulling the franchise from one community and handing it to another, leaving a wake of disappointed fans and distressed creditors. On the contrary, the League has to date spent millions of dollars and years of effort in nursing the ailing franchises and effecting a series of negotiations enabling a continued operation of the franchise in the same city. This happened in the early days of the Chicago franchise and, more recently, in Oakland and Pittsburgh; it may happen again in Kansas City. Last year, when the Pittsburgh franchise encountered more financial problems, the League made substantial loans and invested hundreds of hours in searching for and finding new owners who would acquire and maintain the franchise in that major metropolitan area. The new Kansas City franchise in our League has already applied for and received an interim loan from the League to enable it to finish the season, and we would hope that similar efforts by local owners could result in maintaining the franchise in that important region. Yet there are signs that uncertainties in the tax law and the threat of the imposition of these provisions we are discussing today could seriously reduce the chance of obtaining new investment capital for these franchises. For hockey, it is not a question, as suggested in the House Committee report, of maintaining "the operation of some marginal teams which might not be in existence but for the tax savings"; it is a question rather of enabling owners to enter the industry in the first place with the kind of financial stamina necessary to carry a new hockey franchise through the development years. Experience has demonstrated that a new hockey franchise must be prepared to incur substantial out-of-pocket losses during its formative seasons when it is developing fan interest and building a team of competitive caliber. The provisions of this bill create artificial barriers to the entry of new owners who could otherwise survive this development period.

HOCKEY'S NEED TO EXPAND

In terms of public acceptance in the United States, hockey is in its relative infancy—as is demonstrated by our lack of a national television contract. Hockey has experienced rapid growth during the last ten years and, subject in part to the outcome of this hearing, enjoys great prospects for substantial growth in the future. Historically, professional hockey was limited to the very largest metropolitan areas in the northeast and midwest. We anticipated steady, controlled growth based upon developing a national market for hockey through infusion of large amounts of investment capital, good business practices and effective player development. Experience demonstrates that new sports franchises need time, prolonged effort and financial stamina to reach a successful level. But expansion cannot occur if the marginal operating results of recent expansion franchises are not assisted by infusion of new capital, or if artificial barriers to entry into the industry are created. We in the League are greatly concerned that the above-noted provisions of the House bill would create such barriers to entry into the hockey business and would seriously damage our franchises in cities where operating results in the formative years are marginal or negative. Such artificial barriers could result in permanent elimination of those franchises, notwithstanding the substantial investments of private owners or local municipalities in the construction or improvement of the local arenas housing these franchises.

The proposed bill will also discourage expansion from the point of view of existing or selling clubs. Because expansion almost invariably means that a successful club or club on its way up will have to give up some playing strength to the new franchise, it is already very difficult to get the unanimity required to add new franchises. It may be impossible to get a vote for expansion if what we may call the "lump recapture" provision of proposed Section 209(b) becomes law, since it could result in a large portion of the expansion proceeds being taxable as ordinary income to the existing franchise holder instead of being treated as capital gain as it is under present law.

EFFECT ON PLAYER TRADING AND DRAFT

The theory expressed in proposed Section 209(b) that a sale or a trade or a draft of one player would trigger recapture of depreciation or amortization taken on an entirely different player has no precedent in the tax law and throws an unrealistic monkey wrench into transactions which are vital to improving a clubs' standing in the League—the exchanging, trading or other disposition of players, for the purpose of improving playing caliber and fan support. Perhaps the unexpected and capricious effect of these provisions can best be illustrated in connection with the NHL intra-league draft, a draft which in normal times is held in June of each year to enable teams to lower standing to obtain players on the roster of more successful clubs at a relatively nominal price (now $40,000). In usual fashion a club protects 18 skaters and 2 goal tenders, and the remainder of its players on its roster are available for draft to the other clubs in the League in the inverse order of their standings of the previous season. The general manager, acting in the normal and prudent business way—without regard to tax considerations—would, as he attempts to help his team climb in the standings from the earlier years of the franchise, trade away or make available in the intra-league or expansion drafts those players whose future value to his team is doubtful.

For example, assume one player per team must be made available in the draft. The general manager considers making available: (1) Player A, who has been with the club for four years, whose original basis was $70,000, whose depreciation reserve account shows a potential recapture of $40,000 and who is a seasoned veteran who should continue to give good service for a few more years: or Player B, who was acquired in the previous year's amateur draft, has a basis of $10,000 with no depreciation reserve, has not panned out, and whose chances of helping the team in the future are minimal. In the normal course, the manager would make available in the draft Player B. But he is told by his tax lawyer that under the tax provisions applicable to sports, a draft or sale of Player B for the intra-league draft price will result in triggering depreciation recapture (ordinary income) to the extent of $30,000 of the $40,000 draft price. Therefore, he must consider placing Player A in the draft because his sale or draft will only trigger a $10,000 recapture.

Thus, tax considerations enter into the ability of a manager to obtain or relinquish players for drafting, sale or trading purposes, and this is hardly the type of deliberation to which general managers are suited. I, personally, would not relish informing my general manager, Mr. Punch Imlach, that he must consult tax counsel every time he seeks to sell or trade a player or make him available to another club in a draft.

TELEVISION AND THE ALLOCATION PROBLEM

Another feature unique to hockey is the absence of any national network television contract for its regular season games. We suspect that the impetus for the inclusion in the bill of the 50% presumption stems from two misconceptions concerning the sale of any sports franchise: (a) that there is no real cost behind the player contract; and (b) that the buyer in each case receives a right to participate in a valuable national television agreement and which indicates that the portion of cost customarily allocated to player contracts is excessive. As noted above, in the case of baseball and hockey, assumption (a) has no validity whatsoever. Assumption (b)—that revenues from national television and similar contracts really represent a major part of the acquisition price of a franchise—is clearly unfounded as to hockey. In the case of hockey the picture of a regularly renewed, regularly increasing revenue from national television does not, unfortunately for us, exist at all.[1] The NHL has no national television contract for the 1975–76 season, with no current prospects for such a contract next season. During the years when the NHL did have national television coverage, we had to shift from one network to another, with our last contract with NBC having been terminated by the network, and our receipts from national television in the best year of those contracts were approximately

[1] Certain of the Canadian clubs may derive revenues from Canadian national television contracts which compare with those received by other sports leagues, but the share of the U.S. clubs in these revenues has been limited in the last three years to approximately $35,000 per club.

1/3 of the revenue obtained by the NBA and probably less than 1/7 of the amount per club obtained by football and baseball. Thus, to the extent that national television revenues have any influence on the allocation issue, the problem must be looked at differently for different leagues. When one focuses on local television and radio contracts, the necessity for case-by-case administrative disposition is even stronger.[3] The local television revenues received by the U.S. clubs in the NHL vary all over the chart, from zero to substantial sums. However, in no case are these receipts of the same magnitude as those obtained by other sports from national television. Where other sports can rely on television revenues to compensate for weakness at the box office, hockey depends almost entirely on its gate receipts for its income. Box office performance depends on team performance, and team performance is directly related to player contracts; the franchise must have the financial strength necessary to carry first-class talent on the roster. The average NHL salary has risen over the last five years from $25,000 to $85,000. This dramatic increase, coupled with the absence of national television revenue, has resulted in a number of clubs being unable to generate sufficient gate receipts to cover actual current operating costs, exclusive of interest, depreciation and amortization. Financial conditions in the League today are such that no club, regardless of whether it sells out or not, will generate a cash profit unless it makes the play-offs; and financial success is directly proportionate to the performance of the players under contract—the number of rounds the club lasts in the post-season series. This tenuous profit structure cannot survive radical surgery on the allocation of player contract costs and the method of their amortization. Those questions are more suitably resolved through case-by-case adjustment in the Internal Revenue Service and in the courts since they involve the type of factual determinations of who paid how much for what, particularly appropriate for normal I.R.S. audit procedures.

CONSISTENT ALLOCATION BY BUYER AND SELLER

We have no quarrel with the provision in the House version which would require, in effect, that the seller and buyer make the same allocation of purchase price between player contracts and other assets. This may be beneficial; however, it introduces some element of rigidity which would delay, and possibly discourage, the sale of franchises since it would require the parties to negotiate their tax consequences at the same time that they deal with the economics of the transaction. Its effect would be, in some cases, to require the parties to seek a ruling from the Internal Revenue Service, and on the type of factual question on which the Service does not ordinarily issue a determination in advance. But we believe that adoption of this provision would, to a large extent, eliminate any need for the allocation presumption and depreciation recapture provisions.

WE ARE NOT A "TAX SHELTER"

I trust that we have shown through these examples that the bill is defective in its attempt to impose rigid tax accounting rules on all professional sports without taking into account the significant economic differences between them. The tendency to do that, I believe, is traceable to the misconception fostered in other fields that all professional sports are tax shelters. The term "tax shelter" usually connotes the use of artificial deductions; in the words of the House report, ". . . ones that do not accurately reflect their current expenses." Tax shelters are commonly observed as, situations in which the taxpayer makes a sudden entry and a sudden departure, staying only so long as his tax advantages obtain; reporting payments and accruals of expenses "up front" in such a way as to accelerate deductions and distort income; using vehicles which permit or are designed expressly for the purpose of facilitating tax deferral or tax diminution without business purpose; using leverage—i.e., the employment of borrowed money in excess of equity, often represented by non-recourse loans—so that the real permanent investment by the taxpayer in the enterprise is often overshadowed or negligible in comparison with the debt; and engaging

[3] In a given case the cost allocable to a national or local television contract may itself give rise to amortization deductions. But *see Laird* v. *United States*, 391 F. Supp. 656 (N.D. Ga. 1975).

in transactions which produce "paper" or tax losses but make no economic sense.

There are no tax devices available to or being used by our hockey owners which to any substantial degree accelerate deductions or distort income, other than those permitted by normal tax accounting rules. To the contrary, the present five-year limit on the net operating loss carry forward is penalty enough to avoid abuse of operating loss deductions during a franchise's development years.

The operation of a franchise in the NHL bears little resemblance to the purely formal, temporary and non-economic transaction typical of the undivided and passive interest in a cattle feeding deal, the oil or gas payment, or other typical tax shelters. The operation of each hockey franchise involves the full range of business operations.

The successful establishment of a hockey franchise requires direct participation by owners and management in the day-to-day operations in the business.[8] It requires the infusion of sufficient equity to provide the financial stamina to bear with the losses in the early years. The stability of NHL franchises and the continuance of the original participants in the ownership of these hockey clubs—even those who came in by way of expansion—demonstrates convincingly that the hockey business is not a tax shelter.

Another common tax shelter characteristic is the use of "leverage"—i.e., the employment of borrowed money in excess of equity, often represented by nonrecourse loans—so that the real permanent investment by the taxpayer in the enterprise is often overshadowed by or negligible in comparison with this type of debt financing. In the NHL we have regularly followed the policy of requiring expansion franchises (and any new owner of an acquired franchise) to show evidence of adequate equity investment in the franchise and, moreover, not less than $1,500,000 of working capital.

No National Hockey League club of which we are aware has any need to employ "artificial" deductions. Typically, the out-of-pocket expenses of the operation, without regard to amortization or depreciation, are high enough! Depreciation or amortization of the cost of its principal assets—its player contracts—is not the creation of an artificial deduction any more than it is artificial to amortize the cost of machines over a period of time which may be unrelated to the period of payment for the machines. Amortization of player contracts, which is the focus of an undue amount of excitement in this area, does not permit the use of accelerated methods of depreciation: only straight line is available. Moreover, the useful life (the playing expectancy of a player) is readily obtainable from the average playing life of other players in similar positions whose statistics are well publicized for the benefit of all persons interested in the sport (in publications such as the NHL Guide). To the extent that there are differences in opinion as to the useful life of a player—whether attributable to his age, his rank in the draft, his physical condition at the time of signing, or other factors—these differences are no more and perhaps less esoteric than the multiple criteria used by accountants, attorneys and Internal Revenue agents in the application and administration of the depreciation provisions of the Internal Revenue Code to a horse, a patent or a machine.

The cost and allocation of player contracts and the period for which amortization should be permitted are proper subjects for argument; but these arguments are no different in kind nor in principle from the traditional and common-place practices of industry generally. They should be settled in the same forums as industrial tax disputes, whether the I.R.S. or the courts; they should not be arbitrarily settled by legislative overkill.

THE PROPOSED BILL CREATES
ARTIFICIAL BARRIERS TO INVESTMENT

An investor is considering entering professional hockey. With what does this proposed bill confront him? If he seeks an expansion franchise, he knows that the largest part of his cost in the major assets he will obtain are player contracts. Yet the bill would tell him that he has a very difficult burden to sustain before he can amortize more than half of his purchase price, even though he

[8] The ownership vehicle which has become the hallmark of a tax shelter—the limited partnership—is not used by the majority of the owners of NHL franchises.

knows his players will have limited useful playing lives. If he cannot bargain successfully with the seller, he must accept the seller's allocation of cost. If he desires to use his income from another business to fund the hockey operations, he will have restrictions on the extent to which he can use the hockey losses against his other income. And if he or his general manager seek to trade or sell a player or make him available in an expansion or intra-league draft, he faces the risk that the transaction will trigger unexpected ordinary income tax arising from depreciation taken on entirely unrelated players who are not disposed of.

We urge that there has been no showing of tax or other reasons sufficient to justify the imposition of the discriminatory impediments to investment which these provisions would construct. And in these uncertain and precarious days of the industry, the interests of players, fans, municipalities and taxing authorities coincide in permitting normal investment incentives to work. Those incentives should lead to the maximization of revenue, of profit, and of the tax yield to the federal government. Government policy should be consistent; if we are to compete without any special exemption from the antitrust laws, then we should similarly be allowed to compete without being selectively punished under the tax laws. To some extent, and I think it is justified, owners in professional sports are beginning to feel paranoid. The antitrust assaults the changes in the reserve system, the demands of collective bargaining and the upward pressure on salaries, have all produced changes and strains in the structure of professional sports, the ultimate consequences of which are only dimly perceived. We fear that the addition of unfavorable tax restraints not applicable to other industries—will discourage the flow of investment capital, obstruct the maintenance of existing franchises and unnecessarily impede the entry of new franchises and new owners.

We do not seek any preferred treatment under the tax laws for our member clubs; we ask only that general tax principles continue to apply to our business and that we not be singled out for special penalties or undeserved restraints.

SUMMARY OF THE STATEMENT OF NATIONAL HOCKEY LEAGUE BY ROBERT O. SWADOS, VICE PRESIDENT, BUFFALO SABRES AND SPECIAL TAX COUNSEL, NHL

The National Hockey League urges the Committee to delete provisions singling out sports franchises contained in the bill passed by the House of Representatives. In our view, these sections wold have an unjustified adverse effect on the financial health of the hockey industry, would seriously curtail its ability to maintain franchises now in their development years, and would impair hockey's prospects for expansion.

A complete statement is filed with this summary and we ask that it be included in the record.

The specific provisions objected to by the NHL are as follows:

1. The unprecedented presumption that a sports franchise can allocate no more than 50% of the purchase price to player contracts 1Section 209(c), adding Code Section 1056(d)];

2. The discriminatory "lumping" of all player contracts under a special depreciation recapture rule [Section 209(b), adding Code Section 1245(a)]; and

3. The classification of a sports franchise as a "tax shelter" subject to "LAL", so as to prohibit the use of losses attributable to depreciation taken on player contracts as a deduction from other income [Section 101(a), adding Code Sections 466, 467(a)(6), 468(f)].

These sections of the bill would constitute bad legislation because:

1. All professional sports are not alike and the impact of these provisions would not be the same for all sports, and in the case of hockey would be substantially adverse—yet the bill treats all sports the same;

2. These provisions erroneously assume that the player contract—although admittedly a very important asset of the franchise—has no real cost behind it, and thus its amortization produces an "artificial" deduction;

3. The bill sweeps all sports franchises into the "tax shelter" basket when the facts are that professional sports in general, and hockey in particular, have none of the characteristics of a special tax device and are not tax shelters.

With hockey's substantial player development costs, its lack of significant national television revenues and existing economic situation, the imposition of the proposed sections would be ill-advised and would present a real danger to both the maintenance of franchises now in their development years and the future expansion of the sport to new areas of the country.

In support of these observations, the following facts should be noted:

(a) Hockey player contracts have very substantial development costs behind them (over $6,000,000 paid in the last five years to Canadian and United States amateur hockey by the NHL plus subsidy of minor professional league operations in excess of $300,000 per club per year).

(b) NHL franchises have long-term stability of geographical location and ownership, completely unlike the typical tax shelter.

(c) Hockey's acceptance in the United States is restricted to limited areas and is in its relative infancy. The artificial barriers in this bill create critical obstructions to much needed expansion.

(d) The absence of national television revenue for hockey suggests that an allocation of cost to player contracts of more than 50% is justified.

(e) The unprecedented "lump" recapture proposal introduces wholly unsuitable tax complications into the routine sales, trades, and drafts which are the guts of the operation of the hockey business.

(f) Hockey is not a tax shelter:

(1) No sudden entry and departure;

(2) No use of "artificial" or accelerated depreciation of players—only straight line available;

(3) Regular requirement of $1,500,000 of working capital for new franchises and substantial equity, as opposed to the typical non-recourse loans of tax shelters;

(4) Little use of the limited partnership vehicle;

(5) Direct and comprehensive involvement by owners in the management of the hockey business.

Existing administrative and judicial remedies are more than sufficient to control effectively any apparent abuses of the tax law by sports franchises. Hockey and other sports should not be subjected to discriminatory treatment under the internal revenue code, but instead should continue to be governed by the same tax principles applicable to American businesses generally.

Summary of Principal Points In Statement of National Basketball Association

This Summary contains the principal points made in the Statement of the National Basketball Association with respect to H.R. 10612, Tax Reform Act of 1975.

1. The Bill contains six provisions dealing with professional sports franchises. These provisions have far reaching effects which could adversely affect the fundamental structure of professional sports activities in this country.

2. The National Basketball Association believes that these provisions of the Bill are unnecessary to protect the tax revenue, because any alleged abuse could be, and in fact has been, controlled by existing law and auditing procedures carried out by the Internal Revenue Service.

3. The enactment of this Bill should substantially impair the value of existing sports teams, could seriously hamper the issuance of any new franchises, and could thereby serve to deprive many people of the ability to enjoy viewing professional sporting events.

4. There does not appear to be any justifiable reason to treat owners of sports franchises more adversely than owners of other business enterprises.

5. The LAL provisions of this Bill are being proposed to prevent certain abuses in the area of tax shelters. Since a sports team is not a tax shelter, to apply such provisions to sports teams represents an unjustified expansion of the LAL concept.

6. The operation of a basketball team is highly speculative and risky, as evidenced by the fact that many of the existing basketball teams incur substantial losses of money each year and, as has been recently seen in the American Basketball Association, where many teams have demonstrated an

inability to continue in business because of such losses. Therefore, to view a sports team as a tax shelter is to completely ignore reality, and to treat sports teams in a manner different from other non-tax shelter businesses is unwarranted.

7. The existing rules of the Internal Revenue Service require that depreciation deductions previously taken with respect to any player contract be recaptured at the time of the sale of such contract. Accordingly, a provision requiring such treatment would be unnecessary and would not have any effect on tax revenue.

8. The provision of the Bill that would require sports teams to recapture depreciation or losses with respect to player contracts, other than the player contract being sold, represents a unique and unwarranted extension of the recapture rules applicable to professional sports. Such a provision is an indirect attempt to treat all gain on the sale of one or more player contracts as ordinary income notwithstanding the fact that the House Ways and Means Committee has expressly declined to impose that result in a direct manner. By applying this provision to an isolated sale of a player contract as well as to a sale of an entire team, the movement of a player from one team to another could be substantially inhibited. Furthermore, this provision discriminates against an already economically marginal business without apparent justification.

9. The existing recapture rules are certainly sufficient to prevent sports teams from realizing capital gain with respect to prior depreciation deductions.

10. At the present time a substantial number of basketball teams lose money each year. To deprive such teams of the ability to realize capital gains on the appreciation of their assets, in the same manner as is done by other businesses, would necessarily have an adverse effect on the number of persons willing to operate or acquire sports teams. There does not appear to be any reason for Congress to discourage expansion or continued operation of existing sports teams.

11. National Basketball Association franchises have generally treated the portion of the purchase price allocable to player contracts in a consistent manner. Therefore, a provision requiring such treatment is unnecessary and would not have any effect on tax revenue.

12. The provision creating a presumption that not more than fifty percent of purchase price can be allocated to player contracts is unjustified and fails to give proper consideration to the differences that exist between sports leagues and individual teams in each such league. For example: consideration should be given to the fact that basketball teams receive a considerably smaller portion of their revenue from national television than do some other sports teams; to the fact that the value of a franchise depends upon such things as the number of persons living in the area, the degree of fan interest and the size of the arena; and to the fact that the value of player contracts varies depending upon the ability of the player involved and upon such player's appeal to the fans.

13. The allocation of purchase price among the assets of a sports team does not create any problem that is different from the allocation of the purchase price of any other business. Therefore, there is no apparent reason for creating a special rule for sports teams. The Internal Revenue Service can adequately control any abuse in the area.

14. To subject any depreciation deductions on player contracts to the minimum tax constitutes a failure to recognize the justification for depreciation deductions by sports teams with respect to the cost of acquiring a player contract and, for no apparent reason, singles out sports teams by denying them the right to the tax benefit from such deductions.

Statement of National Basketball Association

This Statement contains the comments of the National Basketball Association on H.R. 10612, Tax Reform Act of 1975, with respect to the portion thereof specifically involving professional sports franchises.

The Bill contains six provisions dealing with professional sports franchises. These provisions have far reaching effects which could adversely affect the fundamental structure of professional sports activities in this country.

The six provisions involved are the following:

1. Section 101(a), which would extend the LAL provisions of the Bill to prevent a buyer of a sports team after November 4, 1976 from applying losses attributable to a portion of the depreciation deduction for player contracts against other income.
2. Section 209(a), which would codify existing practice applying the depreciation recapture rule of Section 1245 of the Internal Revenue Code to the sale of player contracts.
3. Section 209(b), which requires sports teams to establish a "suspense account" which would include all depreciation deductions taken on player contracts after December 31, 1975, plus all deductions taken on player contracts after December 31, 1975, plus all deductions taken for losses on the sale of such contracts after that date. The suspense account would be reduced by all ordinary income recaptured on a sale of any such contract. When any player contract is sold, the provision would require the seller to recapture the gain on such sale to the extent of the amount in this account.
4. Section 209(c), which provides that upon a sale of a sports team, the buyer and seller must specify the portion of the purchase price to be allocated to player contracts, and that such allocations would be binding on both parties.
5. Section 209(a), which provides for a presumption that not more than 50 percent of the total purchase price for a sports team can be allocated to player contracts.
6. Section 301(c), which would treat depreciation deductions on player contracts, which were acquired in a transfer of a team and which are not subject to LAL, as a tax preference item for purposes of the minimum tax.

The National Basketball Association believes that these provisions of the Bill are unnecessary to protect the tax revenue, because any alleged abuse could be, and in fact has been, controlled by existing law and auditing procedures carried out by the Internal Revenue Service. Further, the enactment of the Bill could substantially impair the value of existing sports teams, could seriously hamper the issuance of any new franchises, and could thereby serve to deprive many people of the ability to enjoy viewing professional sporting events. There does not appear to be any justifiable reason to treat owners of sport franchises more adversely than owners of other business enterprises.

Specifically, the following comments are material with respect to each of the provisions referred to above:

APPLICATION OF LAL PROVISIONS TO DEPRECIATION OF PLAYER CONTRACTS

The LAL provisions of this Bill are being proposed to prevent certain abuses in the area of tax shelters. Since a sports team is not a tax shelter, to apply such provisions to sports teams represents an unjustified expansion of the LAL concept.

The Internal Revenue Code does not contain any special provision creating tax benefits for sports teams. Unlike tax shelters, deductions claimed by sports teams represent actual expenditures of money and do not generally stem from the use of non-recourse loans, which are commonly present in most tax shelters. Further, the deductions claimed by sports teams do not include any artificial deductions which can be claimed to actually constitute capital expenditures, such as prepaid items or accelerated depreciation. Player contracts are treated in the same manner as assets used in other businesses. The initial cost of acquiring such contract must be capitalized and, in recognition of the nature of such assets, such acquisition cost can be deducted over the useful life of the contract. Since such contracts are treated as intangible assets, sports teams are not even permitted to use any method of accelerated depreciation, but are limited to the use of straight line depreciation, and are not entitled to claim an investment tax credit with respect to the acquisition of such contracts.[1]

The operation of a basketball team is highly speculative and risky, as evidenced by the fact that many of the existing basketball teams incur substantial losses of money each year and, as has been recently seen in the American

[1] See Rev. Rul. 67-379, 1967-2 C.B. 127.

Basketball Association, where many teams have demonstrated an inability to continue in business because of such losses. Any profits from operations or from the appreciation in assets result from hard work and imaginative management. Under these circumstances, to view a sports team as a tax shelter is to completely ignore reality, and to treat sports teams in a manner different from other non-tax shelter businesses is unwarranted.

RECAPTURE OF DEPRECIATION ON SALE OF PLAYER CONTRACT

The existing rules of the Internal Revenue Service[2] require that depreciation deductions previously taken with respect to any player contract be recaptured at the time of the sale of such contract. Accordingly, a provision requiring such treatment would be unnecessary and would not have any effect on tax revenue.

UNIQUE DEPRECIATION RECAPTURE FOR PROFESSIONAL SPORTS

The provision of the Bill that would require sports teams to recapture depreciation or losses with respect to player contracts, other than the player contract being sold, represents a unique and unwarranted extension of the recapture rules applicable to professional sports. Such a provision is an indirect attempt to treat all gain on the sale of one or more player contracts as ordinary income notwithstanding the fact that the House Ways and Means Committee has expressly declined to impose that result in a direct manner. By applying this provision to an isolated sale of a player contract, as well as to a sale of an entire team, a substantial and unique burden is imposed on the ability of a sports team to operate. To impose such a burden on an already economically marginal business is unwarranted and unnecessary. Furthermore, this provision could have the effect of reducing the number of player contracts disposed of by operating teams and could thereby substantially inhibit the movement of a player from one team to another.

This provision discriminates against professional sports without any apparent justification. All other businesses are entitled to treat the appreciation in an asset used in its business as capital gain, subject to the recapture rules. To require sports teams to treat such appreciation in a different manner is inequitable and unwarranted. The existing recapture rules are sufficient to prevent sports teams from realizing capital gain with respect to prior depreciation deductions. To deny sports teams the right to realize capital gain on the appreciation of its business assets and to apply the recapture rules other than in the usual asset by asset manner constitutes a complete departure from a very basic precept of the tax law. To apply such a unique concept to sports teams alone is completely unjustified.

If this provision were to become law, the value of all existing sports teams and the ability of such teams to continue operating would be substantially reduced. At the present time a substantial number of basketball teams lose money each year. To deprive such teams of the ability to realize capital gains on the appreciation of their assets, in the same manner as is done by other businesses, would necessarily have an adverse effect on the number of persons willing to operate sports teams. In a similar manner, this proposed provision would substantially reduce the number of persons will to acquire new or existing franchises. There does not appear to be any reason for Congress to discourage expansion or to discourage the continued operation of existing sports teams. To do so would only deprive the many Americans who enjoy professional sporting events of the privilege of obtaining such enjoyment.

ALLOCATION OF PURCHASE PRICE TO PLAYER CONTRACTS BY BUYER AND SELLER

In almost all cases, buyers and sellers of National Basketball Association franchises have treated the portion of the purchase price allocable to player contracts in a consistent manner. Further, under existing law, the Internal Revenue Service has adequate means with which to control any alleged abuse in this area. Therefore, a provision requiring such treatment is unnecessary and would not have any effect on tax revenue.

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[2] See Rev. Rul. 67-380, 1967-2 C.B. 291.

PRESUMPTION THAT NO MORE THAN 50 PERCENT OF PURCHASE PRICE CAN BE ALLOCATED TO PLAYER CONTRACTS

This provision is unjustified and fails to give proper consideration to the differences that exist between sports leagues and individual teams in each such league.

Basketball teams receive a considerably smaller portion of their revenue from national television than do some other sports teams. Accordingly, the portion of the purchase price properly allocable to the value of a basketball franchise (and the right to national television revenue incident thereto) is considerably less than the portion that is properly allocable to the value of other sports franchises.

The value of a franchise is dependent, in substantial part, on the number of persons living within the area in which the team plays its home games, the degree of fan interest peculiar to that area, the size of the arena in which such games are played and many other factors. Similarly, the portion of the purchase price properly allocable to the value of player contracts varies depending upon the ability of each player and upon such player's appeal to the fans. To treat all teams as having players of equal value, or to impose an arbitrary limit on the value of player contracts held by any team, fails to give proper consideration to these differences.

The allocation of purchase price among the assets of a sports team does not create any problem that is different from the allocation of the purchase price of any other business. Therefore, there is no apparent reason for creating such a special rule for sports teams. The Internal Revenue Service can adequately control any abuse in the area. The recent case involving the allocation of purchase price among the assets acquired in the sale of the Atlanta Falcons[8] aptly demonstrates the ability of the Service in this area. Moreover, leaving this area to the audit procedures of the Internal Revenue Service, as is done with respect to other businesses, would permit more adequate consideration to be given to the facts and circumstances present in the particular case involved and would not leave the issue to be resolved in an arbitrary and unreasonably manner.

APPLICATION OF MINIMUM TAX TO DEPRECIATION OF NON-LAL PLAYER CONTRACTS

This provision would impose a burden on sports teams which could have a devastating impact. To subject depreciation deductions for player contracts to this additional tax burden constitutes a failure to recognize the justification for depreciation deductions by sports teams. Player contracts are a valuable, but wasting, asset of a sports team. In the same manner as other businesses are permitted to depreciate the cost of such assets, sports teams are allowed to recover the cost of acquiring such contracts pro rata over the useful lives thereof. Once the cost, if any, of acquiring a particular contract has been fully recovered, no further depreciation deductions are allowed with respect to such contract. The structure of our tax laws recognizes the right to such recovery, and there is no apparent reason to single out sports teams by denying them such right.

As discussed above, sports teams are not tax shelters and should not be treated as such. Moreover, the depreciation deductions that would be subjected to the minimum tax by this Bill are not accelerated deductions (as noted above, accelerated depreciation is not allowed on player contracts), but merely represent the recovery of a cost of a valuable asset over a reasonable period of time. In no other case is straight line depreciation treated as a tax preference item. To isolate sports teams for special adverse treatment is unjustified and, as discussed above, could seriously impair the availability of professional sporting events to the American people.

CONCLUSION

In summary, the proposed provisions are unwarranted and unnecessary. Without any apparent reason, burdens would be imposed on sports teams which are considerably different and more adverse than those imposed on other business entities. The result of such action could substantially reduce

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[8] E. Cody Laird, Jr. and Joanne H. Laird v. United States, 391 F. Supp. 656 (D.C.

the number of professional sports teams that could continue in operation and the number of new persons that would be willing to begin such operation.

Should any material be submitted to the Committee in connection with H.R. 10612 as to which further comments of the National Basketball Association are appropriate, it would be appreciated if the Committee will afford the National Basketball Association the opportunity to make such comments.

The CHAIRMAN. Our next witnesses are on a panel consisting of Leo Jaffe, chairman of Committee on American Movie Production; Burton S. Marcus, Committee on American Movie Production; Walter Diehl, international president of the International Alliance of Theatrical Staff Employees and Moving Picture Machine Operators of United States and Canada; Sam Robert, coordinator of the New York Conference of Motion Picture and Television Unions and National Conference of Motion Picture and Television Unions and vice president of Local 52; and Paul Roth, chairman of the board of the National Association of Theatre Owners; Steve D'Inzillo, New York business representative of the Moving Picture Machine Operators Union of the International Alliance; Alan J. Hirschfield, president and chief executive officer of Columbia Pictures Industries, Inc., and Kathleen Nolan, national president of the Screen Actors Guild.

This panel is scheduled to testify for 35 minutes overall. I assume Mr. Leo Jaffe will testify first and then the various members of his panel.

STATEMENT OF PANEL CONSISTING OF LEO JAFFE, CHAIRMAN OF COMMITTEE ON AMERICAN MOVIE PRODUCTION; BURTON S. MARCUS, COMMITTEE ON AMERICAN MOVIE PRODUCTION; WALTER DIEHL, INTERNATIONAL PRESIDENT OF THE THEATRICAL STAGE EMPLOYEES AND MOVING PICTURE MACHINE OPERATORS OF THE UNITED STATES AND CANADA; SAM ROBERT, COORDINATOR OF THE NEW YORK CONFERENCE OF MOTION PICTURE AND TELEVISION UNIONS AND NATIONAL CONFERENCE OF MOTION PICTURE AND TELEVISION UNIONS AND VICE PRESIDENT OF LOCAL 52; PAUL ROTH, CHAIRMAN OF THE BOARD OF THE NATIONAL ASSOCIATION OF THEATRE OWNERS; STEVE D'INZILLO, NEW YORK BUSINESS REPRESENTATIVE OF THE MOVING PICTURE MACHINE OPERATORS UNION OF THE INTERNATIONAL ALLIANCE; ALAN J. HIRSCHFIELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF COLUMBIA PICTURES INDUSTRIES, INC.; AND KATHLEEN NOLAN, NATIONAL PRESIDENT OF THE SCREEN ACTORS GUILD

Mr. JAFFE. Mr. Chairman, Senators, my name is Leo Jaffe. I am chairman of the board of Columbia Pictures Industries, Inc., and chairman of the Committee for American Movie Production.

My associates and I would like to express our sincere thanks to the committee for allotting us this valuable time to examine a problem that is plaguing the motion picture industry. Hopefully,

with your help, we can get some measure of relief for a situation that is of critical importance to every segment of our industry.

For more than 45 years, I have been involved in motion picture production, financing and distribution. What you are witnessing here today, Mr. Chairman and Senators, is a "first" for our industry. For it is the first time that producers, distributors, exhibitors, and the craft, technical and talent unions and guilds are united on a single issue.

What is this issue that is so compelling that these natural and long-time adversaries would put aside their traditional differences and speak as one voice? The issue is the tax legislation that would eliminate limited tax incentives for investment of risk capital in motion picture production.

The reason we are all united is that we—as well as the American public—will all be the losers if such legislation is allowed to pass.

The American motion picture industry reaches across the entire fabric of our country's economic, cultural and social life. As my colleagues in the industry will demonstrate here today, the movie industry is vitally important for the economic well-being of many hundreds of thousands of American workers and taxpayers. And I would like to point out that what we are talking about is not limited to a single region of the United States. Motion picture production is no longer confined to Hollywood and Burbank—but reaches across the country.

At a meeting recently held in Denver, Colo., called by the Governor of Colorado, 28 States sent representatives of their film councils to the meeting. There they voiced their strong concerns about the pending legislation before this committee. They have joined forces with us on this issue because they recognize that the loss of risk capital means a further loss of film production in their States.

For example, the great States of Colorado, Arizona, Louisiana, Georgia, Texas, New York, Ohio, Oregon, and others have, in recent years, seen millions of dollars enter their communities through motion picture production.

The higher earnings being reported in the industry by various companies are misleading and have, by and large, been generated by a handful of pictures like "Jaws," "The Towering Inferno," "Earthquake," and a few others. These figures also include the revenues that were received from sources other than motion pictures, particularly in companies that are broadly diversified or those which are part of larger conglomerates.

But the motion picture companies who are virtually entirely dependent on motion picture production and its byproducts have suffered severely in recent years.

The number of pictures produced has been reduced drastically. When more than 400 features were distributed about 20 years ago—that number has dropped to approximately 180 in 1975. This production would have been further reduced if not for outside financing that has been encouraged by current tax incentives.

These tax incentives are now in jeopardy and could eliminate independent financing and investment in pictures. With the knowl-

edge that production is now at its lowest point, the inability to have access to such money will further jeopardize the economy.

Theaters have already been badly hurt—labor is being destroyed in the process. Hopefully, after hearing my colleagues, you will have a better understanding of our situation and, if possbile, will help us eliminate the present chaos that exists in many quarters of our industry.

If you will permit me but another moment, I would like to point out that all major countries are today offering substantial subsidies and emoluments to induce American producers and creative talent to their shores. Also bear in mind that the motion picture industry has earned more than $500 million annually abroad, and has returned approximately $375 million in favorable trade balance to our country.

The words "tax shelters" have taken on an ominous note. Actually, what we are recommending is that investment in film retain the same incentives accorded venture capital investments in other areas of the economy. The Government will not be deprived of a single dollar of tax revenues. Instead, under our industry proposal, additional tax revenues will be created.

We want to keep our production here, utilizing American labor, not only in Hollywood, but in many States throughout the country. We have the talent, the technicians—and the audiences ready to see our product. But a healthy motion picture industry is dependent on the availability of risk capital. And our industry is united on this issue because its very life depends on it.

Thank you.

At this time, I would like to introduce Burt Marcus. Mr Marcus will present the views of the industry in greater detail and in turn will be followed by other members of our panel.

Mr. MARCUS. Mr. Chairman, Senators, 2½ years ago we were faced with a dramatically declining production schedule and dramatically declining employment that followed it, simply because the cost of production and cost of marketing had not increased but had multiplied several times and because those costs had strained every available traditional capital source.

We looked for other ways to finance production. We had to attract outside venture capital. We did not want to do tax shelter investments. We wanted outside venture capital. We did not utilize any special statutory provisions that accelerated deductions. Those were not there. We rationally worked out ways of financing film.

We are not complaining about limiting abuses that may have arisen in the context of that financing. We very much want those abuses to be reformed. However, we feel as though the means and end of that method of reform in the House bill have become confused.

In our financing, we do not happen to have accelerated statutory deductions. When somebody purchases a picture from us, they amortize the cost directly in proportion to the income that they receive from the picture. But we were stuffed into the LAL provision that has been designed to take care of situations where there was an accelerating of deductions through statutory provisions in relation to 20- to 30-year assets.

We had none. That was easy to surmount; it was surmounted by saying that in the case of film, all deductions shall be deemed to be accelerated deductions. We do not really think that is fair. We know that we need the money. What we see in the House bill is not a method to reform the abuses but a method of killing the availability of money.

Now, this money is terribly important money. So is the Treasury's money important money. We believe that the estimate that the Treasury has given is that there is a loss of $31 million simply has no basis in fact. We think we can demonstrate it to you.

In the context of the investment that we have attracted on the first 13 films that we have done, the investor will over a relatively short time span, pay more in taxes than they have deducted. That is not really a tax shelter situation. We know that the money that we attract goes directly and immediately into the economy, into jobs. We know that 70 cents of every dollar that we attract in this venture capital to our business goes immediately into production, immediately into wages. That is 70 cents of every dollar. That is only a part of the story, though.

If we can attract $15 million to make additional new pictures, the effects on the Treasury and the economy are very favorable. And we are talking of new films not about supporting on the market of buildings that are already up: We are talking about money for incremental production and jobs. If we can attract that and we do nothing more than break even, we will generate about $35 million of film rentals for the distributor. Although we have only broken even, in addition because we only get 40 cents of every dollar that comes into the box office, $55 million or so will remain in the local communities and cities in this country. That happens within the 2, 3, 4 years of the time that the money comes to us.

Now, let us analyze what has happened. Our market will be eliminated; our money market availability of these funds will be eliminated by the House bill if it is sustained. In an industry that is already very highly concentrated—there are perhaps six major studios which produce about half of the films—you will find greater concentration.

Banks will not lend capital for films; certainly not unless the borrower is a very large organization. What about the independent film makers who have to scratch together enough money so that they can continue filming. They have to go to nontraditional sources to get risk capital, risk capital that will finance quality production films. These are films like "One Flew Over the Cuckoo's Nest," and others which the major companies refused to do because they didn't think they were commercially viable.

Independent producers are the people who took the risk and made the decision to make the film. How much has that generated for our economy apart from the $2 million that was spent to make the film? I think we must analyze the means in relations to the ends.

The abuses that are being potentially used in this type of financing are simply a function of two elements. These are the degree leverage and the period before loan repayment. If the period before the loan repayment—the period of deferral, or the degree of leverage are abnormally extended an abuse and a tax shelter may be created.

It is easy to eliminate the abuse. We have proposed and we have tried to get people to at least require that a minimum investment must be put in in cash dollars, perhaps 25 percent or the cost of the film, require that all borrowings be repaid within 5 years after the film is released and require that in order to get any tax incentive on these films that it be produced in the United States, where it does create jobs.

If that were done, the LAL provision would not offend us. The "at risk" provision offends us because we have been singled with two other areas in the entire economy as economic periods. We do not think a revolutionary reshaping of a fundamental provision of the statute, should be shoved in under the emotionally charged guise of eliminating a tax shelter, is fair—and in this case the tax shelter does not really exist, it is even less reasonable.

Finally, I just want to say that we face enormous competition from abroad that is directly subsidized. Nonetheless, we bring back half a billion dollars a year in foreign exchange. This is enormously valuable to our country in bringing our culutre to other countries and bringing our culture abroad and selling a lot of our products, and I think that we ought not to be discriminated against in the pending legislation.

Now, I would like to introduce Walter Diehl, to speak in behalf of the production workers in our industry.

Mr. DIEHL. I am Walter F. Diehl, international president of the IATSE, which has 61,000 members. I am also speaking today on behalf of the Hollywood Film Council, an organization representing 27 unions and guilds involved in motion picture production in California.

At one time, Hollywood reigned as the major film-producing capital of the world. Enough films were produced to give the public a weekly change of double bills. Annual production reached an average of 500 films during the 1930's, 475 in the 1940's, while 425 films were produced in 1950.

Film production continued to decline when only 350 films were produced on the average in the beginning of the 1950's, and a sharp decline took place in 1958 with a production output of 241, which was a drop of 59 films from 1957. Since 1958, production has continuously declined at an alarming pace, to the point that only 180 films were released in the United States in 1975, and not all of these were made in the United States.

The 180 films made last year were produced for the same amount of dollars as the 425 films in 1950. As of March 5, only 18 films were in production in this country this year.

Due to the development of technology in the motion picture industry, the technician spends less time on a motion picture production—and this technology which makes the American film the most respected on the world markets is vital to our national resources. No matter how small the production, technology has and will always play an important part in film production.

It is also vital to note that our technicians employed in the industry are seasonal workers; there is less work in the summer months but more in the autumn season which runs into early spring. But with

less theatrical films being produced, even the seasonal work is in doubt. And due to the lack of product, theaters throughout our country are continuously crying for more product.

All the unions and guilds in the motion picture field each have a large number of skilled professionals who are always ready to work in film production, and when one looks at the unemployment statistics, the industry's production potential is not even being scratched.

Approximately 28,000 IATSE members are directly involved in film production in Hollywood and New York and 7 other major centers of the United States. Of these, approximately 45 percent are currently unemployed.

On behalf of the IATSE and the Hollywood Film Council unions and guilds, and the film industry, we need stimulating action so that we will not see a further decline of U.S. film production.

Our unions believe in tax reform. We believe that if there are abuses by a few individuals, these abuses should be rectified. However, our industry needs the stimulus of risk capital if the production of movies in America is to be maintained—and, hopefully, increased. Therefore, I urge this committee not to deprive our industry of the tax incentives available to investment in other industries, as suggested in the industry-supported proposal outlined here today.

Thank you.

In addition to what is set forth in the statement that I just submitted, I would like to draw your attention to the fact that because of the vast improvement of motion pictures and the technological changes, it is now possible to make a feature picture strictly within a studio, because, as you were told, the number of studios in Hollywood has shrunk to six major studios.

There are rental properties in the city of New York. We do not have a real motion picture facility in New York, and there is no real motion picture studio as such. Most of the stuff in New York is done on location, on the streets of the city, in various other areas, and this is why the production is now spreading to all parts of the United States.

Production, as you know, has now been spread throughout the various areas. A great number of the States that you gentlemen represent are also being used as these locations.

I have just been told that I am 2 minutes over my time, and with that, I would like to introduce to you Mr. Sam Robert, a member of our organization.

Mr. Robert. Mr. Chairman and Senators, I am Sam Robert, executive coordinator of the National Conference of Motion Picture and Television Unions. My colleague, Walter Diehl, has already outlined the effects that further reduction of film production here in America will have upon the workers in our craft unions.

Kathleen Nolan will, I am sure, develop this point further when she testifies on the effects declining production will have on the talent guild members. Accordingly, I would like to restrict my very brief remarks to another aspect of this situation, one that working men and women are not supposed to be concerned about, but which deeply troubles us.

It seems odd to me that we fail to recognize the unique character of our American movies. For years they have told the story of the American democracy to the entire world. They have shown the glories of our culture and the seamy side as well. They have shown us in all lights, the good and the bad. I believe people throughout the world respect us for it. When an American film is critical of America, it is living proof that America is still a haven for the free expression of ideas.

We tend to think of movies as a strictly commercial enterprise in much the same way that we think of the auto industry, meatpacking, real estate, oil and gasoline. I am afraid that that is the way it has been considered in the tax reform bill. We forget sometimes that the box office is not simply a cash register. It is a transfer for something very special in the life of our people.

Most countries of the world consider movies to be important to the cultural and artistic life of the country that gives them birth. They are also ambassadors to the rest of the world. Movies, as you have been told, are even subsidized by the governments of these countries. Too often we are overlooked in our own country, and for over 50 years the movies have not only provided entertainment and stimulating interests for all of America, but have told the story of American democracy and the American ability to the rest of the world.

Our movies enter almost every nation in the world and reach the masses of these countries and continue to make friends and continue to convey to the world the vitality of the democracy in our way of life. And what a better way, as we enter our country's bicentennial year, than to reaffirm the democratic principles on which our Nation is founded.

It is with these considerations, along with the economic factors which have already been pointed out, that we would ask that you consider the needs and value of the tax incentives from the motion picture creation to continue to produce.

To supply our own people and audiences around the world with our pictures, we must continue to have assistance, especially to encourage new young people, young film makers, to enter the field of production who can bring us some fresh, new, and creative pictures.

This is my final point: At a time when we have seen the growth of monopolies and conglomerates, here is an industry which is still open and which, in fact, has to be opened to the independent entrepreneurs with drive and imagination to make it on their own initiative and create mobility.

Isn't that what America is all about, Mr. Chairman and Senators and the committee? By all means, let us have a tax reform bill that makes certain that everybody in this country, millionaire or working man, pays his fair share of taxes. Yes, let's plug up the tax shelters that help the wrong people, but do not let us throw this precious baby out along with the dirty water.

Let us remember, as Barbara Streisand pointed out at a recent testimonial to the great director, William Wilder, that the American motion picture industry is an American institution.

Let us hold it up, sustain it, encourage it and support it.

I would like to introduce Mr. Phillip Roth, who is the board chairman of the National Association of Theatre Owners.

Mr. ROTH. Phillip Roth writes the dirty books. My name is Paul Roth.

About 30 years ago I had the pleasure of managing a theater out in Virginia named after your late father and family. Today I am the chairman of the board of directors of the National Association of Theatre Owners, which represents two-thirds of the theatres in question.

Our president was to be here with me today, and he expresses his regret that he could not be. He asked me that I may say a word to you in your deliberations on the tax legislation, particularly in the form presented by the House of Representatives, because it has a serious impact on the Nation's theaters.

Our theaters represent an investment of approximately $5 billion, currently employing approximately a quarter of a million people with an annual payroll of about $1.4 billion every year.

We went through our hard times in the late forties with the advent of television and some other problems. Just recently, we have been able to see a resurgence in attendance, where it has now gotten us to the point that we are entertaining approximately 20 million Americans a week, not exactly the 80 million that we were able to entertain in the late forties, but a resurgence from our low point.

We know that the resurgence is directly attributable to three things: first, to the American public's continuing love affair with motion pictures; the second, the fine films that have been made in the last few years by old and young, established and new film makers alike; and, finally, by the millions of dollars that theater owners have put into new theaters in new communities and the refurbishing of old theaters in the established communities.

The key to all that is obviously film, at Mr. Diehl said. Twenty-five years, 450 pictures; last year, 180. A great many of those 180 were made possible by the laws which exist today. These laws allowed the attraction of risk capital in the production of motion picture, and permitted a number of independent competitors to risk capital and, as we understand it, an opportunity to compete for capital, which would be denied them, or serious curtailed by the House's version of the bill which you are considering.

We feel that it would be disastrous, though, as theater owners, and we feel that our theaters are paying $16 million to State and localities in admission taxes alone, and that is nothing compared to our local, real estate, personal property and sales taxes.

We also have our corporate taxes, and what-have-you. Our payroll is directly taxable, and it is going to carry a quarter of a million Americans, who are largely job workers, older citizens, or family breadwinners who are hit by inflation and find night and weekend operation of theaters one of the few ways they have to augment their incomes.

Of the films that we now have that were completed or partially financed by capital attracted by tax incentives, to which we have been entitled, we know that we spent approximately $90 million at the

local level in newspaper, radio, and television, billboads, and what-have-you. We feel that we serve our community, not only in terms of the number of dollars that we put in or the number of jobs that we offer, but we think that we offer one of the few accessible and reasonable low-cost forms of entertainment and diversion in the United States that is available, particularly to middle-income families who populate the thousands of communities which we serve.

I do not want to belabor the same points or attitudes that the other speakers will make. I will say that you cannot put spaghetti through a motion picture projector. Most of the time if you do not have film, you close up or curtail, or you are forced to resort to cheap exploitations and foreign quickies. There is some serious question there, whether or not you are, in fact, able to serve your community.

Motion pictures have been considered to be a legitimate source of risk capital. For the reason that we cannot fathom, the House would strip away that group of producers who go into the market and compete for that capital. We think it would be disastrous. It would be disastrous to our audiences and to our employees, and would endanger an American art form. We think that it is completely unfair in terms of our relations with other industries.

So, in those terms, we commend closing the loopholes, assuming there are any, and encouraging domestic producers, which is desperately needed to employ our talented people. It is important that you do, in fact, retain the incentives for the investment of risk capital in the production of motion pictures.

We thank you very much.

I would like to introduce Mr. D'Inzillo.

Mr. D'INZILLO. Mr. Chairman and members of the committee, I should like to make some brief remarks about some of the factors involved which do not readily appear on the surface and are not too commonly known.

I would like to say at the outset, in my home State of New York we are now in the process of trying to get our Governor to do what the State Governor of Texas did sometime ago in establishing a State film commission to attract a lot of motion picture production, and the State of Texas has been doing a remarkable job.

My name is Steve D'Inzillo, and I am chairman of the East Coast Council of Motion Picture Unions, which is made up of regional representatives from various locals encompassing cameramen, editors, studio mechanics, cartoonists, film laboratory technicians, and projectionists.

I am also the business manager for the Projectionists Union, Local 306. Those of you who are Democratic Senators and who will come to New York for the Democratic Convention will be able to see first-hand some of the things I want to point out as happening to theaters and communities in New York, particularly the midtown area right near where your convention will be as a result of the shortages of motion picture films, theatrical films. As a consequence a lot of theaters are doing a lot of things that they would not otherwise do.

First, I would like to touch on the fact that even in a city like New York, motion picture production itself is an important job fac-

tor. When we speak of motion picture production, we do not always think of all the facilities required to produce a film, all of which increase jobs, or decreases them if there are not pictures in production; particularly, things like film processing labs, which we call recording studios.

There is also equipment and rental services and rental studios. In New York, we only have a very few small ones and they are empty for lack of production. The technical houses and the special effects houses are also affected. What happens when we have a tremendous slowdown in production, we do not use as much stock, and it has its effect in faraway places, such as the Eastman Kodak Co. and the du Pont Co., who are the principal producers of raw stock. When the industry slows down, employment stops there, too.

I think a very big point should be made of the fact that if this bill passes as it is, it will tend to encourage monopolies in our industry. Only the bigger, financially sound companies will be producing pictures. The smaller companies and independent producers will not be able to do so.

Risk capital comes too high. One independent producer who was trying to get far less than $500,000 was complaining of the fact that he had been asked to pay as high as 25 percent interest to get the money.

Another aspect that will affect jobs and job potential if this bill passes, will be a return to a practice that existed prior to the present statute's enactment: namely that a lot of production will go overseas. Our unions fought bitterly with the producers in this country for going overseas, even though we did not understand the tremendous financial pressures that existed for them to do so, but it cost us jobs, and we do not want to see a return to that situation.

Now, producers do not start out to make a bad picture, but the fact is that the harder money is to come by and the more it costs, the tendency is to restrict the budget for the picture, and in cutting costs, a very good investment will turn out very often to become, unhappily, a bad picture.

A lot of theaters are running reissues excessively. Now, we are complaining about reruns on television. The same thing is happening in the theaters and this is a case simply because there are no new pictures to use. Many pictures that should only run a week are running 2, 3, and in some cases, 4 weeks simply because there are no pictures to follow.

In the heart of Times Square the De Mille Theater, a beautiful theater, is closed now for 9 months. The particular membership of my local union recently authorized me to make special deals with some exhibitors in order to reopen it. It has gotten to that point.

The Music Hall, known throughout the Nation, now has a regular policy of dispensing of the running of motion pictures for close to 3 months per year, simply because there are not enough theatrical films of good enough quality to play at the Music Hall. This factor has taken a tremendous number of jobs away from us, particularly in the motion picture profession.

There were 15,000 theaters in the country that employed over 30,000 people. Now, with automation, there are less than 18,000 with

one man running several theaters. For us, it means jobs and we urge the committee to change that portion of 10612 which will enable the industry to have this tax deferral.

I am sorry, Mr. Chairman, for going over my time.

I would like to introduce Mr. Alan J. Hirschfield, the president and chief executive officer of Columbia Pictures Industries.

Mr. HIRSHFIELD. I am Alan J. Hirshfield, the president and chief executive officer of Columbia Pictures Industries, Inc.

I joined this company some 3 years ago. When I joined the company, we had a studio and distribution organization that cost us about $20 million to keep in business. In order to accomplish this, we had to produce a minimum of some $40 million worth of production within a given 12-month period. That was at a time when we had a maximum of $25 million of our own money and we had to try to come up with a production program, and this meant a minimum of about $15 million in outside financing to have a complete schedule which would put us back in a profitable direction.

Without that additional money, we would have been forced to abandon our production distribution business and go out of business as a major film producer in the United States. We were able to raise this money even with the enormous debt load and horrendous balance sheet situation only because of the availability of the tax deferral mechanism, and the moneys that came as a result of it, which would be eliminated under the bill now pending before this committee.

In short, if the House bill were now law, we would have been a bankrupt company. This is a company that made "Bridge Over the River Kwai", "The Guns of Navarrone", and is a company which I think over the years has received great critical acclaim.

Now, we have not had duplication of that record. Instead, we did raise that money and we were able to make "Funny Lady." We were able to make in New York a new movie by Woody Allen and we were able to make in Louisiana, "Hard Times", and we were also to make a movie in Connecticut called the "Stepford Wives." We were also able to make in Arizona a film called "White Line Fever". and another picture in Texas.

Mr. Marcus alluded to a picture, "One Flew Over the Cuckoo's Nest", which in our genius we passed up, because we did not think there was any market for it. That picture was made possible by outside investors. Financially, it will gross somewhere in the neighborhood of $25 to $30 million, and the foreign gross will be in excess of $10 million.

We fail to see where the Treasury loses money in that kind of a situation. Sixty-two other films were made recently based on this kind of financing.

As my colleagues have noted, moviemaking has become a national business. Eighty percent of the films that are made today are made on location. They are not made at the studio. Twenty-eight States have developed film commissions, which have been referred to before.

In regard to subsidizing, in terms of foreign opportunities, we have that as an alternative.

It is interesting to know that in a recent white paper prepared by the Labour Government in Great Britain, the recommendation

was made that in order to help the declining production in the United Kingdom, the tax financing advantages used in the United States be introduced in that country.

I think what we do is not a "ripoff", as some people have suggested. Our investors this past year put in some $16 million in investments; they will get back over $18 million. I do not see how the Treasury loses, but it can only profit in this kind of a circumstance. Jobs were created and retained at the local level, and as a company, we are still in business.

We ask you to give us the same opportunities as the groups that have come here, in terms of tax treatment. It is my privilege now to introduce Miss Kathleen Nolan, who is the president of the Screen Actors Guild.

Miss NOLAN. Thank you.

I would just like to say that for a group of gentlemen who are not actors, you do go on for a long time. I can understand it because, as Mr. Jaffe said, it is the first time that the industry has come together in a very real way. We may have our differences, which we settle through collective bargaining, but on this issue we are all united.

I am an actress, but I come to you today not only as one who has spent her life as an actress from the age of 13 months old, but as the president of the Screen Actors Guild, the national president. I represent an organization that has 32,000 professional actors across this country. I think that we have clearly defined ourselves, not only by our work but by the conditions of our work.

Again, I find myself hearing Congress speaking against a plan which will strengthen our group and force the serious actors to accept poverty as a precondition of his or her profession.

Many of you here in Washington have been concerned, as we all have been about the 8.5 unemployment rate in this country. Well, I am not only concerned about the 8.5 percent; I am concerned about the 85 percent unemployment rate in the Screen Actors Guild. It is a staggering statistic, and there is a great myth about the motion picture actors.

Contrary to that myth, they are not all millionaires. There are not too many millionaires among us, only a few. Those are the ones that you read about. That is what they write about but they do not write about the 81.5 percent that made below poverty level last year.

We could talk about that, too. Were they all on the unemployment line? Not all of them; a lot of them were working as waitresses or gas station attendants, or at various other jobs. I think that is a shame. I think it is bad. I speak not only for the actors today, but I also speak for the Writers Guild of America and the Directors Guild of America, for all of the creative guilds that work in the motion picture industry.

I would also say that we probably promote our own myth in this regard: next Monday night we will be at the Academy Awards in our rented dresses, rented tuxedos, and our rented cars. All we will be showing to the billions of people around the world is that all is well in Hollywood and all is well in "Tinsel Town."

I can assure you that is a fantasy. The reality is that it is not well. If this legislation is passed, it is going to be even worse.

We rely on two major industries for our employment. One is the motion picture industry and the other is the television industry. Well, if you watch television, which some of us work in and some of us cannot really stand to watch any more, you see that there has been a decline in the television product.

I did a television series many years ago, which I hope somebody remembers, called, "The Real McCoys." We did 39 episodes and there were 13 summer reruns. Someone in the television network decided that it would be a terrific idea to give the American public more reruns. So he cut it from 32 to 30, then 26, then 22. It looks like in the new season most of the shows will be 17 and the balance will be reruns.

Then, there was another external power, the FCC. In their great wisdom, they decided that they would impose a prime time access rule so that there would be more diversity in programing. What that has produced is foreign-made shows and mind-numbing game shows, and that is what we are giving people on television.

If we do not do something about this legislation, what will be given in the motion picture industry will be just a few choices. We will be given just what the major studios can afford to take a chance on, and none of the marginal kind of films that have been referred to before, such as "One Flew Over the Cuckoo's Nest," which was an extraordinary film about men in a hospital ward.

Certainly, women have disappeared off the American screen. Films with minorities would not be made. We will just be blowing up buildings and the artists of this country will merely be stage weights between the sound of guns and the blazing sirens, and I do not think it is really fair to our artists.

The appalling thing is that in every civilized country around the world there is support for the artist and for the motion picture industry. They have minister of culture and they also have incentives for the motion picture industries. We have none of that; we are not even asking for a plan, or any kind of a plan such as they have in the rest of the world. We are just asking you not to take away what we already have.

Indeed, we are saying, "Let's clean it up and let's stop abuses, and let's stop confusing the American artists, the American writers, directors, with the makers of pornography."

We are not in the business of making pornography. Professional actors, writers, and people at this table are interested in making distinguished films and we are joining with the rest of the industry in asking that the tax deferrals remain. We are asking for the same treatment that is available to other businesses, and we are asking that we be allowed to maintain this risk capital.

We are asking that in this computerized competitive society, that you recognize that the American film industry is important, and that the tax shelters, as we understand it, are a ripoff. But we do not consider that a tax deferral incentive for financing motion pictures is a ripoff.

We ask for your help and your support.

Thank you.

Senator HARRY F. BYRD, Jr. [presiding]. I want to thank each of you. It has been a very interesting panel and I think that this committee is learning a great deal about the motion picture industry today.

Senator Curtis?

Senator CURTIS. Thank you, Mr. Chairman.

Mr. Marcus, if I understand the problem that you have described here today, and you correct me if I am wrong, under the existing law an individual might have $10,000 to put into a film, but he borrows $50,000 more, and so that is $60,000 expended in the early stages of the production for wages and all other expenses of producing a picture. And under the existing law—and therefore this film shows a loss, because he has spent $10,000 of his own money, and he has borrowed $50,000, and that has all gone out, and there are no returns coming in, so the mode of businesses operating take a loss, and that loss can be taken by the investor by whatever income he has; is that correct?

Mr. MARCUS. Yes, it is.

Senator CURTIS. Now, what the House bill would do would throw this into LAL, and that you continue to take that loss all the time that this money is flowing out, but it would have to go into the LAL process and be delayed?

Mr. MARCUS. Yes; that is correct, Senator Curtis.

Senator CURTIS. And that is what would shut off your risk capital?

Mr. MARCUS. Yes; that is part of what would shut off the risk capital.

You see, when a lawyer goes out and works for a year and a half or 2 years on a case, he is incurring expenditures, for associates that work for him, staff, rents on his office, and under the cash basis accounting he deducts those expenditures. That is the way the cash basis accounting works. In 2 years, or 3 years, or 4 years, when he wins a large settlement and gets a good fee, he takes it into his income and that is the cash basis accounting also.

So in our transactions, when somebody who does not own a picture furnishes the financing and services of producing the film and expends the money in the course of production, he deducts the expenditure part of the money, and that is his own money plus the part of the money that is borrowed. The borrowed money must inevitably come back into the income at the maturity of the loan.

We are suggesting that that maturity should not extend beyond 5 years after release of the film, simply to avoid the serious leverage and deferral situation.

You know, in real estate, 10-to-1 is the common ratio. We are suggesting for you to shorten the leverage, make it smaller, require real cash dollars to go into jobs, perhaps 25 percent of the cost of the film. That will increase the jobs directly.

Senator CURTIS. What you are saying is that if there are some angles of abuses, you are making these suggestions as a way to clear those up.

Mr. MARCUS. We would like them to be cleared up because we really do have a responsible industry.

Senator CURTIS. Do you subscribe to the theory that your industry operates as a tax shelter?

Mr. MARCUS. No, it does not. When we went out—and as Mr. Hirschfield suggested—and had to accommodate a $15 million need based on tax shelter. Nobody can profit from our business deals based on taxes. Anybody who went into it for profit solely from taxes would have lost a lot of money.

If the suggestions that we are making here were adopted, it would be perfectly clear that nobody should be going into it just for tax shelter income; they should be going into it as a very risky entrepreneurial investment basis. To accommodate that risk, if you will, they should have the normal deductions.

Senator CURTIS. I am in accordance with the position that you take here.

Senator Kennedy appeared before this committee a week ago, and I am reading from his testimony, "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 the 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 hardcore pornography."

Do you wish to make any comment in reference to his statement as it pertains to the film business?

Mr. MARCUS. I appreciate the opportunity, Senator.

Initially, I think we have to say that in a system where 50 cents of every $1 earned is taken by the Government, if you wish to induce somebody to invest the other 50 percent, you cannot say to them that you can invest 50 percent, but if you win, one-half of that is going to be taken; if you lose, you are not going to get any benefit for it, either.

Additionally, the concept that this money is used for pornography is nothing more than cheap shibboleth. Pornography comes in 95 percent of the situations to a theater when, because of the unavailability of quality products, the theater owners cannot attract sufficient people to meet his obligations. When he cannot attract that sufficient number of people, he turns to much more reliable sources and that is pornography

By the way, much of that pornography is manufactured abroad, and we suggest that the deductions only be available for United States production. That was the second point.

Third, this is entrepreneurial venture capital. All of the incentives I have talked to induce people to risk money in our economy. If the incentives are taken away, where does the money go? It goes into the banks; it goes into Washington. The banks do not invest in entrepreneurial situations. Banks do not take a heavy risk. The only person drying up the entrepreneurial capital helps is the person who has a large amount of his own capital and hence larger availability of capital from traditional capital suppliers, for example, banks.

If the entrepreneur cannot get risk capital to go into something new, the only place that the new idea can be brought is to the large institutions. That is because it has $18 billion in assets and is able to take a risk, and it can offset all of the losses against its income because it is so complex that nobody is ever going to find out, even if the law were in existence to prevent it, which it does not.

I think that we have to look at the value of movies in our economy and the historical role that the entrepreneurial capital has played in our economy, and the importance that it will continue to play. Why should we take an industry like our fine industry, which is the high standard in the world, and say that it is going to be made an economic pariah for investment?

In Canada, they have enacted legislation so that an individual can deduct the entire cost of purchasing Canadian film in the years of the investment to stimulate Canadian production. England has subsidized and is looking for more of the major companies from around the world and also our film industry, by the way, to subsidize.

Ours, which has the best and finest technicians and the finest performers in the world, is being shut off by legislation.

Senator CURTIS. I appreciate your comment.

I think the panel has done a very fine job. I would like to ask you if what the House has done becomes law, will it add to revenues in the United States Treasury? Will it increase employment in the United States? Will it promote business?

Mr. MARCUS. If what the House has adopted becomes law, it will cut production, cut employment, cut revenues to the Treasury, and is economically unsound in any long-range view at all.

Senator CURTIS. It has been a very splendid panel.

If I were to criticize it at all, it would be that where you enumerated all the places where you have motion picture activity going on, you had a quorum of this committee, but you left out the choicest place.

Senator HARRY F. BYRD, Jr. Did any of your colleagues have an opportunity to present your viewpoint before the House Ways and Means Committee

Mr. MARCUS. Senator Byrd, as you have heard, the industry is not a traditionally organized industry. It was only when the horror of the House bill and its effects became apparent that we were able to get ourselves united. Unfortunately, we did not at that time.

Senator HARRY F. BYRD, Jr. So the House committee acted without the benefit of the viewpoint of the industry which is being affected by this?

Mr. JAFFE. Yes; that is correct.

Senator HARRY F. BYRD, Jr. Senator Bentsen?

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

I find the testimony very interesting. It certainly shows the value of the industry, but I never had any question about that. My disappointment is that you have not gone into more detail as to what tax abuses have occurred and what we can do about them.

I am interested in trying to have equity in the tax system. Now, I have no doubt at all about the various ways in which your industry makes a contribution to our country in the way of culture and em-

ployment. But I assume that the tax inequity and the problems come about because of overuse of nonrecourse financing. I would guess that it's a question of leverage and how far that is used.

As I understand your proposal, it is one that would provide a minimum of 25 percent equity in the deal. I would like a few more comments on that. I would like to know what you think we ought to be doing to eliminate the abuses.

Mr. MARCUS. First of all, a large portion of the abuses are these transactions that are really economic shams. They have no economic relevance to the world. Somebody will buy right in the United States a foreign film that has no value for $5,000. They sell it for $150,000 in hand and another $1,400,000 in a nonrecourse vote, when everyone knows that the value of that foreign language film is commercial exhibition in the United States is zero.

That is nonsense. That is not a viable transaction on an economic basis. There should be no incentive. It does not help our economy. It does not really do anything. It is a sham.

All of the problems in this business in terms of abuses are functions of two interacting things, the period to repay the amount of the loan, at which time every bit of income must come and the degree of leverage. By providing minimum investment requirements for example, 25 percent of the cost of film—and limiting the period of deferral—for example, 0.5 from the first commercial exhibition. These things can be eliminated. We have worked very hard to take away that leverage, to take away the long-term deferral.

So there is no way that somebody who has any sophistication could go into a transaction until they thought they could profit by whatever incentives exist by virtue of the cash methods that exist for every other business. This does not accelerate any of these things. It really is a real economic transaction and that has been proved.

In how many tax shelter areas that you have talked about are there situations where within 5 years that the investor will profit in terms of a million dollars? These are economic transactions of investors investing in excess of $150,000. They are advised by the best lawyers and they are advised by the best accountants. They are not going to go in solely for tax benefits that really are of themselves illusory in terms of profit potential. There is no way to profit solely from taxes.

We also wanted these incentives only for domestic productions, for honest productions to keep jobs for our people.

Senator BENTSEN. At least 80 percent would have to be.

Mr. MARCUS. Eighty percent here.

Senator BENTSEN. Recapture in 5 years.

Mr. MARCUS. Five years. That would be deductions taken into income in that time period. You see, LAL was for a long term, net the 20-year, 30-year period and a long-term mismatching of income and deductions. It maybe is fair in that context the accelerated deductions—for example taxes and interest during construction—are used to create long-term mismatching of deductions and income. You can deduct them before income is produced and you get 20 years or more income thereafter. It is the same with real estate, the same with construction. By statute, they are deductible. You still come out with 20- or 30-year assets.

In a film in our transaction, 100 percent of whatever income could be realized will come in in 5 years. That is not a long deferral.

Senator BENTSEN. I think you have made a good point. Getting bank financing for this type of thing today, with the problems the banks have had in trying to clean up their tax shelters, they are not going to keep making this type of investment. This would limit production to the very major companies.

Miss NOLAN. Right.

Mr. HIRSCHFIELD. Senator, if I may, also for some reason we have been treated with the brush that every time the subject comes up, some fellow will scream, "Pornography." So just for your knowledge, the pornographic picture runs in the neighborhood of $25,000 to $75,000 to put together. I don't know of any that have been financed with so-called tax deferral systems.

We would, if we could, suggest in a bill that their exclusion be made but it is our understanding that this would abridge some of the first amendment problems. So we cannot suggest it, but we would like to suggest it as a practical matter. This is not going to curb the making of pornographic films; it is not going to help pornographic films.

I also want to make quite sure that it in no way bears any relationship to what we consider the American film business to be.

Senator BENTSEN. Thank you, Mr. Chairman.

Senator HARRY F. BYRD, Jr. The Senator from Maine, Mr. Hathaway.

Senator HATHAWAY. Thank you.

Mr. Marcus, you said that this is really not a tax shelter, yet right here in Variety, February 25, this year, one article is entitled, "Columbia Gets Credit Extension Dollars," and it suggests that Columbia has relied on tax shelter financing. Then in another issue—let's see—this is the same issue of Variety, there is an advertisement here that goes like this, "Feature Length Hardcore Gay Film," U.S. world rights available, tax shelter, million-dollar gross potential." Also you mentioned the point that the movie industry was not doing very well, yet the Wall Street Journal in August of last year says in part—and I will put the whole article in the record:

"That at a time when corporation liquidation is under extreme pressure, movies are reducing long-term and short-term debts." This article goes on to say that movie companies are totally free of outstanding bank debts. It gives MCA, Twentieth Century Fox, and says that they are particularly strong.

It goes on to say that it is not just because of the spectacular movies that are being produced. I assume a lot of that is due to the fact that you have a tax shelter provision that gives you an advantage over other businesses.

[The material referred to follows:]

MOTION PICTURE TAX STRUCTURE

I. POPULARITY OF MOVIE SHELTER

Business Week in its August 25, 1975 personal financial advice section featured a five page instructional article entitled "How to Invest in Movies." It stated that in the last three years movie shelters have suddenly become so

popular that about half of all films produced in the United States today are financed through shelter partnerships: "you can often buy into a film partnership for as little as $10,000—sometimes as little as $5,000—and anyone in the 50% plus tax bracket ($44,000 a year) is a candidate.

"Most of these partnerships have involved big money—$100,000 and up. But more and more that is changing. 'Certainly million-dollar investors are needed,' says New York film packager Stephen W. Sharmat, "but so is the $10,000 man.' Sharmat has three partnership deals in the works: Breakheart Pass starring Charles Bronson, Carmella with Liza Minelli and Ingrid Bergman, and The Killer Elite with James Caan."

The Great Gatsby, For Pete's Sake, Fritz the Cat, Funny Lady, Shampoo, Bite the Bullet,. and Day of the Locust have been among the more successful shelter vehicles.

Since each feature movie usually costs anywhere from $1 million up to an occasional $10 million or more to produce and only a few dozen features are distributed each year the cost to the Treasury is less than other shelters. But the availability of this exotic loophole to the wealthy few is being increasingly publicized.

II. TWO BASIC TYPES OF FILM SHELTER

(1) Business Week extolled film shelters as follows:

"Before 1972, about the only time for individuals to invest in a film was after it was finished, the original financing having been done by the banks, studios, and distribution companies. Using an "amortization purchase," an investor—as an individual or a partner in a syndicate—bought a capital asset (the film). The tax break was the write-off over the seven-year life of the film. That form of investing is still very much alive. What is new today, though, is the service company partnership.

Such a partnership is formed before the film is ever made. And it contracts not only to finance but also to produce the film, subcontracting the actual movie-making chore to a production company and the distribution to a film distributing company. Thus, what you buy is not a capital asset but a share in what the Internal Revenue Service calls a "going trade or business."* What makes the share so valuable is that the partners typically put up only 25% in cash, borrowing the rest from a bank (Bank of America, First National Bank of Boston, and Chemical Bank in New York are the big movie lenders), but still can write off the entire cost of the film, usually within one year. The result is a 400%-of-investment writeoff—a tax shelter that ranks with the best that real estate, oil, or cattle ever offered.

Furthermore, the promissory note that the partnership gives the bank in return for the borrowed 75% is nonrecourse, meaning that it can be collected solely from movie receipts and will not attach to the partners personally. "We rely mainly on the credit worthiness of the film distributing company and usually charge one or two points over the primate rate," explained a vice-president of Chemical Bank.

If the picture fails to make a profit, you have your front-end tax advantage. Whether it makes money or not, your deduction will eventually be recaptured by the IRS, but not for several years. Usually the present value of the tax shelter far outweighs the later tax.

If you are lucky and pick the one movie in 10 that becomes a real hit, you may make a windfall. It happened to Daniel J. Riviera, a Seattle lawyer who tired of the stock market in 1972 and got interested in films. Riviera bought a 10% share in a low-budget film called *The Harrad Experiment*. The movie did well, and today Riviera says he will get back $100,000 for the $20,000 he put up. "I was looking for a shelter and hoped I'd get my money back, too," he explains. "I nearly fainted when the picture did so well."

The partnership acts just as a general contractor does in real estate construction. It winds up with no ownership interest in the film which it has been paid to put together.

(2) Business Week recommends: Consider the tax side. A production-service investment is best in a year in which you have a big jump in income and can benefit most from taking a very large write-off in that year. Conversely, an amortization purchase spreads your tax benefit over seven years, with the biggest advantage gained during the first three years.

III. ADDITIONAL ABUSES

Forbes Magazine (August 15, 1974, "A Loophole for (Greedy) Pigs"), described how the first type of 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 requirements, 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 payoff 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.

IV. TECHNICAL EXPLANATION OF ASSET PURCHASE

(1) Purchase of the rights to a film within a specified territory (e.g. the United States) is the purchase of an equity interest in a depreciable capital asset.

(2) The partnership can write off as depreciation the entire amount paid (including the portion paid for by issuing a note rather than cash) less salvage, provided it can prove it did not pay more than the film could arguably be worth. The possibly huge variation in revenues yielded by ostensibly similar top grade films (from a few hundred thousand to over 100 million dollars) facilitates exaggeration.

The factors to be considered are projections of potential revenue from the film based on the story, the stature of the stars of the film, review of the negative cost of the film, comparison of revenues of comparable pictures, consultation with experienced motion picture distributors as to the value of the film and their interest in distribution of the film, appraisal of fair market value from experienced independent motion picture authorities showing a reasonable chance of commercial success, certifications by the seller if he is the producer of the actual production costs of the film and a comparison of these costs with the purchase price, and independent parties engaging in arm's-length negotiation and dealing.

(3) Film owners may choose the same accelerated method of depreciation as other taxpayers. In addition they may use the income forecast method. Here the deduction is computed by multiplying the cost of the film by a fraction having a numerator equal to the net receipts from the film for the taxable year, and having a denominator equal to the estimated total net receipts to be derived from the film. For example, if a film costing $1,800,000 has produced in its initial year net receipts from rentals after distribution fees and expenses of $1,500,000 and it is expected that the film will produce total net receipts of $2,500,000 during the life of the film, then the depreciation expenses would be

$1,080,000, assuming there is no salvage value. The $1,080,000 is determined as follows: $1,500,000 (net receipts from the film in taxable year) divided by $2,500,000 (estimated net receipts to be derived during useful life) x $1,800,000 (cost) = $1,080,000.

This method could throw almost the entire writeoff into the first 2 or 3 years since by then, most films will have been fully exhibited and sold to television.

(4) While the IRS had disallowed attempts to take the investment credit on films the Committee reports and floor debates accompanying the Revenue Act of 1971 are now regarded as a clear indication of legislative intent to allow the credit.

(5) Also under the 1971 law if the useful life of any asset for depreciation is three years or more, one-third of the credit is taken—if it is five years or more, two-thirds—and if seven years or more 100%. The Conference Committee report states that as to films, if the income forecast method is used, the depreciation without affecting the credits' availability. If not more than 76% is to written off over 3 years and not more than 97% is to be written off over 5 years, the film will be deemed to have a 7 year life and qualify for 100% of the credit. If the write off is not more than 94% over 3 years, a 5 year life is assumed—and hence, a two-thirds credit.

(6) The code allows no credit if an American made film is used predominantly outside the United States but some purchasers of the rights to distribute foreign-made films in the United States have claimed the credit on the cost paid for negatives. Past proposals put before the Committee would limit the credit to production costs incurred in the United States.

(7) If the film is later sold outright, section 1245 recapture applies—i.e. proceeds will be ordinary income up to the amount of all depreciation previously taken and only the remainder, if any, will be capital gains.

(8) The need to report this ordinary income can be postponed by continuing to lease the film (or at least offering to lease it). This is done where the value of the film has been inflated to boost the writeoff. Sooner or later it will become apparent that revenues will not be sufficient to pay off the note and the supposed lender will have to foreclose on the due date. But responsible practitioners have used notes with maturities of 10 years or more—often with options for further renewal or extension—to postpone income recognition.

(9) The funds representing taxes saved as a result of the shelter can be invested for 10 or 20 years. At 6% compounded interest a sum will triple in 20 years.

In past years the Committee considered the following illustration of the value of deferral in a film shelter:

Cost (cash $200,000, mortgage $1,800,000)	$2,000,000
Projected revenue over lifetime	500,000
1st year:	
Revenue	400,000
Amortization	1,600,000
Tax deduction	(1,200,000)
2nd year:	
Revenue	100,000
Amortization	400,000
Tax deduction	(300,000)
Investment:	
Cash	200,000
Economic profit (all cash invested is lost because film is unsuccessful at box office)	(200,000)
Tax loss	(1,500,000)
Present value of tax benefits at 60 percent bracket and 6 percent interest	890,000
Amount recaptured in 20 yrs	1,300,000
Present value of recapture at 60 percent bracket and 6 percent interest	287,000
Net tax benefit	603,000
Excess of tax benefit over lost investment	403,000

V. TECHNICAL EXPLANATION OF SERVICE PARTNERSHIP

(1) The service partner acts as a general contractor—just as a real estate contractor. Neither takes title to any finished product—either a building or a film—so no expenses need be capitalized. Each hires subcontractors, e.g. plumbers or actors and producers, and immediately deducts all sums paid to them under the cash method of accounting.

(2) The partnership gets a distributor to guarantee that it will pay a stipulated price for a completed picture. Given this guarantee banks will loan the partnership most of the funds to pay the subcontractors.

NEED FOR SUBSIDY

(1) Hollywood should follow the example of Broadway. As Business Week noted:

The Broadway theater is booming. The 1974–75 season that ended last May topped the previous season's take at the box office by nearly 18%. The gross for Broadway itself plus shows on tour came to more than $108 million, the highest ever. Anyone who wants a show business investment just might hit it big by backing a straight play or a musical. In the bargain, you may even make a break into the movies. A half-dozen Broadway shows each season are made into movies. And you can take a shot at Broadway with as little as $500.

But investing in Broadway is not investing in Hollywood. The sharpest contrast: "Nobody has even been able to apply the leveraged tax-shelter idea to the theater," says Morton Gottlieb, producer of such hits as *Sleuth* (three-year stage run with profits of $2.6 million) and the smash, *Same Time Next Year*, starring Ellen Burstyn.

"People invest in the theater on a straightforward basis," Gottlieb adds. "If a show is a hit, they make money. If it fails, they write off their actual dollar loss, nothing more."

(2) The Wall Street Journal, August 26, 1975, carried the following headline:

Movie Stocks Gain in Appeal as the Industry's
Improving Strength Points to Good Earnings

The Journal stated:

"Analysts credit the 'improving fundamentals' in the motion picture industry with attracting Wall Street.

Movie stocks outraced the market averages through the first half and posted new 1975 highs in July, which analysts concede was partly due to the general surge of stock prices. But they also assert that movie companies have been improving their internal structures, making earnings prospects for 1975 and 1976 extremely good.

"At a time when corporate liquidity is under extreme pressure, the movie industry is reducing its short-term and long-term debt," says Benjamin K. Aurand, analyst at Becker Securities Corp., Chicago. "Some of the movie companies are totally free of outstanding bank debt," he adds. He believes MCA and Twentieth Century Fox are "inparticularly strong financial positions and are expected to outperform the market well into 1976."

It isn't simply that spectacular movies produced recently are boosting the industry, says Arthur E. Rockwell, analyst at Sutro & Co., San Francisco. "It's the combination of fundamental developments in the industry over the past few years that is beginning to catch Wall Street interest."

"The across-the-board improvement in the industry's profits is in contrast to corporate profits generally," he says, and "we expect this trend to continue at least well into 1976."

Mr. MARCUS. May I respond, starting at the last point.

Two companies that you mentioned, MCA and 20th Century Fox, do not use this financing, so that has nothing to do with it. The reality is that MCA is a very large conglomerate corporation, and 20th Century Fox is a very heavily capitalized asset-based company. That is the reason that they do not use it. They have done better but

there are sources of revenues that are much more diverse in our industry.

With regard to Variety, its characterization of "tax shelters," I think that all they did was pick up on the language and publicity that has been generated during the House hearings and pick up the words, "tax shelter" and use them as a name for a type of financing that they were doing. I think that it is the kind of thing that if he says it is true, and you say it is true: it must be true. Everybody uses it.

In Variety, they are somewhat colorful and less than conservative. I think that was viewed in that flavor in terms of dramatic profit in the film industry. Sure, "Jaws" did gross well, in excess of $100 million, but how many films have grossed that? I do not think there are any; perhaps "Towering Inferno" did, but what you are doing is picking out two or three projects and ignoring the fact that there are a lot of others that just do not become that much of a reward situation but that create huge numbers of jobs for our people and really put money into the economy very quickly.

There are situations where we should not provide incentives. There are the situations where a film is made abroad. It is probably a piece of garbage, I don't know, but you have somebody saying: "Hey, come make a tax shelter investment, promoters, and make some money out of promoting a tax shelter." That is wrong. We very, very strongly want to eliminate that.

Senator HATHAWAY. Well, you are saying that you are getting some kind of a tax break; otherwise, you would not be here.

Mr. MARCUS. I am getting the same break that any taxpayer who operates on a cash basis accounting system gets. There is no statutory benefit that is provided for our industry or that is used in this type of transaction. It is a normal cash basis accounting system that we are using. That is all we have. We do not have any statutory provisions.

Senator HATHAWAY. Why are you making the suggestion that we limit the amount of equity to at least 25 percent and recapture for 5 years? Why don't you leave it the way it is?

Mr. MARCUS. Because I would prefer that the people that tend to abuse the economic laws in their transactions not be able to abuse it. We think that the Internal Revenue Code deals with those transactions, but we feel that it is important that the tax laws not be abused in a money market that we worked very hard to create.

Obviously, what we have seen in this legislation is that the more abuses there are, the more desires there are to get rid of them legislatively and/or administratively. We would rather have a scalpel approach rather than a meat ax means to an end.

Senator HATHAWAY. In the example that you gave earlier about the $10,000 cash investment, plus the $50,000 money that was borrowed, you mentioned that the House bill would not allow you to take any more than 50 percent. You do mean 50 percent of the $50,000 and not of the $10,000?

Mr. MARCUS. That is the House—the example, if I can articulate the example a little more, the example that was given was $10,000 cash and $50,000 borrowed. I assume that the borrowing did not

mean on a recourse borrowing. The first thing that the House bill would eliminate in any fashion would be the tax effects of nonrecourse borrowing entirely. It would eliminate it for film even though it would remain available in real estate where higher leverage ratios and longer term deferrals are the norm. It is available in every other segment of the economy, with the possible exception of sorghum and cattle breeding.

Second, the LAL provision would limit deductions solely to income from a particular film. No other film, no other businesses, as a result of the film—you really would not bet any deduction at all until the maturity of the debt. We do not feel that we should be singled out so selectively for that type of treatment.

Senator HATHAWAY. But you would not mind if we did it for everybody?

Mr. MARCUS. I would have to analyze what the proposal was, Senator Hathaway. I am just not good enough to comment. I know that this does discriminate against us. I think that if the economy had time to prepare for your proposal that, it might be perfectly fine, but to pick us out and say that we are going to get you as a starting point—we think it is unfair.

Senator HATHAWAY. But if we phased it out over a period of 10 years?

Mr. MARCUS. If you phased everybody else also.

Senator HATHAWAY. Well, if we eliminate all these loopholes in the brackets of 42 percent rather than 50 percent, make the lower bracket only 7 percent, the lowest bracket——

Mr. MARCUS. It would have to be because this is a whole tax system moving this way, not that you are going to do it to the film industry. The other side of that position is that someplace, somehow this country is going to have to attract risk capital into its economy and limiting incentives that have been very successful, incentives that have not been any special industry benefits, special statutory provisions just to deduct losses, if it occurs, and if you foreclose all the incentives in the interest of tax symmetry, I think you will end up with an economy that is quite rigid and stagnant. Risk capital comes from individuals.

We do not really regard that as favorable.

Senator HATHAWAY. Maybe it would be better by a direct appropriation that doing it this way. Taxpayers in general do not understand tax shelters.

Mr. MARCUS. I am not sure that that is really a fair way of dealing with something as complex as the tax legislation.

Senator HATHAWAY. Thank you very much.

Mr. D'INZILLO. Senator, I would like to make a point that the unions are not here to say that the industry in any way does not want to pay its fair share of taxes. We are here because we are convinced from our experience in sitting down with individual producers and financing the cost of production, and you get to know some of the problems in financing the picture as a whole and, therefore, we are convinced of the legitimacy of the problem of financing that motion picture.

Now, we know the problems that the companies have as a whole in attracting risk capital. We know from our own experiences—my

own local union has been reduced to a total of 1,400 in the membership from a total of 2,400 only because of the loss of jobs, the closed theaters. I think we should take note of the fact that most of the hardcore pictures require very little capital. They are made in all kinds of little hideaways, private apartments, cheap hotels, and things like that.

I am sure that everyone knows where that money comes from I do not think——

Senator HATHAWAY. And there is no clothing expenses.

You mentioned Twentieth Century Fox.

Mr. MARCUS. MCA.

Miss NOLAN. Universal.

Senator HATHAWAY. They do not use these devices. I thought that you said it was going to hurt the whole industry. How much of the industry is going to be affected?

Mr. MARCUS. We just did a survey in November. We found that six distributors that we polled, something like 62 out of 115 films were financed.

Senator HATHAWAY. Financed which way?

Mr. MARCUS. This way.

Senator HATHAWAY. Do you know what that amounts to moneywise?

Mr. MARCUS. I think the number was something like $20 million to $30 million.

Senator HATHAWAY. And 62 out of 115 films; some of them may have been very brief.

Mr. MARCUS. Let me suggest something out of Hollywood in Variety 2 weeks ago. The industry this year, the industry being our industry, would make between $100 million and $125 million at a cost of $400 million and $450 million, which comes to an average of $4 million per film. When you compare that to the price parameter of pornographic pictures, $25,000 to $75,000.

I think that the survey that we did in November, it may have been $39 million in financing that was projected. We are just not sure.

Senator HATHAWAY. That is not significant.

Mr. MARCUS. If you happened to have a role in that picture——

Senator HATHAWAY. If it is only $40 million out of $150 million.

Mr. MARCUS. First of all, the money market in films is new, perhaps 2 years old, on a rational money market basis where meaningful amounts of dollars have flowed into the production and so a lot of people are trying to learn how to use it. Columbia started using it on a business basis before most of the others.

So 100 percent of our films are financed in this way. Others have been increasing their percentage as they have learned how to use it, and these people who are capable of financing have been attracted to the money market. So you have an evolving situation.

Miss NOLAN. May I say something?

You are talking about Universal and Twentieth Century Fox. You are talking about "Jaws" and "Towering Inferno," and those are two very large films. They had very large profits. There were not that many actors used in either one of those films, a fish and a building, but what happened is that these companies that do not

need this kind of outside financing make a picture like this. They do not need to make 15 or 20 films that use the talents of the industry.

They do play upon the excesses of what we are dealing with in this country. That is why labor is supporting what has come to be known as "the Columbia plan", because Columbia has dealt with the abuses, and labor traditionally, I would think, would go along with reform in every way.

We have supported what they have come up with because at least it does deal with cleaning up some of the abuses along the way and yet not eliminating the entire tax deferral.

Senator HATHAWAY. Fine; thank you very much.

Thank you, Mr. Chairman.

Senator HARRY F. BYRD, Jr. What is the effect of the New York City Bar Association limit on the use of tax preferences as it might apply to your organization?

Mr. MARCUS. Senator Byrd, I have only had an opportunity to review it. I have not had an opportunity to really analyze it thoroughly. Based on the limited review that I have done, I think that it is probably a better way of going than the House bill.

What I would add to that, however, is that you also have to define what the preference is. At this point, under the House bill, it is defined as to all deductions in the case of film. That is discriminatory, and if all deductions were defined as preferences in the case of film, we find that to be discriminatory toward us

If that proposal were adopted, if you carved out and limited the exceptions in accordance with our proposal, and said that everything else got thrown in, I think that would be fair. It is a way of reforming the abuse, but stll allowing venture capital market to exist and still keeping some normal type incentives for the investor to take a very heavy risk.

Senator HARRY F. BYRD, Jr. How many production employees does the motion picture industry have now, roughly?

Mr. ROBERT. Including the Talent Union?

Mr. DIEHL The number of employees?

Senator HARRY F. BYRD, Jr. Yes.

Mr. DIEHL. We represent 61,000.

Miss NOLAN. I represent 32,000 plus writers and directors, and that would be another 10,000. That does not include New York as far as the writers are concerned or parts of the rest of the country.

Mr. DIEHL. There are a great number of unorganized people who are film makers, and such, and I would say that the employment situation in this country, including motion picture theaters, is somewhere between 300,000 and 500,000 people. You will never get a clear figure, because it is the type of thing where people come and go.

Senator HARRY F. BYRD, Jr. How does it compare with, say, 20 years ago?

Mr. DIEHL. It is less.

Senator HARRY F. BYRD, Jr. Substantially?

Mr. JAFFE. Very substantial; yes.

Mr. DIEHL. You take our motion picture industry in Hollywood alone, due to the differences in the work, the automation, the changes in the equipment that is being used, our people in the studios are down vastly from what they were.

Senator HARRY F. BYRD, Jr. Mr. Marcus, would you want to submit for the record a more detailed view of your appraisal of the New York situation?

Mr. MARCUS. I certainly will; yes.*

Senator HARRY. F. BYRD, Jr. Mr. Roth, you mentioned that you managed a theater in Elkton, Va. If my memory is somewhat accurate, Harry and Sam Roth owned the Virginia Theatre in Harrisonburg.

Mr. ROTH. Yes, sir, the State Theatre. They are both my uncles and I managed that one, too, and read the Daily News Record every morning.

Senator HARRY F. BYRD, Jr. Do you still read it?

Mr. ROTH. Yes, sir.

Senator HARRY F. BYRD, JR. Very good.

I would like to thank all of you.

Senator HATHAWAY. I have no more questions.

Senator HARRY F. BYRD, Jr. Thank you, gentlemen and Miss Nolan, very much. It has been a very interesting panel.

[The prepared statements of the preceding panels. And the submission referred to above follows. Oral testimony continues on p. 703]

STATEMENT OF LEO JAFFE, CHAIRMAN OF THE BOARD OF COLUMBIA PICTURES INDUSTRIES, INC.

Mr. Chairman, Senators, my name is Leo Jaffe. I am Chairman of the Board of Columbia Pictures Industries, Inc. and Chairman of the Committee for American Movie Production.

My associates and I would like to express our sincere thanks to the committee for alloting us this valuable time to examine a problem that is plaguing the motion picture industry. Hopefully, with your help, we can get some measure of relief for a situation that is of critical importance to every segment of our industry.

For more than 45 years, I have been involved in motion picture production, financing and distribution. What you are witnessing here today, Mr. Chairman and Senators, is a "first" for our industry. For it is the first time that producers, distributors, exhibitors, and the craft, technical and talent unions and guilds are united on a single issue.

What is this issue that is so compelling that these natural and long-time adversaries would put aside their traditional differences and speak as one voice? The issue is the tax legislation that would eliminate limited tax incentives for investment of risk capital in motion picture production.

The reasons we are all united is that we—as well as the American public—will all be the losers if such legislation is allowed to pass.

The American motion picture industry reaches across the entire fabric of our country's economic, cultural and social life. As many colleagues in the industry will demonstrate here today, the movie industry is vitally important for the economic well-being of many hundreds of thousands of American workers and taxpayers. And I would like to point out that what we are talking about is not limited to a single region of the United States. Motion picture production is no longer confined to Hollywood and Burbank—but reaches across the country.

At a meeting recently held in Denver, Colorado, called by the Governor of Colorado, 28 states sent representatives of their film councils to the meeting. There they voiced their strong concern about the pending legislation before this committee, and they have joined forces with us on this issue because they recognize that the loss of risk capital means a further loss of film production in their states. For example, the great states of Colorado, Arizona, Louisiana, Georgia, Texas, New York, Ohio, Oregon and others have, in recent years, seen millions of dollars enter their communities through motion picture production.

The higher earnings being reported in the industry by various companies

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*See p. 691

have, by and large, been generated from a handful of pictures like "Jaws," "The Towering Inferno," "Earthquake" and a few others. These figures also include the revenues that were received from sources other than motion pictures, particularly in companies that are broadly diversified or those which are part of larger conglomerates.

But the motion picture companies who are virtually entirely dependent on motion picture production and its by-products have suffered severely in recent years.

The number of pictures produced has been reduced drastically. When more than 400 features were distributed about 20 years ago—that number has dropped to approximately 180 in 1975. This production would have been further reduced if not for outside financing that has been encouraged by current tax incentives.

These tax incentives are now in jeopardy and could eliminate independent financing and investment in pictures. With the knowledge that production is now at its lowest point, the inability to have access to such money will further jeopardize the economy.

Theatres have already been badly hurt—labor is being destroyed in the process. Hopefully, after hearing my colleagues, you will have a better understanding of our situation and, if possible, will help us eliminate the present chaos that exists in many quarters of our industry.

If you will permit me but another moment, I would like to point out that all major countries are today offering substantial subsidies and emoluments to induce American producers and creative talent to their shores. Also bear in mind that the motion picture industry has earned more than $500,000,000 abroad, and has returned approximately $375,000,000 in favorable trade balances to our country.

The words "tax shelters" have taken on an ominous note. Actually, what we are recommending is that investment in film retain the same incentives accorded venture capital investments in other areas of the economy. The government will not be deprived of a single dollar of tax revenues. Instead, under our Industry proposal, additional tax revenues will be created.

We want to keep our production here, utilizing American labor, not only in Hollywood, but in many states throughout the country. We have the talent, the technicians—and the audiences ready to see our product. But a healthy motion picture industry is dependent on the availability of risk capital. And our industry is united on this issue because its very life depends on it.

Thank you.

At this time, I would like to introduce Burt Marcus.

STATEMENT BY BURTON S. MARCUS, VICE PRESIDENT AND GENERAL COUNSEL OF COLUMBIA PICTURES INDUSTRIES, INC.

I am Burton Marcus, Vice President and General Counsel of Columbia Pictures Industries, Inc. I speak on behalf of the Motion Picture Association and the Committee for American Movie Production which embraces every group comprising the Motion Picture Industry of our country.

Film is a great and valuable industry in which more than 300,000 of our citizens are directly involved—one which has contributed an indigenous American art form to our citizens and to the world, and which has made an enormous economic contribution while utilizing no resources other than the intelligence, creativity and skills of our people. Our industry has brought the impact of our culture to every corner of the world which has responded by buying the exported products of our economy. Our industry contributes directly to the economy of virtually every city and town wherever a movie theater is. Movie production has also become a national business. The $400,000,000 annual film production expenditure is shared by many states such as Arizona with 19 films during the last few years and Georgia with 20 films. Louisiana, New York, New Mexico, Colorado and Oregon have also shared significantly in the economic benefits of film production. The trend is likely to increase with more and more production outside of Hollywood.

We are not here to talk about so-called "tax shelters". We are here to object categorically to the discriminatory treatment accorded film investment in the

LAL provision of H.R. 10612. Whereas in each of the other areas—real estate, oil and farming, the House Bill merely limits certain accelerated deductions flowing from special statutory incentives; in the case of films, the House Bill aims at and would succeed in eliminating all film venture capital investment by foreclosing the usual ability to offset any deductions against income. Again, we are not addressing statutory incentives such as intangible drilling costs or accelerated depreciation—we are talking only of the ability to offset income with deductions under normal accounting and tax accounting procedures.

For what policy reasons should LAL affect all deductions from film investment, when LAL was created to affect only selected accelerated deductions provided by statute in the case of real estate, oil and gas, and farming? The effect will be end any venture capital investment in film. An investor will not undertake a high risk investment in film where he cannot offset losses against other income in the usual manner; when alternative investments with lesser risk provide the ability to ofset losses against other income. Why should investment in film be subjected to such gross discrimination under our tax laws?

The film investment effecteively precluded under the House Bill generates incremental film production. Theater owners are already suffering from the dramatic contraction of the number of films in distribution each year, and some have been forced to exhibit exploitation films simply because there was not enough quality film to attract sufficient attendance to mete obligations.

Moreover, the Treasury benefits from risk capital investment for incremental production. On the first thirteen films which we released that were financed with outside risk capital, we will return to the investors a profit exceeding $2,000,000—and hence the investors wil lrecognize that much more taxable income than they deducted. But this represents only a small part of the Treasury profit. If we can attract $15,000,000 in investment for incremental product, almost 70 percent of that (or $10,500,000) will flow immediately into direct wages, in an industry beset by shocking unemployment levels. Moreover, if these films do nothing more than breakeven, they will generate approximately $33,750,000 in film rentals for us. An additional $50,625,000 will be left in the local economies around the country, because we receive less than 40 percent of every box office dollars as film rentals on average. Additionally, at least another $20,000,000 may have been spent for advertising in the local economies. Thus, the $15,000,000 of venture capital investment will have generated more than $100,000,000 in revenues for the economy directly, much of which will be generated within a relatively brief period after initial exhibition. This is without giving any effect whatsoever to significant peripheral revenues from food concessions, any multiplier effect of the movement of the new money in the economy or to the many neighborhood businesses that depend upon theater traffic for income. The profit that must follow from the venture capital initially attracted grows quickly and dramatically to the benefit of the national economy and the Treasury.

Why, then, should investment in film production be discriminated against under the House Bill? Let u sdispense once and for all with the shibboleth that venture capital investment is used to make pornographic films. For example, DEEP THROAT cost $25,000 to make and had an assured profit potential. That is not the high cost, high risk venture capital investment the House Bill would eliminate. It is estimated that the industry will produce approximately 100–125 quality films this year at a cost of between $400,000,000 and $450,000,000,[1] which represents an average cost per film of approximately $4,760,000. It is simply not rational to eliminate venture capital in our industry simply because some tiny trickle of funds into pornographic films. Moreover, adoption of the House Bill to eliminate venture capital investment in quality films would inevitably reduce production of quality films, increase the quality film shortage facing exhibitors and thus effectively increasing the market for exploitation films.

Next let us examine the possibility that in certain transactions the tax laws have been abused to structure transactions in which investors can "profit" from the tax consequences without reference to the economics of the investment. The existence of an abuse in a money market gives reason to reform the abuse —not to eliminate the money market. The abuses of the securities markets during the 1920's were not reasons to eliminate the securities markets in the 1930's.

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[1] Estimates in the March 1976 Variety.

In the case of film investment we must relate the means of dealing with the abuse rationally to the end of eliminating the abuse and not eliminating the money market. If the tax abuses can be eliminated without disturbing the rationally structured money market, there is no reason to use the tax laws in a discriminatory manner to prevent our industry from attracting venture capital on the same terms and with the same tax consequences as pertain in other industries.

Whatever abuses that might exist in film financing may be easily eliminated. The potential for abuse derives solely from the interrelationship of two factors—leverage and the length of the period before deductions must be returned to taxable income. The degree of leverage is the ratio of invested cash to borrowed money. The period before recapture relates solely to the length to maturity of the loan. If the maturity of the loan is sufficiently short (e.g. it must cash) and the period to maturity of the loan is sufficiently short (e.g. it must be repaid by the end of the fifth year after the film is first exhibited), the potential for tax abuse is eliminated because the tax benefit is so small in relation to the magnitude of the investment that tax benefits alone would not approach recovery of the investment. The value of tax benefits would, thus, assume the proper proportion within the symmetry of the Internal Revenue Code, i.e., merely cushion the economic loss in a high risk venture capital investment.

LAL is then not necessary. In addition, we suggest that the limited incentives remaining be available only for films produced substantially in the United States, so in order to attract investment and produce jobs in the American film industry.

Having seen that the potential for tax abuses may be eliminated easily, let us analyze the manner in which film investment is treated under the House Bill. For example, LAL is a concept that was tailored to limit certain long term mismatchings of income and deduction in real estate investments. These mismatchings arose under statutory incentives (deductibility of interest and taxes during construction and accelerated depreciation) and dramatically with ownership of an asset that would produce income over twenty to thirty years at the least. As applied to oil and gas, LAL was also aimed at statutory incentives (primarily intangible drilling costs) in the context of ownership of an asset that would produce income over ten to fifteen years.

In film investment financing there is no such long term asset, and there are no specific statutory incentives which accelerate deductions beyond normal accounting rules.[2] In a financing transaction where the investors acquire ownership of the film there are no accelerated deductions. Amortization is on an income forecast method pursuant to which the proportion of film cost amortized in each year is a function of the proportion of total income from the film realized in that year—a direct matching of income and amortization. Similarly in a transaction where the investors produce the film they own no asset subject to capitalization and all of the income to be realized is realized within five years after the film's first exhibition.

Given that LAL was structured to capitalize deductions which were accelerated by statute over the life of a long-term asset it is difficult to understand why the concept should apply to film investment where there is not such a long-term asset nor any statutory incentive providing accelerated deductions. The House Bill simply declares that in the case of film, all deductions for amortization, production or distribution shall be "accelerated deductions"—without regard to whether they are or not.

The "at risk" provision of the House Bill also have a similarly harsh and unnecessary impact. As Secretary Simon pointed out, "The 'at risk' limitation is premised on the assumption that the present tax treatment of non-recourse financing is unsound." That assumption is erroneous. Given the fact that non-recourse financing pervades every aspect of our economy—home mortgages in some states, commercial real estate, revenue bonds, etc.—and that its tax treatment is a fundamental concept of our tax system, the rationality of altering that basic concept should be subjected to open and intense analysis. Instead, the proposal in the House Bill would severely undermine that basic concept

[2] It is interesting to note that Secretary Simon, in his address to this Committee, indicated that he thought LAL inappropriate in application to sports business because "The Internal Revenue Code contains no special tax benefits for sports franchises." The same is true of film.

in order to strike "tax shelters". Such a revolutionary alteration of the basic concepts of our tax system is unnecessary. Moreover, we regard the selection of our industry along with one or two others for selective deprivation of fundamental tax benefits available to all other sectors of the economy as unfair and discriminatory. We cannot understand why non-recourse financing with fifteen or twenty year maturities should be permitted in real estate, where customary leverage ratios approximate ten to one, but not in film where these ratios rarely reach four to one and where the term to maturity runs only from four to seven years.

The "at risk" provision in the House Bill is so structured that were a producer—corporation or individual—of $50,000,000 worth of film in a yar to finance such production by collateralizing the borrowings with assets, he would not be permitted deductions accorded virtually every other business unless he agreed to assume liability that he would not otherwise assume. If the producer were a corporation, it could merely engage in the artifice of creating a shell subsidiary to assume liability and include that in a consolidated return. The "at risk" provision should be rejected.

We have seen that the House Bill discriminates against investment in film on both levels. Non-accelerated deductions such as straight line depreciation are available for real estate under LAL, but not for film. The "at risk" provision singles out film and one or two other areas of investment to be deprived of tax treatment otherwise available to every other area of investment. The House Bill would eliminate venture capital investment in film, but permits venture capital investment to continue in real estate and oil.

The object of tax reform should be solely to cure abuses by the most rational and least disruptive means.

We urge that "at risk" be eliminated altogether. We would further propose that LAL be adopted to deal with the aberrational or abusive transaction, but that it be made inapplicable to deductions from motion picture investments where all of the following conditions pertain:

1. A minimum of 25% of the cost of the film (the maximum amount deductible) is invested in cash. This will eliminate any incentive to inflate cost.
2. The amount of debt must be recaptured and taken into income by the end of the fifth year after initial exhibition.
3. A substantial portion of the film cost (e.g. 80%) must be expended in the United States.

This proposal will preclude the possibility of recovery of investment from taxes and will insure that any limited incentive is used to support our domestic industry and will support employment for our highly skilled workers.

Our industry is a valuable one for our economy and our country, and the availability of venture capital investment to our industry is critically important to every segment of our industry. If the availability of venture capital is shut off by restrictive and discriminatory tax legislation the inevitable result will be a further shrinkage in the number of films produced domestically and hence the number of films available for exhibition in our theaters.

While some major studios might be able to maintain the present level of production at least some would be forced to turn to production outside the United States to countries where meaningful subsidies and tax incentives for investment are available.

It is most important to note that the elimination of venture capital investment in film through tax legislation will inevitably lead to a further economic concentration of production. The proposed tax legislation would sound the death knell for the young filmmakers and independent producers who, although talented, have at least marginal access to capital markets.

If the incentives are rationally tailored as an inducement to risk investment—so that they cannot become an end—the economy will always benefit. If incentives for venture capital are curtailed only those with entrenched wealth will benefit and the power in our economy will become increasingly concentrated.

Submitted to the Committee on Finance, U.S. Senate, In Connection With Hearings On H.R. 10612

In testimony before the Committee on Finance, March, 1976, the Committee on American Movie Production submitted the following tax reform proposal which involves repeal of the "at risk" provisions in section 207 of H.R. 10612 and enactment of an exception to the LAL provision in section 101 of H.R. 10612.

LAL would not apply to a movie or video tape if—

(i) The investor makes a 25 percent equity investment at the outset;

(ii) Any nonrecourse debt is repaid or recaptured into income no later than the fifth year; and

(iii) The movie or tape is predominantly produced in the United States.

This minimum investment and recapture provision would eliminate all tax abuses and would assure that any investor could not profit from taxes.

The application of this tax reform proposal is illustrated by the following Cash Flow and Tax Effect Analysis.

CASH FLOW AND TAX EFFECT ANALYSIS

EXAMPLE OF PRODUCTION—SERVICE TRANSACTION

Production begins April 1976 and is first exhibited commercially in December 1976. The film production cost is $4,000,000.

1. First there is a commitment agreement with an individual pursuant to which the individual will finance and produce the film for $4,000,000.

2. The individual forms a limited partnership and the limited partnership interests are syndicated for $1,200,000 in equity in units of $120,000. Costs of syndication are $20,000 or about 20 percent of invested capital.

3. For services rendered this production-service partnership receives a fee in two parts;

(a) An amount contingent upon the performance of the film in exhibition. This contingent compensation may be a percentage of the gross film rentals, the net proceeds or a combination of the two, and is scaled to return the cash invested at the approximate break even point of the negative interest in the film. Film rentals minus (i) distribution fees and costs, (ii) union and guild payments, (iii) advertising and print costs and (iv) third parties (e.g. talent) participations if any-negative interest. After negative interest is recovered, there is net profit. The contingent portion of the fee terminates at the earlier of the following events: (i) the contingent portion totals $3,000,000 (three times cash invested); or (ii) 5 years from the first exhibition of the film:

(b) A fixed fee of $3,000,000 payable in three equal annual installments in 1978, 1979 and 1980. This may be in the form of a guarantee of distribution revenues from the distributor or in the form of letters of credit from foreign distributors. If the film is made for a major distributor who distributes worldwide, the distributor would commit to pay the $3,000,000 to the production-service partnership. If an independent producer is making the film, he might sell territorial distribution rights to domestic and foreign distributors and receive their bankable guarantees or letters of credit equal to $3,000,000. These would be utilized to pay the fixed compensation. Hence the total fee payable to the producing entity is $6,000,000 of which $3,000,000 is payable only out of proceeds realized from the film.

4. The partnership enters into a loan agreement with a bank. It pledges as collateral for its loan of $3,000,000 the fixed fee compensation and sometimes all or some portion of contingent compensation.

5. The partnership engages production personnel, pays production costs, and the film is made. The partnership's only interest is its right to receive up to the $6,000,000 fee for production and financing services. It has no ownership interest or other rights in the film or underlying rights. Upon completion, the film is delivered by the partnership to the owner.

6. Tax Consequences to Partnership:

(a) During the year or years of production (in our case 1976) the partnership, on a cash method of accounting, will deduct the amounts expended on the production (i.e., $4,000,000).

(b) Any amounts received by the partnership as contingent compensation will constitute taxable income at ordinary rates. Whether the film will begin to return income in 1976 or 1977 will depend partly upon the length of the period of production which in turn usually correlates with the cost of production. A $2.5 million film starting in April 1976 might be released initially in the period August-October 1976. A $4 million production could be ready for exhibition in the September to December 1976 period.

(c) The partnership will realize taxable income of $1,000,000 in each of 1978, 1979, and 1980 as the distributor guarantees mature and/or the loan matures.

7. Cash Flow and Tax Effect for Investor:

The following assumptions are made.

(a) An individual investor in the partnership invested $120,000, of which $100,000 went into the film and $20,000 to cost of syndication and administration.

(b) The individual is in a 50% tax bracket.

(c) The individual's annual after-tax cost of money is 5%.

(d) All events for tax purposes are effective at the time for filing a return in April of the year following the year of deduction or realization of income.

I.—The film returns no contingent compensation

	Cash
Year ending April 1976—Investment in film	—$120,000
Year ending April 1977—In 1976 the partnership will show no income and expenses of $4,200,000 which yields an after tax benefit to a 10 percent partner of $210,000	----------
Year ending April 1977—Cash flow	+210,000
Net position at April 1977—$210,000 tax benefit less $120,000 investment less $6,000 interest on $120,000 at 5 percent for 1 year	+84,000

For illustration ignore the fact that in the example fixed fee/loan repayments would be made in 1978, 1979 and 1980 and hence taxable income would be realized in each of those years. Assume, instead, that the partners take the maximum possible deferral, i.e., the greatest possible tax benefit permissible under the proposal. Hence the $3,000,000 would come into income in December 1981—60 months after initial exhibition.

4/82 the partnership has recognized $3,000,000 of taxable income on the fixed fee/loan repayment of which a 10% partner's share is $300,000. He must pay $150,000 tax.

In order for the net $84,000 left at 4/77 to grow to meet the $150,000 payment due 4/82 (at which point the investor will have achieved nothing but a break even on his investment) the $84,000 net left at 4/77 would have to grow at an after tax rate of 12.30 percent or 24.60 percent pretax. Short of that, the investor cannot break even—let alone profit from tax consequences.

II.

The film does nothing more than return $100,000 on the initial $120,000 investment ($70,000 of the $100,000 would be returned in 1977 and 1978 in equal amounts and $3,000 equally in 1979 and 1980).

	Cash
April 1976—Initial investment	—$120,000
April 1977—$210,000 tax benefit, —$120,000 initial investment, —$6,000 interest at 5 percent after tax	----------
Net April 1977	+84,000
April 1978—$35,000 income received 1977 as contingent compensation, $17,500 tax	+17,500
April 1979—$35,000 income received 1977 as contingent compensation, $17,500 tax	+17,500
April 1980—$15,000 received 1979, $7,500 tax	+7,500
April 1981—$15,000 received 1980, $7,500 tax	+7,500
April 1982—$300,000 noncash income from loan repayment and $150,000 paid in tax	—150,000
April 1982—Net cash position of investor (includes tax benefit and after tax income)	134,000
April 1982—Taxes paid on all items of receipt	200,000

Even here, where the investor has recovered $100,000 pretax of his $120,000 investment, his net after tax receipts and tax benefit will not equal the $150,000 tax required to be paid in April 1982

If each year through April 1982 the partner reinvested his tax benefit and cash receipts at a compounded annual after-tax rate of 5%, he would have generated an additional after tax return of $30,879 through April 1982 making a total net after-tax return of $164,879, and would come out $14,879 ahead after having made the last tax payment in April 1982. He would, however, have generated $230,879 of total tax payments.

Burton S. Marcus,
Committee For American Movie Production.

APRIL 9, 1976.

Mr. MICHAEL STERN,
Staff Director, Senate Finance Committee,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I devote substantially all of my time to the development, financing, production and distribution of motion pictures. Over the last three years, I have been involved in nine completed pictures in the capacity of producer, executive producer or associate producer, as well as raising financing. In five of these, all of the production financing was privately arranged. In four of them, part of the production capital was provided by distributors. All nine of these projects were initiated and developed by independent motion picture producers. In all cases, some of the capital involved private investment that received certain tax benefits. This money probably would have been impossible to raise if the investors had not received some tax benefits; and undoubtedly, some of the pictures would not have been produced!

Of the nine pictures, five are already in distribution, and in all five cases, the investors are assured that they will have a one hundred percent cash-on-cash return on their investment plus a significant profit. Of the four pictures not yet in distribution, three seem likely to fully recoup their cash budget cost and make a profit. To date profits have run as high on my pictures as 270 percent of initial investment. That 's a pretty good record—eight out of nine. And my investors will pay more taxes than they deducted.

The pictures I have done include some of the greatest film stars in the world—Elizabeth Taylor, Burt Lancaster, Robert Ryan, Jane Fonda, Ava Gardner, Robert Shaw, Shelley Winters, Richard Roundtree, Cliff Robertson, Genieveve Bujold; and some of the best creative, directorial and production talent in the world. These pictures have been filmed all over the world—Los Angeles, Dallas, New Orleans, London, Lenningrad, Italy and Jerusalem. The distributors include Twentieth Century-Fox, Warner Bros., Avco Embassy Pictures Corp., Columbia Pictures Corp., and American International Pictures. These pictures have been quality films. In most all cases, the most significant revenues have or will have been generated in the United States.

Though I am very pleased with this record, I realize that I could not have been able to accomplish this without the down-side protection of certain tax incentive benefits. Without providing potential investors with the down-side tax incentive protection as well as the up-side economic incentive, it is simply too difficult to try to raise private capital with the risks involved.

I have reviewed the tax bill passed by the U.S. House of Representatives and find that the restrictions placed upon the motion picture industry to be extremely harsh. Granted, there have been significant abuses of the tax benefits for motion picture investment by U.S. promoters, but these do not justify such harsh across-the-board retaliation for an entire industry. If any legislation is deemed necessary, I would welcome a more rational, objective standard for "sorting the wheat from the chaff", such as those proposed by Mr. Burton Marcus of Columbia Pictures in his testimony before your Committee.

Today, the other significant financing alternatives for an independent producer are either to seek financing from a major U.S. film company, or to seek foreign capital. While it is difficult to negotiate a favorable arrangement with a major distributor, there are innumerable opportunities in foreign countries. Most of the key countries of the world endeavor to foster their motion picture industry through direct subsidies (e.g. England, Italy), tax benefits or incentives (e.g. Canada, France, Germany), special financing or investment incentives (e.g. Germany, Israel, Canada), and soft currency production arrangements (U.S.S.R., Yugoslavia, etc.).

These countries provide certain objective standards to sort out for legitimate nationality productions rather than blindly providing benefits for all films or, on the other hand, providing no benefits at all for any films. For example, the direct subsidies in Italy and England are based on box office success for pictures produced in their country as long as they have the proper qualifying elements. In Canada, the investor receives 100 percent write-off in the first year that principal photography is completed, if there are adequate Canadian elements to qualify as a "certified feature film"; even if there are insufficient national elements, the investor is accorded a 60 percent diminishing balance capital cost allowance.

All of these opportunities are available to help a competent producer finance

the production of his motion picture. However, none of these incentives are available for making or financing a film in the United States. There are no subsidy benefits from our government for making a film in this country. There are no "co-production" arrangements between the United States and any other country whereby the U.S. production can take advantage of the foreign assistance while producing partly in the United States.

Without some assistance, the independent producer must rely in this country on the major film companies for financing pictures for production in the United States. If the legislative intent is not to increase concentration of economic power in the industry, even further than already unfortunately exists, then the independent film producer must be given viable assistance to accomplish his purpose. To enact the legislation passed by the House of Representatives would represent a major blow to the independent producer and the United States movie industry as a whole. For this reason, I respectfully suggest that your Committee consider a significant amelioration of those provisions.

Very truly yours,

HARRY N. BLUM.

ADDENDUM

For your information, these independent productions in which I have been involved all had moderate production costs ranging between $800,000 and $3 million.

Budgetary cash cost of all of these productions was approximately $13,500.00. Of this amount, please note the composition:

(1) Only about $3,200,000 was contributed by United States studio-distributors (of which over half was in one picture);

(2) About $1,200,000 was supplied by foreign distributors, and;

(3) Private capital provided about $9,000,000 for these pictures, about two-thirds of the total.

APRIL 23, 1976.

COMMENT OF COMMITTEE FOR AMERICAN MOVIE PRODUCTION ON MINIMUM TAX PROPOSAL BY TAX COMMITTEE, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

1. The Minimum Tax (or Percentage of Income Limitation on Tax Preferences) would limit "tax preferences" to 50 per cent of taxable income computed without regard to such preferences. Preferences in excess of 50 per cent would be carried over to succeeding years subject to the same limitation.

2. The proposal is designed to deal with "tax preferences" which it generally describes as "tax incentive" measures that specially alter the basic structural computation of net income in the Code in order to achieve some desired goal of public policy—such as more rehabilitation housing under § 167(k). No definition of tax preference is provided, but it is clear that the proposal generally relates to those "items of tax preference" now specified in section 57, such as capital gains, etc. Further evidence of this is found in the emphasis placed upon there being a basic item-by-item review of each item of tax preference (or tax incentive) with the view that some might be dealt with by direct repeal.

3. Since the proposal is directed at tax preferences (or special statutory tax incentives), the proposal by definition can have no application to motion pictures where there are no "tax preferences" or statutory tax incentives, either in the form of special accelerated deductions or special exclusions from income.

In the case of motion picture investments, the only deductions involved are depreciation under the income forecast method which is no more a "tax preference" than straight-line depreciation; and the expenses of producing motion pictures which are ordinary income deductions just like any other expense of earning ordinary income.

Any "tax abuses" in motion pictures relate not to the nature of the deductions involved, but to the combination of excessive leverage and extended repayment periods for debt. Those limited problems can be readily dealt with outside any minimum tax or limitation on tax preferences.

BURTON S. MARCUS,
Committee for American Movie Production.

STATEMENT OF WALTER F. DIEHL, INTERNATIONAL PRESIDENT OF THE INTERNATIONAL ALLIANCE OF THEATRICAL STAGE EMPLOYEES AND MOVING PICTURE MACHINE OPERATORS OF THE UNITED STATES AND CANADA (*IATSE*)

I am Walter F. Diehl, International President of the IATSE, which has 61,000 members. I am also speaking today on behalf of the Hollywood Film Council, an organization representing 27 unions and guilds involved in motion picture production in California.

At one time, Hollywood reigned as the major film producing capital of the world. Enough films were produced to give the public a weekly change of double bills. Annual production reached an average of 500 films during the 1930s, 475 in the 1940s, while 425 films were produced in 1950. Film production continued to decline when only 350 films were produced on the average in the beginning of the 1950s, and a sharp decline took place in 1958 with a production output of 241, which was a drop of 59 films from 1957. Since 1958 production has continuously declined at an alarming pace, to the point that only 180 films were made in 1975.

The 180 films made last year were produced for the same amount of dollars as the 425 films in 1950. As of March 5th, only 18 films were in production in this country this year.

Due to the development of technology in the motion picture industry, the technician spends less time on a motion picture production . . . and this technology which makes the American film the most respected on the world market is vital to our national resources. No matter how small the production, technology has and will always play an important part in film production.

It is also vital to note that our technicians employed in the industry are seasonal workers, there is less work in the summer months, but more in the autumn season which runs into early spring But with less films being produced, even the seasonal work is in doubt. And due to the lack of product, theatres throughout our country are continuously crying for more product.

All the unions and guilds in the motion picture field each have a large number of skilled professionals who are always ready to work in film production, and when one looks at the unemployment statistics, the industry's production potential is not being scratched on the surface.

Approximately 28,000 IATSE members are directly involved in film production in Hollywood and New York. Of these approximately 45 percent are currently unemployed.

On behalf of the IATSE and the Hollywood Film Council unions and guilds, and the film industry, we need stimulating action so that we will not see a further decline of U.S. film production.

Our unions believe in tax reform. We believe that if there are abuses by a few individuals, these abuses should be rectified. However, our industry needs the stimulus of risk capital if the production of movies in America is to be maintained—and, hopefully, increased. Therefore, I urge this commitee not to deprive our industry of the tax incentives available to investment in other industries, as suggested in the Industry-supported proposal outlined here today.

Thank you.

STATEMENT OF SAM ROBERT, EXECUTIVE COORDINATOR OF THE NATIONAL CONFERENCE OF MOTION PICTURE AND TELEVISION UNIONS

Mr. Chairman and Senators, I am Sam Robert, Executive Coordinator of the National Conference of Motion Picture and Television Unions. My colleague Walter Diehl has already outlined the effects that further reduction of film production here in America will have upon the workers in our craft unions. Kathleen Nolan will, I'm sure, develop this point further when she testifies on the effects declining production will have on the talent guild members.

Accordingly, I would like to restrict my very brief remarks to another aspect of this situation—one that workingmen and women are not supposed to be concerned about—but which deeply troubles us.

As we enter our country's Bicentennial year, extolling freedom of expression and the American democratic way of life, it seems odd to me that we fail to recognize the unique character of our American movies. For years they have told the story of the American democracy to the entire world. They've shown the glories of our culture and the seamy side as well. They've shown us in

all lights—the good and the bad. And, I believe, people throughout the world respect us for it. When an American film is critical of America, it is living proof that America is still a haven for the free expression of ideas.

I would hate to see this unique American art form shrink in stature . . . become hesitant in its search for universal truths . . . become less innovative and creative. That can happen.

We have a tendency in this country to think of movies as a strictly commercial enterprise in much the same way we think of the auto industry, meat packing, real estate, oil and gasoline. This is a fallacy. This is where the rest of the world is ahead of us. Movies outside of the U.S. are privileged commodities. They are rightfully regarded as works of art that are important to the cultural life of the country that gives them birth—and ambassadors to the rest of the world.

In order to survive, movies must continue to be innovative. They must continue to open their doors to young people. They are like a human body that continually need nourishment.

If risk capital is not available to our independent producers and to the major studios who need such capital to survive, the doors will be shut to many young, creative filmmakers. For when capital is in short supply, the opportunities for innovative, breakthrough films are closed.

Mr. Chairman, Senators—let us have a tax reform bill that makes certain that everybody in this country—millionaire and workingman—pays his fair share of taxes. Let's plug up the phony tax shelters that proliferate pornography. But let's not throw the baby out along with the dirty water. Movies are unique. Our industry remains responsive to new ideas. Permit it to have the wherewithal to give expression to those ideas. I urge you to permit a limited tax incentive—the kind outlined in the industry proposal.

Statement of Paul Roth, Chairman of the National Association of Theatre Owners

My name is Paul Roth, and I am Chairman of the Board of Directors of the National Association of Theatre Owners, on whose behalf I am speaking today. Our president, T. G. Solomon, was unable to attend today, and sends his apologies. NATO, as we are commonly known, represents approximately two-thirds of the nation's 15,500 theatres. We are appearing before this committee today because of our very deep concern that tax legislation currently being considered in this Committee will have a severely debilitating effect on film production in the U.S.

The exhibition sector of the motion picture industry, which we represent, employ about 250,000 full and part time people and our total national payroll exceeds $1.4 billion. Attendance at motion picture theatres has declined severely since the advent of television in the early fifties, and only in the last few years have patrons begun to return to motion picture theatres in what looks like a gradual upturn in attendance. We firmly believe that the keystone of this resurgence in attendance has been the recent production of highly entertaining and popular American motion pictures as well as the billions of dollars which exhibitors have invested in the construction of new theatres and the refurbishing of existing houses. Many of the films which have been drawing patrons back to the theatres have been made possible by venture capital investments which would be penalized by the House version of the bill now before you.

The most critical problem that faces the theatre industry is a lack of quality product, both currently and for the forseeable future. In 1950, when there were approximately 18,500 theatres in the country, 425 motion pictures were released through them. In 1975 the number of theatres has declined only slightly, but only 182 pictures were released by the 21 major and independent producers for which we have records. Because of this dramatic contraction in the number of films available, certain theatres who are unable to attract timely, quality product have been forced to turn to pornography or cheap foreign action pictures to continue to meet their obligations.

Nonetheless, most of our theatres depend on quality, American made film entertainment to survive. What does this survival mean to the Treasury of the

United States in terms of national tax policy and what does it mean to localities? On the national level, aside from our $1.4 billion payroll, which is taxable, scores of subsidiary industries from trucking to candy profit from the range of activities associated with motion pictures exhibition. These subsidiary services have an impact on a number of sectors of the national economy and should not be overlooked. But more important is the economic affect of motion picture exhibition on local communities.

Theatres pump $16 million into State and local coffers through admission taxes alone.

Local real estate, sales and corporate income taxes add to this figure substantially.

The $1.4 billion payroll which American theatres disburse yearly—much of it to non-skilled, entry level personnel—directly impacts local economies in a variety of ways.

Local media—newspapers, radio, television and billboards—are stimulated by promotional spending entailed in Motion Picture exhibition. It has been estimated that the 1975 local advertising expenditures, just for films which were financed at least in part by venture capital attracted by the limited tax deferral incentive, were close to $90 million.

Movie theatres serve the public interest in non-economic ways as well. They provide low cost entertainment for families in low income areas, both urban and rural—an affordable chance to get out of the house for a social occasion. They provide light and traffic, in this way theatres are often a major factor in keeping decaying neighborhoods alive. "The Last Picture Show" is indeed a tragedy for any community.

The leaders of the various guilds and the industry representatives who are here with us today are adamant that they possess the talent pool necessary to produce quality American motion pictures at an even greater rate than they have in the past years. What they are lacking is risk capital; capital which can be raised only if some limited form of tax incentive cushion is available. Filmmakers must compete in the capital market for funding with a variety of ventures which combine a lower overall risk and the same investment incentives that the proposed legislation would eliminate for film. Unless movie producers are allowed to compete for this high risk capital on an equal footing, we face an even more severe constriction of available product for the future.

To conclude, it has been charged that the current tax laws are perhaps open to abuse. We urge that the appropriate reforms, suggested in the Industry proposals, be instituted to correct any abuses. But to impose tax penalties with respect to film investment, while preserving normal tax results for most other areas of risk financing, can only further limit production. This would be a disaster for the exhibition industry, which has a $5 billion investment in theatres in this country, and will force still more theatres to close or resort to exploitation films or foreign imports to keep their doors open.

STATEMENT OF STEVE D'INZILLO, CHAIRMAN OF THE EAST COAST COUNCIL OF MOTION PICTURE UNIONS

I am Steve D'Inzillo, Chairman of the East Coast Council of Motion Picture Unions, which is made up of regional representatives from various locals encompassing cameramen, editors, studio mechanics, cartoonists, film laboratory technicians and projectionists. I am also Business Manager for the Projectionists Union, Local 306.

Several of my uinon colleagues have discussed and will continue to express to you the effect that the decline in motion picture production here in America will have upon the people involved directly in production.

My union—the Projectionists—is in the midst of a crisis involving the loss of jobs through automation and the proliferation of twin multiple theatres. Any further loss of jobs resulting from the closing of motion picture theatres would place a tremendous burden upon our membership. The tax legislation that was passed by the House of Representatives—and which this Committee is considering at these sessions—would further limit American film production. This could be the signal for the closing of many theatres and the kind of situation that our union fears most.

When a theatre closes, its effect is felt in many ways. In addition to the loss of jobs for the skilled technicians such as the projectionists, it also means the loss of jobs for many part-timers, particularly students, who have long found that the job of usher and ticket-taker is a means toward getting a higher education. In addition, there is a social effect that the closing of a theatre has upon a neighborhood. Unlike a grocery store or a dress shop or a hardware establishment that closes, a movie theatre is a rather unique construction. It has but one life. That of a movie theatre. I am sure you have all seen the deserted movie house, with its empty marquee that soon bears the marks of vandalism. And inevitably, the local diner or the ice cream parlor that stood near it begins to feel the pinch and, in rapid succession, an entire neighborhood is blighted. The flourishing movie theatre, on the other hand, generates an excitement that stimulates a whole community.

For theatres to flourish they need movies—good quality films—not cheap porno films or "quickie action flicks" from abroad. I strongly urge the Senate to allow the motion picture industry to have the same tax incentives that other risk capital industries have. I urge the retention of limited tax incentive legislation as outlined in the industry proposal.

Thank you.

STATEMENT OF ALAN J. HIRSCHFIELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF COLUMBIA PICTURES INDUSTRIES, INC.

Thank you Mr. Chairman and Members of the Committee for giving us this opportunity to express our Industry's position. I thought when I worked in Wall Street it was supposed to be the biggest gambling casino in the world, but when I found myself almost three years ago making a switch to the movie industry I soon changed my mind. I don't think it's necessary to tell you how risky the motion picture business is—it's really rolling the dice every day of your life—or to put it another way, we are in the disposable new product business. The shelf life of our product is very short, the public's taste can change literally as the film is being made and what looks terrific in a script sometimes doesn't look so great on a big screen, even with Raquel Welch wearing it. Nonetheless, our business is going through a renaisance, helped in no small part by the availability of outside funding for production of film.

When I came to Columbia Pictures three years ago, we were faced with the following situation: We had a film production and distribution facility which presented us with approximately $20 million in yearly overhead expense. In order to justify this, we had to produce a minimum of $40 million worth of quality motion pictures to put through the distribution system. I say minimum because we are in a high risk business and even this level of production would not guarantee a return on investment commensurate with the overhead expense which we were supporting. Also at this time, the Company had an outside debt of close to $165 million and a net worth of $8 million. We had a maximum of $25 million to invest in film production, thus we needed a minimum of $15 million in outside risk capital to support the $40 million production schedule which, with luck, could put the Company back on a profitable track. Without that money we would have been forced to abandon production and distribution businesses. We were able to raise this venture capital mainly due to the limited tax deferral mechanism which would be eliminated under the bill now pending before this Committee. In short, were the House bill now law, Columbia Pictures would have been bankrupt. I realize that it is not the duty of this Committee to insure the stability of profitability of private enterprise. At the same time, motion picture production, not only by large distributors such as ourselves but by scores of independent producers, serves our country not only economically but artistically in the wide variety of ways which my industry colleagues have outlined for you today. All we ask for is equal tax treatment with other high risk investment opportunities so that we can continue to produce high quality American motion pictures.

With the advent of TV in the fifties, weekly attendance at motion picture theatres went from almost 80 million a week down to 16 million 3 years ago. The American film as an art form and more importantly as a business form was diminishing with the consequent disastrous effect on production, employment and on the fortunes of this industry. Some two to three years ago we

began experiencing an upturn, not only in America but all over the world. Coincident with it was the availability of substantial funding by outside investors in so-called tax deferral structures which were adapted to film production. Without this kind of money I can assure you, beyond question, that I would not be sitting here today. Whether they were to your tastes or not, films like Shampoo and Funny Lady would never have seen the light of day. Taxi Driver would not have been made in New York or Hard Times in Louisiana or Stepford Wives in Connecticut, or most of the 20 films made in Georgia over the last few years simply would not exist. One of our new pictures, Close Encounter of the Third Kind which is commencing shooting in Wyoming and Alabama with a ten million dollar budget, is an example of this kind of production. A picture which will probably win the Academy Award this year called One Flew Over the Cuckoo's Nest was made in Oregon. Cuckoo was considered too risky for every major movie company and, in our own genius, we passed it up, too. We didn't think there was a market for it, but tax deferral financing made the production of this film possible. In addition to our pictures, at least 62 others were made possible by this kind of outside venture financing.

As an industry, we brought in a favorable balance of trade last year exceeding $375 million theatrical distribution and an additional $62 million for features televised abroad. This year our trade balance will be greater; and again, many of the films which will help produce this revenue were funded by outside financing. In virtually every foreign country there is some form of substantial subsidy available to the filmmaker, usually government sponsored—England, France, Germany, Italy, Canada, Japan, Australia, Spain and Communist countries as well offer substantial inducements for film production. It is interesting to note that in a recent White Paper prepared by the Labour Government in England, a recommendation was made that, in order to stimulate declining production in the UK, the tax financing advantages used in the U.S. be introduced there.

What we do is not a ripoff and 95% of what all the majors and independents in our business do is not a ripoff. There have obviously been abuses in film financing as there have been in other areas. We have recommended and heartily endorse changes which would eliminate these abuses, and in the end, cost the treasury nothing. Our own investors last year, based on current estimates, put up some 16 million dollars in cash—they will get back a minimum of 18 million dollars in cash, excluding any other benefits. Their 16 million dollars of high risk investment produced more than 40 million dollars of film production which has to date produced world-wide gross receipts of over 200 million dollars. Foreign earnings have flowed back to U.S., and domestic grosses have benfited local communities in a variety of ways.

Again, our business is not to siphon money from the public or the U.S. Treasury—rather we are trying to find an orderly way to run our company and our industry profitability. We can only do this by stimulating picture production. Obviously, we're in a risk business. Obviously, we seek whatever means are available to cut these risks or diminish them. Outside financing can accomplish this to some degree by giving us the means to produce additional pictures while enabling us, as a company, to be in business today. The same can be said for almost all small independent producers in the United States as well as for a large part of the production by our fellow major distributors.

Statement of Kathleen Nolan, National President of the Screen Actors Guild

My name is Kathleen Nolan. I am National President of the Screen Actors Guild. Our guild represents 32,000 actors. And, if you're concerned with eight point five percent unemployment, think for a moment about 85 percent unemployment. That's the national figure with respect to our membership.

I'm here today speaking not only for my guild, but for the other two major creative guilds as well—the Writers Guild of America and the Directors Guild of America—both of which are facing enormous unemployment in their ranks.

Contrary to the myth about movie actors and actresses, hardly any of us are in the millionaire class. Only six-tenths of one percent of our membership earns more than $100,000. Three point four percent earns between $15,000 and $25,000 per year—and 80.6 percent are below the poverty level. The Writers Guild of

America is currently facing a 45 percent unemployment rate and the Directors Guild of America has more than 40 percent.

I'm here today to urge this committee not to discriminate by tax legislation against the film industry—and to permit our industry to continue to attract risk capital to be invested in American motion pictures.

Our members derive their employment from two major sources—motion pictures and television. In recent years, when the rest of our economy was growing, our sources of employment were declining. While more money is being spent on motion picture production today than ever before, sky-rocketing costs have resulted in fewer and fewer movies being made here in America. This past year approximately 125 films were produced by the major studios—a decline from the 400 to 450 produced in the 1950s. This has had a disastrous effect on our employment situation.

At the same time that movie production has declined, the television networks discovered they could make considerably more profit by reducing the number of original programs shown on their stations. In a matter of ten years, we have seen original production decline from 39 episodes per series per year to 32, then 28, then 26, 24, 22—and they are now talking about 17 new episodes per series per year, with the rest being re-runs. This, too, has had an enormously negative effect on the employment situation in our creative guilds.

While this was happening, the FCC created the prime-time access rule which, instead of creating new forms of programming, as was its intention, forced television stations to rely on cheaply-produced foreign product from England and Canada and a depressing array of mind-deadening game shows. This, too, has hurt us in terms of unemployment.

Our government agencies seem to have a penchant for destroying our home grown industries and building up the product of our foreign competitors. If the Senate allows the House tax bill to stand—the result will be the destruction of the American film industry—at least, to the extent of driving production abroad.

In addition to more foreign production, what we are going to see is the perpetuation of mediocrity in films. This once great art form—an indigenous American art form—will increasingly rely on the "safe" picture. Off-beat movies like "One Flew Over The Cuckoo's Nest," "Alice Doesn't Live Here Anymore," "Sounder," "Conrack" and "Aaron Loves Angela" will simply not be made. And movies involving women and minorities—a struggle in which we are just beginning to make some head-way—will be avoided in favor of the sure box-office winner.

The motion picture industry is one that does not deplete our natural resources. The profits it generates are intellectual as well as monetary. It remains America's best spokesman abroad and the most potent mirror of American life.

With the enormous risk involved in producing quality films . . . with the rising costs of these films . . . the American film industry should not be subjected to still another blow to its already battered body. A decline in risk capital will result in a further decline in film production and, inevitably, a decline in the quality of these productions. I believe the Senate would no more want to see books and newspapers removed from the American home—than to see American movies gradually disappear or be dissipated into celluloid pap.

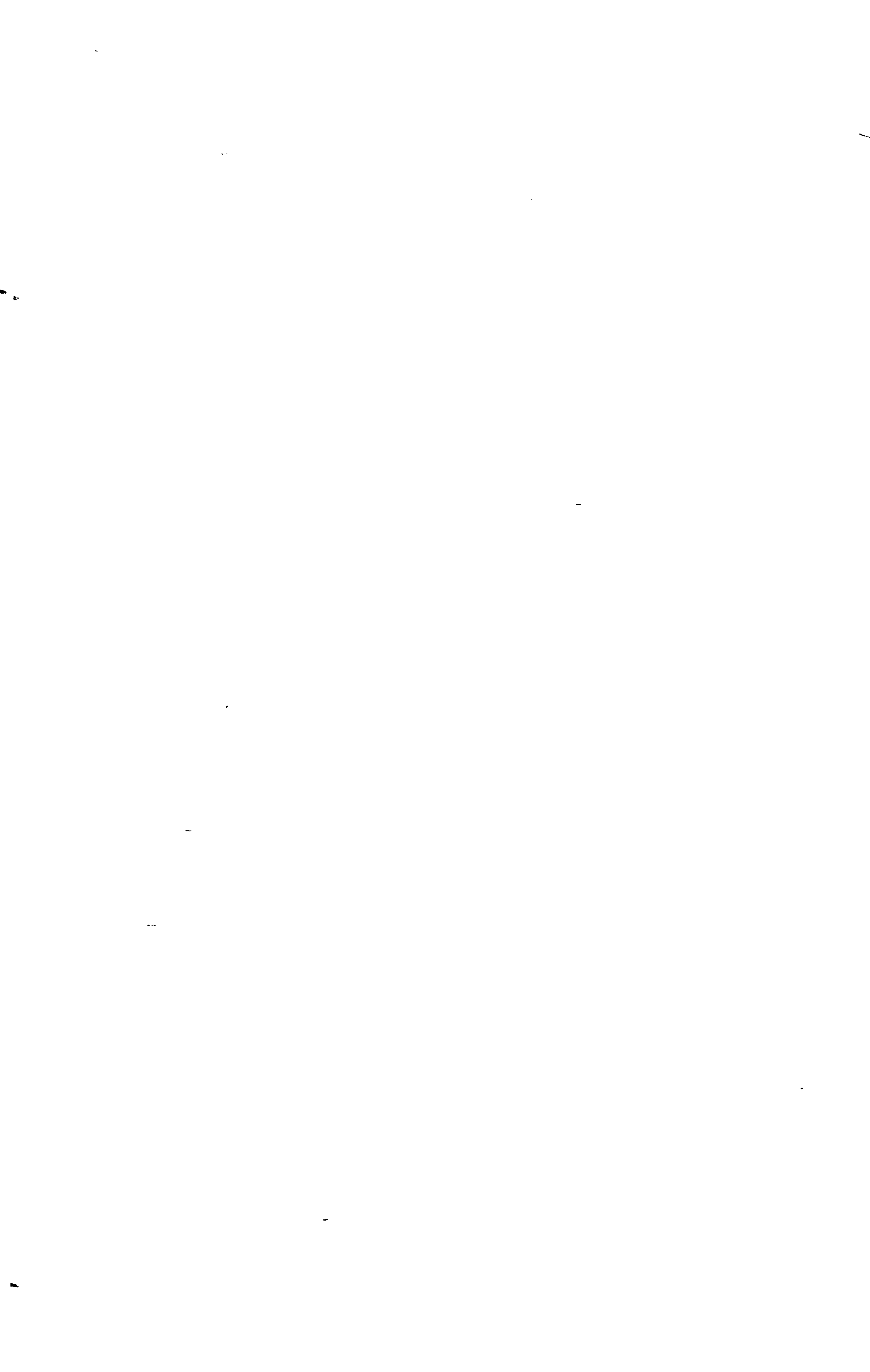
Virtually every country in the world offers a subsidy to its filmmakers. We are not asking for that. We are simply asking not to be discriminated against. We are asking for the same tax treatment that is available to other business investments to help increase production here in America, to increase employment, to make it possible for America's filmmakers to continue to produce innovative, trend-setting films which will remain the standard of the world market.

We support the Industry proposal which allows for limited tax incentives as an encouragement to investors to risk their dollars in American films. We believe H.R. 10612 unjustly discriminates against the American film industry at a time when we can ill afford to see its further decline.

Thank you.

Senator HARRY F. BYRD, Jr. The committee will stand adjourned until 10 o'clock tomorrow morning.

[Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, March 25, 1976.]



TAX REFORM ACT OF 1975

THURSDAY, MARCH 25, 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, Bentsen, Curtis, Fannin, Hansen, Dole, and Packwood.

The CHAIRMAN. This hearing will come to order.

The first witness that we have this morning is Mr. Robert H. Preiskel, chairman, Committee on Taxation, Association of the Bar of the City of New York.

We are pleased to have you before our committee, Mr. Preiskel, and we appreciate the thoughtful endeavors of your group to try to help us accomplish tax simplification.

STATEMENT OF ROBERT H. PREISKEL, CHAIRMAN, COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Mr. PREISKEL. Thank you very much, Senator Long.

I appreciate the opportunity to appear before the committee on behalf of the Committee on Taxation of the Association of the Bar of the City of New York.

I would like to talk about LAL and the minimum tax, and if I have time, I would like to make some general observations about certain trends which concern the members of our committee.

As we perceive it, LAL and the minimum tax are basically concerned with two separate and distinct problems. The first is the existence of tax preferences which do not produce benefits commensurate with the resultant loss of, and associated dislocations to, the revenue.

The second is the excessive use of preferences by individual taxpayers to inordinately reduce their tax liabilities although the preferences of which they avail themselves are in themselves beneficial to society.

At the taxation committee we have accepted as policy determinations that certain preferences are not justified by the benefits that they produce, and that there should be a limitation on the amount of benefits to which a taxpayer is entitled. I think that we would all tend to think that subsidies should be handled outside of the revenue system. We are not really competent to decide that issue; neither are we com-

petent to decide whether preferences are exorbitant. Some on the committee believe that if a taxpayer is making expenditures in the national interest, there is no reason why he should be limited, but as I have said we have accepted as policy determinations, that there are in fact two problems with which the Congress and we must concern ourselves.

There is no doubt that LAL and minimum tax will inhibit the use of tax preferences, but, in our opinion, they do not deal adequately with either of these problems.

The first problem is the fact that certain preferences do not produce benefits commensurate with their cost. We believe that it should be handled by meeting all of the preferences head-on, evaluating them, modifying them, either by reduction, increase, or elimination on an item-by-item basis. Thus, the deduction for capital gains could be reduced from 50 percent to 40 percent. That would produce about the same amount of revenue as a 15-percent minimum tax on a 50-percent capital gains deduction. This would really be structural reform. the law would be simplified and all that would remain would be the desirable tax preferences.

LAL and the minimum tax do not operate in this way. Some preferences relate to low-income housing, others deal with baseball franchises or with the gas and oil, and others with the deduction for capital gains. Some of the preferences deal with timing benefits, such as rapid acceleration. Some of them deal with changes in rates or exclusions from income. We do not believe they should all be treated in the same way.

LAL and the minimum tax are enormously complex, especially LAL. The minimum tax, if it becomes high enough to be effective, may require basis and other adjustments. With respect to real estate, we believe that LAL, which permits deductions from one item of property to be offset against income from other items of property, discriminates in favor of persons who have developed a substantial amount of real estate income. It is difficult to know why an incentive intended to produce investment in new real estate should produce greater benefits for the person who already has real estate income rather than the person who has other income.

We also think that LAL and the minimum tax are ineffective. They do not apply to corporations; corporations do tax shelter income. You will see a further deflection of income from individuals to corporations where they can use tax shelters. All in all, we think as far as the first problem is concerned, LAL and minimum tax, are ineffective, complicated, and do not really accomplish tax reform.

The second problem, the excessive use of preferences by individual taxpayers, is also not handled appropriately by LAL and the minimum tax. In effect, they burden all preferences once one gets beyond $40,000 with an identical burden. A taxpayer, once he gets beyond $40,000, pays 14 cents on the dollar for every preference that he has. As a matter of fact, a minimum tax may make shelter even more of a rich man's game. It may be worth paying 14 percent to shelter 70 percent income but not to shelter dollars that will be taxed at only 50 percent.

We have developed a recommendation. It has been sent to you—I guess we sent it down February 9—which we think deals with the second problem much more appropriately.

Basically, we suggest a disallowance of deductions to the extent that they inordinately reduce what would have been true taxable income. It is very similar to Secretary Simon's proposal. Basically, we suggest that the amount of preferences which a taxpayer is entitled to use be limited to a percentage of his taxable income as if it were computed without preferences.

Now, we have not picked any percentage; that is a policy decision, which would have to be made by Congress. But to give you an example, if a taxpayer had $200 of accelerated depreciation, which would be a tax preference and taxable income after that of $100 under our proposal, if a 50-percent rule were used, his deduction for accelerated depreciation would only be $150, 50 percent of his true economic income before deduction of what is deemed to be an artificial loss.

So, basically, what we are saying is that everybody has to pay a fair tax on his true economic income, and we determine it in that manner.

We would provide for a carry-forward of any unused tax preference items for reasons which I will discuss later. We believe that to be appropriate.

We have submitted a draft of legislation. We are sure that it is not as good as it might be but we think it works, although there is probably some cross-referencing required. We think it is simple and effective. It absolutely disallows those preferences which are excessive. It does not make them available to a taxpayer who is willing to pay 14 percent for them.

We also think it is preferable to the minimum tax and LAL because it does not operate directly against the preference. Under the present bill, a person who is about to make an expenditure that is apparently socially desirable, has first to determine whether he is likely to have enough accelerated income from a piece of property to get benefits from the reductions attributable to that property. He then has to pay a 14-percent tax on the preference he gets. We suggest that, within the permissible limitation, preferences should not be burdened with LAL or a minimum tax. A taxpayer should be allowed to enjoy without burden the benefits of preferences when he is making expenditures in the national interest which are not excessive.

We have provided for a carryover. It is our opinion that if a person makes expenditures which are in the national interest, and it turns out he is wrong about how much to spend, he should be required to defer any excess preferences, but that if, over a period of time, his expenditures are reasonable in relation to his economic income, he should be allowed those preferences.

That is basically the proposal; any person under this proposal who constantly tax shelters excessively would, in effect, have a portion of the preference disallowed. If not, he would have them deferred and ultimately allowed.

If there are no questions about LAL and the minimum tax, I would like to make some general observations.

There are some trends in the Tax Reform Act which trouble us in New York. One of them is the notion that whether one is entitled to a

preference, or the extent to which one is entitled to a preference, whether a method of accounting or accelerted depreciation—I think my time is up.

The CHAIRMAN. You may finish your statement.

Mr. PREISKEL. That this should depend upon whether he is an entrepreneur or a sole owner, or engaged full time in an activity. We believe that to be wrong. It is really not quite fair that enormously rich people who can take on projects should get preferences while the middle class should not be able to get them through syndication. The preference is there to stimulate the investment of capital, whether that capital comes from a lot of people, whether it comes from an entrepreneur, or from others.

It seems to us, as long as the preference is desirable and it goes along with the investment of the funds, there is no reason why one should be against syndication.

We also, I think, detect an unfortunate tendency toward legislation intended to deal with narrow current problems. Allocation of purchase price is really not a problem only for sport franchises; nonrecourse debt is not a problem only for oil and gas, or films; it is just as much a problem in the real estate industry. Legislation should try to handle those problems generally and not by picking out the small problems in specific areas.

The foreign tax credit proposals correctly provide for recapture of losses. It is not correct to then reduce the foreign tax credits which remains available. There is a redundancy there, and a distortion. Finally, to say a person who has a foreign loss should recognize income where he ordinarily would not seems wrong and not necessary—the amount of revenue in the whole proposal is $30 million; the amount attributable to that last little recognition bit must be insignificant.

The CHAIRMAN. I will have to ask you to end your oral statement at this point.

I will invite you, as well as your association, to favor us with more of the suggestions along the lines that you have in mind, which in my judgment are very meritorious suggestions. Our staff has been very much impressed by the suggestions that your group has made. They contain a tremendous amount of merit and ought to be studied. I wish that you would give us further studies. We are trying to get Secretary Simon's people to tell us more specifically the kind of thing that they have in mind for their tax proposals. It occurs to me that some simplified tax procedure that Secretary Simon has advocated might be started at this point as an alternative tax system for that that we would choose as the minimum tax now.

I am convinced that what your group has suggested is far better. It is far less complicated than what we have on the statute books today. It may be, however, that is what Secretary Simon is suggesting, once we get more detail as to how that would work, would be better.

What tends to happen when we start to look at the minimum tax proposal is that someone shows up with the ambitious idea of advancing the rate to 50 or 70 percent all over again. The minimum tax could set the stage for us repealing many things in the Tax Code that you

were discussing which would do nothing but impede what business can do.

I am going to urge all my colleagues to carefully study charts and examples that show what would happen under the suggestions that your group has made. One thing that concerns me is that, up to now, we have tended to penalize capital accomplishments that are productive. If a man sells his home, we will let him take that money and buy another home, and we do not insist on taxing the enhancement of value at that point.

If he sells his ranch and invests the increase in value in stocks in a corporation or business machinery to start a plant and a factory, we levy a big tax on him. By the time we get through with the minimum tax and all the other things such as LAL in the House bill, it works out to a tax of about 42 percent on a profit that, in some respects, did not really exist at all. Sometimes you are talking about the mere fact of inflation on assets that have been held for a long time. We ought to give a better break to capital accumulation. If we are afraid that one is going to accumulate too much, maybe we ought to look at that question more in terms of the gift or inheritance tax laws. Then after he worked to build a financial empire, the benefit would be diffused more generally to society at the end of his life.

Have you had the occasion to study or look into some of the details of Secretary Simon's suggestion?

Mr. PREISKEL. No. All that we have seen is the statement; that is all. We have not done anything beyond that. I suppose—I do not know if further details will be available. If they were made available to us, we would be very happy to look at them.

The CHAIRMAN. We are asking for them. When we get them, I hope that we can make them available to you.

Senator Bentsen?

Senator BENTSEN. Mr. Chairman. I am very pleased with this testimony, because I think he goes right to the heart of the issue. As I look at the minimum tax, what we have seen thus far in proposals for increasing that minimum tax, they do not get to the problem at all. What we are trying to do, it seems to me, is stop the abuse of preference income. The question is, as you aptly stated, it is the merit of each preference item.

The subject of the accumulated use—overuse of all of them, is quite another subject. What we are trying to stop is someone who supposedly makes $1 million in cash flow and lives off that and pays no taxes, or virtually no taxes and the publication of that obviously destroys confidence in the tax system and the overuse of it.

Now, you come up with a very simplified approach to the minimum tax that I have seen operating thus far. The suggestions that I have seen so far for the further increase of it will not touch the man who is living off of the cash flow and who pays no taxes; it will not touch him at all. It does not increase his taxes a bit. But they do add to the taxes of the man already paying substantial taxes.

So your approach would go a long way on that and I am very pleased to see it. I am very interested in it.

One thing that simplifies all of this: If you had the same kind of top tax bracket on the investment of capital income that you have

on earned income, I never understood the reason why someone could be a prizefighter and make $1 million, or a country folk singer and make $1 million a year and pay 50-percent tax, but the earnings of the intra-capital and of the savings can go to 70 percent.

All over this country you are finding people who are making tax decisions and not economic decisions. Sometimes they are making very idiotic economic—tax decisions, thinking that they are going to save taxes and going into all kinds of stupid tax shelters. They go into some of them that really are not good.

Mr. PREISKEL. This is something that people are finding out now, that they have made investment decisions.

Senator BENTSEN. Well, I am very impressed, and I want to continue to study your approach.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. It is the best statement that we have had. I think it is the best one that we have had in the hearings so far. I am going to ask you just a couple of questions.

On page 2 you make reference to the fact that the Code should be to raise revenues and that you should not have any tax preferences at all. I think that's what you are driving at. Now, in theory, I agree with you, but you say that other mechanisms should be used.

We heard testimony the other day that the best way to get money for housing was from tax incentives. What other mechanisms do we have? The end of low-cost housing?

Mr. PREISKEL. Although we on the tax committee would prefer that all subsidies be handled out of the tax law, we are not really competent and do not have any special expertise to make that determination. But I think the best way to handle subsidies would be directly.

Senator PACKWOOD. A lot of people, a lot of Congressmen, come to the conclusion that we do not subsidize things well here in the Congress.

Mr. PREISKEL. I suppose you could use direct subsidies without any more strings than you now use in the Internal Revenue Code. Now, someone checks off a number of his tax return, and in effect, he is subsidized by the Government so long as he is perhaps putting up some of his own money. Nobody really pays very much attention to the kind of project or controls the expenditures.

It has been suggested that if we really don't want controlled subsidizing we could say to a person send in a request saying that he is putting up a project and asking for money; later on audit. We would find out whether he has really done what he said. That is pretty much what happens now.

Senator PACKWOOD. Or take the homeowner who deducts the interest rather than the deduction. What you are saying, he would pay it, then he would just send in the bank statement with his income tax return that he paid $2,000 of interest; will you deduct that from my tax or send me the $2,000.

Mr. PREISKEL. Or send me a portion of the $2,000 which does not depend on his tax bracket; yes. That is pretty much what happens today, except that the amount of his subsidy depends on his tax bracket.

Senator PACKWOOD. There is a great tendency in the Congress to put

on controls. If I were that confident that we would simply send the homeowner the $2,000 for his interest, I go along with it. I am not that confident because they will not follow it the way we want and the way we design it.

The last question is on page 8. Preferences and preferential methods of accounting are created to stimulate and reward the investment of funds, and it seems difficult to understand why a full-time participant's investment should have different tax consequences than an investment by a part-time person.

The farmers testified and said that they do not really need the tax preferences. They can borrow, but they do not need the tax preferences. If our policy is not to encourage the investment of outside income in farms, but to find some way to keep the farmers on the farms, keep the people who live on them and work on them, that would not hold with your statement.

Mr. PREISKEL. That is correct. If that were the policy, that is correct.

Senator PACKWOOD. That is the policy. I think that they pretty well indicated that they do not need the preference for the capital. They need some cash benefits to stay in business.

Mr. PREISKEL. I was thinking of something like real estate where outside capital is important.

Senator PACKWOOD. Thank you very much. It was a very good statement.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I have been very much interested in your statement.

Do I understand in general that what you propose is rather than having LAL or minimum tax, we apply a remedial act to the preference itself?

Mr. PREISKEL. Yes, an alternative tax to come to grips with the basic decision that everybody should pay some taxes, not avoid all tax, even through the preference, which is available, is desirable.

Senator CURTIS. What particular preference, in your opinion, results in the most cases of unconscionable tax practices?

Mr. PREISKEL. That is something that is beyond my competence to answer.

Senator CURTIS. Is it interest paid? Is it a charitable deduction?

Mr. PREISKEL. I am really not competent to make that decision. Whether a particular activity is sufficiently beneficial to society is beyond my field of expertise. People contribute to very strange kinds of charities. It is hard for me to see the benefit in them all, but I suppose there is much to be said for pluralism, which is a good thing. I do not know that all of the housing that is built should have been built, but I do not know that it would not have been.

Senator CURTIS. At what point would you place a limit on the deduction for the interest paid?

Mr. PREISKEL. Well, I think that the basic concepts, which have been followed and embodied in the Tax Reform Act, are basically sound. I do not think there should be a deduction for personal interest.

Unfortunately, it is complicated to start distinguishing between personal investment and business interest. I would think that we can eventually go down below $12,000 on personal interest, although I do think that mere generous transitional rules are in order; many people

have made commitments and are tied into large interest-bearing loans that they just cannot get out of quickly.

Senator CURTIS. Is it interest paid regardless of the reason? Isn't that considered a tax preference, the deduction for interest paid?

Mr. PREISKEL. No. At the moment, it is just a complete deduction with no adverse consequences. Personal interest is not the problem. It is just deducted and that is the end of it.

Senator CURTIS. In the minimum tax, is it not regarded as a preference item?

Mr. PREISKEL. Only to the extent that the minimum tax would apply to the excess of your deductions from adjusted gross income over 70 percent of adjusted gross income, and someone with large interest in that category would have to pay a minimum tax on it. There is also under the new proposal a limitation on the amount of personal interest.

Senator CURTIS. I saw in your summary the hypothetical taxpayer who has the $200,000—the 200 of the present 100 for the normal taxable income. You would lessen the value of his preference. How would that apply to the homeowner or farmer in these days of high interest, who has very, very sizable interest payments, and what happens in a year that he has little or no income?

Mr. PREISKEL. I do not think that would affect him at all. I do not think that our proposal would affect at all the ability of a person to deduct interest.

Senator CURTIS. Is medical deduction a tax preference?

Mr. PREISKEL. We have not defined tax preferences.

Senator CURTIS. No, no. I mean in the existing law.

Mr. PREISKEL. In the existing law?

Senator CURTIS. It is.

Mr. PREISKEL. No.

Senator CURTIS. Are charitable deductions?

Mr. PREISKEL. No.

Senator CURTIS. I think it would be helpful to this committee if someone would come up with some real objective studies as to what our problem is. We hear a great many political speeches about individuals with high incomes paying no taxes. I have never run into any of those individuals. There might be a lot of them but I think that we need, in order to come to a sound solution, need to find out just what the problem is. How much of it is in the political speeches that the candidates who are running for office make and how much of it is really true?

Under your plan, assume that an individual is a lawyer and has $50,000 in professional fees and $100,000 in the tax preference income. How would your proposal apply in his case?

Mr. PREISKEL. He would have to pay a tax on $75,000 worth of the income. In other words, under those circumstances, true economic income would have been $150,000. That is assuming that $100,000 of preferences are not true economic losses. We would limit his right to avail himself of preferences to 50 percent of such income. Now, that is a hypothetical case; that is the 50 percent.

Senator CURTIS. If I may finish.

What would this $100,000 tax preference income, what could that consist of?

Mr. PREISKEL. It could be accelerated depreciation in real estate; or could be the deduction for charitable contributions. The deduction could be for intangible drilling expenses. You could throw a lot of things in there, percentage depletion, all of those expenditures which someone deems to be artificial losses, and not true economic deductions. That is a policy decision which we do not feel that we are competent to make.

Senator CURTIS. Well, something that is not a true deduction is something that somebody else takes and we do not. I think that is the only difference.

I have a couple more questions that I would like to have you answer for the record, if you would. I will see that they are delivered to you.

The CHAIRMAN. The Senator will submit those questions.

[The questions and answers referred to above follow:]

Question 1. You stated that the LAL provisions of the House bill would favor those already in the real estate industry over those who are just entering the real estate field. Please explain why this is so.

Answer. LAL permits artificial losses (accelerated depreciation and interest and taxes during the construction period) from one item of real property to be offset against income from other items of real property. This favors a taxpayer already in the real estate industry because he will have a previously developed stream of real estate income from which artificial losses on new items of property can be deducted while persons newly entering the field do not have such income.

Assume, for instance, two taxpayers each of which makes identical investments in real estate and assume further, that each investment would generate artificial losses of $50,000 in 1976. Assume, as is likely to be the case, that neither of these investments will generate net related income in 1976 sufficient to absorb those artificial losses. A, who has invested in real estate in the past and who will have income in 1976 arising from such investments (which may very well have been in syndicated real estate operations which gave rise to tax shelter in prior years) will be able to deduct his artificial losses from that other income. B also has other income but it is not from real estate and therefore cannot deduct his 1976 artificial losses from that other income; instead, he must wait until his real estate activities develop sufficient income to absorb the artificial losses, something which may never happen or may happen years in the future.

Question 2. You referred to the increasing preoccupation of our tax laws with "inconsequential" matters. Would you illustrate what you mean by this statement?

Answer. Several illustrations spring to mind.

1. The investment credit for garden tool expenses.

2. Several provisions affecting the computation of the foreign tax credit.

(A) Bill Section 1032 contains certain amendments dealing with the foreign tax credit which are expected to raise some $30,000,000 in revenue. Our report, which was sent to you on January 28, 1976, discusses these provisions in some detail. The bill basically makes three adjustments in the computations of the foreign tax credit but I would now like to address myself only to that contained in proposed Sec. 904(f)(3) which requires that under some circumstances a taxpayer who has sustained an overall foreign loss will actually recognize income on transactions which would normally be tax free. It is difficult to believe that this provision would account for anything but an insignificant portion of the $30,000,000, it is highly complicated, creates difficult problems of interpretation of other provisions of law and is unrelated to the basic operation of the foreign tax credit.

(B) Bill Section 1034 contains certain amendments dealing with the manner in which foreign source capital gains are to be treated for purposes of foreign tax credit; the bill is intended to prevent taxpayers from gaining undue advantage where foreign source income is capital gain and domestic source is ordinary income. The bill is appropriate in concept but, once again, it is highly complex and raises only $10,000,000. Moreover, it probably would not raise anything like that amount of money if it were appropriately drafted to make the foreign tax

credit work really properly, because it would have to deal with the reverse situation in which taxpayers do not get sufficient foreign tax credits because they have foreign source ordinary income and domestic capital gains.

3. The bill provides for allocating purchase price in the case of acquisitions of sports franchises. It is hard to believe that this problem could not be dealt with adequately at the administrative level. It is a problem which arises with respect to all activities and hardly seems significant enough to require special legislative treatment.

Thank you again for the opportunity to appear before you. If we at the Committee on Taxation can be of any further assistance, please do not hesitate to call upon us.

Sincerely,

ROBERT H. PREISKEL,
Chairman, Committee on Taxation, The Association of the Bar of the City of New York.

The CHAIRMAN. Senator Dole?

Senator DOLE. I have no questions.

I do want to make certain that I understand the thrust of your statement.

You also pay a tax on at least 50 percent of your taxable income?

Mr. PREISKEL. On at least 50 percent of the economic income one would have had if there were no preferences.

I want to say again that 50 percent number is purely—you may decide 60, 70 or 30, but that he does pay at least that much on what his earnings are economically.

Senator DOLE. That is all I have.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

In your statement, you say that the Tax Reform Act is awesome in its complexities. That is an accurate statement. Then you say that much of this is attributable to familiar causes, the major of which is probably the use of the Internal Revenue Code to influence economic behavior and not merely to collect revenue in an equitable manner.

It seems to me that you are making a very important point there and one which very seldom is made before this committee. Basically, the revenue code should be for the purpose of collecting revenue and in an equitable manner rather than attempting to get into all sorts of economic behavior patterns. I am glad to see you point that out.

I think that Senator Bentsen made an excellent point, that what this committee should be doing, as I see it, is trying to eliminate the abuse of preferences and not necessarily eliminating all the preferences.

I assume that you also agree.

Mr. PREISKEL. That is correct.

Senator BYRD. I am not sure that I understand your proposal as submitted.

Let me put this question: if a person has an income of, say, $100,000 and makes charitable contributions totaling $40,000, now that $40,000 is reduced by 50 percent, is it? How is that handled?

Mr. PREISKEL. No, our proposal would not necessarily touch that at all. You would first have to decide whether that falls into the tax preference category. We have not decided that it would. If it did not fall into the tax preference category, it would have no effect unless the taxpayer also had excess tax preferences; the $40,000 contributions reduces his taxable income, and since the amount of preference

that a person is entitled to depends on taxable income, the preferences he could take that year would also be reduced. In effect, you do allocate through this device some of your personal deductions against your preference. Under the proposal as we conceive it, if it were decided that it were a preference item, one would say that with $40,000 charitable contributions and $100,000 taxable income, the true income would be $140,000. If you said that the preference should be limited to 50 percent of the true income, the $40,000 deduction would not be disturbed.

If you limited it to 20 percent of true income, you would then allow only a $28,000 charitable deduction, and tax would be paid on $112,000, and $12,000 would be available as a carry forward. We have not tried to decide which should fall within the tax preference definition for these purposes.

Senator BYRD. So long as your tax preferences do not exceed 50 percent of your total income; then there would be no change in the present law.

Mr. PREISKEL. That is correct, assuming that 50 percent is the appropriate number.

Senator BYRD. Thank you, Mr. Chairman.

The CHAIRMAN. One thing that does bother me about this is the problem that Senator Byrd raised.

If we left out charitable contributions from the preferences, we are also going to leave out donations to universities and things that fall into the same section of the code. All of those are gifts to public organizations. If we do that, we may then leave ourselves subject to the choice that a person makes $1 million and still pays no income tax.

This gets back to the quarrel between the layman and our preacher. He tells us that we ought to give 10 percent of everything we make to the church. If you go back to the beginning, the church and the state were all the same thing; isn't that right? In other words, Moses was the church and the state at the time he was leader. The folks back at that time were not trying to run a check on Moses to see whether he was using their 10 percent to inspire them to do good or whether he was using it to build tabernacles to shelter the people from the rain.

If we look at the minimum income tax, the question is, should we give him credit for what he is paying to the church? If you go back and look at the history of the whole question, when he was paying it to the church, he was paying it to the state. It was the subsequent philosophy of government to separate the church and the state, but if we followed your approach and decided that we were going to let a gift to a religious body not be subject to tax, do you think that we could make folks understand that the gift should be considered the same as if it were a tax itself that was being paid by the taxpayer?

Mr. PREISKEL. That is more than a simple tax lawyer could answer. I think you are really in an area of policy involving substantial policy determinations. I do not think I can answer that question.

The CHAIRMAN. Well, the fact that you leave it to the committee and the Congress to decide what we should view as a tax preference and what we should not view as a tax preference is one reason that I think that your idea has a great deal of appeal to this committee.

You suggest also that you leave it for the Congress to decide whether we should apply the same tax rate for purposes of the minimum tax that exists elsewhere in the code or whether we should adopt a different rate.

Mr. PREISKEL. Well, I would have to leave it to Congress but, I believe, Senator Long, it seems to me that in light of the purpose of the provision, I do not see any reason for different rates. If it becomes a revenue-raising measure, you might want to impose a different rate, but if the purpose is merely to prevent someone from avoiding tax on too much of his income, I do not see any reason why it would have to shift to a different rate.

The CHAIRMAN. You would use the same rate structure?

Mr. PREISKEL. We would use the same rate structure, and change the amount of each preference if we felt that more tax should be paid, or less tax, on for instance capital gains. I think that we would do that in the preference end of it rather than in this alternative tax.

The CHAIRMAN. Thank you very much for some very constructive thinking.

I think that it would be very important, in view of the excellent credentials of your group and yourself that you would favor us with some imaginative thinking.

Senator Fannin?

Senator FANNIN. Mr. Chairman, I would like to ask one question. I am sorry that I could not be here to hear all of your testimony, but I have heard some comments.

I was wondering, the real estate group was here and the realtors had a little different approach to this. They would take normal taxable income without tax preferences and then add to that on tax preferences. The 50 percent of that would be the taxable amount. If the 50 percent resulted in a higher tax than the normal tax, you would pay that amount; if it did not, then you would pay the normal tax.

Mr. PREISKEL. That is basically our proposal.

Senator FANNIN. Thank you very much.

[The prepared statement and attachments of Mr. Preiskel follow. Oral testimony continues on p. 761.]

STATEMENT OF ROBERT H. PREISKEL, CHAIRMAN OF THE COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

SUMMARY

1. The existence of preferences which do not produce benefits commensurate with their cost is a problem different from the excessive use of preferences by individual taxpayers. These two problems should be dealt with separately.

2. The first problem should be dealt with by examining each of the preferences and eliminating or reducing it rather than by superimposing a complicated system limiting the preferences and imposing a flat excise tax on them.

3. The Minimum Tax merely reduces the value of all preferences to all taxpayers except to the extent excluded from the Minimum Tax; it does not deal effectively with the person who excessively reduces his income by their use.

4. The Bar Association recommends that instead of the Minimum Tax, the Code be amended to limit the deduction for preferences to a percentage of taxable income computed without the deduction for such preferences. If a taxpayer had $200 of preferences, $100 of normal taxable income after such preferences and if it were deemed that the appropriate percentage were 50%, the taxpayer would be allowed only $150 of preferences (50% of $300) and the remaining $50 of such preferences would be disallowed but allowed as a carryover in future years.

5. The Tax Reform Act shows an alarming tendency to create narrow detailed legislation for narrow current problems.

6. The tax treatment of income from a business and whether or not a person is entitled to preferences should not depend upon whether he is engaged in it full time or on his own or through a partnership or syndicate.

7. The Tax Reform Act does not adequately deal with structural reform or complexity.

STATEMENT

Thank you, Mr. Chairman. I am pleased to appear before you in my capacity as Chairman of the Committee on Taxation of the Association of the Bar of the City of New York.

The Committee on Taxation has submitted, or will shortly submit, comments with respect to Titles I, II, and III dealing with LAL, tax shelters and the Minimum Tax, those portions of Title X dealing with investments in U.S. property, the foreign tax credit, portfolio investments, possessions corporations and Sections 367 and 1248, and Title XI dealing with DISC. I would appreciate it if those reports were associated with and made a part of my statement.

It is impossible to talk about all of those provisions in any detail at this time. I would, however, like to discuss LAL and Minimum Tax and to make general observations with respect to the rest of the Tax Reform Act.

LAL and the Minimum Tax provisions are intended to deal with two problems which are separate and distinct. The first is the existence of tax preferences which do not produce benefits commensurate with the resultant loss of, and associated dislocations to, the revenue. The second is the ability of a taxpayer to eliminate or excessively reduce his liability for income taxes by use of tax shelters which are in themselves justifiable because they produce benefits commensurate with their costs.

These problems should be solved separately and failure of the Tax Reform Act to deal with them separately has resulted in legislation which is ineffective and inordinately complex.

The preferred solution to both problems would appear to be excision from the Code of those provisions intended to affect economic behavior and use of the Code and revenue system solely to raise revenue in an equitable manner, with all incentives and subsidies handled through other mechanisms. It does not appear that such a solution is a likely prospect at this time and we have therefore assumed that the Code will continue to provide preferential treatment for certain kinds of activity. We have also assumed it desirable to limit the extent to which a taxpayer can reduce his tax liability through the use of preferences even though in each case he is making a decision which is fundamentally in the national interest and is in direct response to and in accordance with incentives intended by Congress.

The first problem (the existence of preferences not justified on cost-benefit analysis) should be solved by an intensive scrutiny of each of the preferences, its cost, its effectiveness as an incentive and the desirability of the conduct which it encourages with a view to its modification or elimination from the Code. For example, it would be simple to provide preferential treatment for a portion rather than all of an expenditure, or to reduce the rate of accelerated depreciation or spread the deduction for intangible drilling expenses over a period of years. The deduction for capital gains could be reduced; a reduction to 40% would appear to produce substantially the same result and revenue as the imposition of a 14% Minimum Tax on a 50% deduction.

I am aware of the difficulty in confronting each of the preferences head on. I am heartened, however, by the fact that since 1969 legislation has been enacted increasing the capital gains rates, changing the definition of capital gains, limiting the deduction of investment interest, reducing depreciation benefits accorded to real estate and changing the recapture rules with respect to such depreciation, reducing percentage depletion allowances, repealing the investment credit, changing the rules with respect to charitable contributions, modifying the foreign tax credit for foreign oil and gas income, and otherwise dealing specifically with preference items. These changes certainly indicate that Congress can deal specifically with preference items.

The Committee is opposed to LAL and the 14% Minimum Tax as solutions to the first problem for the following reasons:

1. Their basic response is to distortions deliberately created and intended to produce certain kinds of behavior and result. Elimination or simple modification

of those provisions which create the distortions seem clearly preferable to the creation of a complex layer of new provisions to deal with them.

2. They treat similarly items which are as different as the tax preferences for low income housing, sports franchises and capital gains; it is hard to believe they should all be treated identically.

3. They avoid and may well defer basic tax reform.

4. LAL has a kind of seductive symmetry to it—artificial losses from an item of property are available only against income from that property. It is difficult, however, to see why as a policy matter this is a preferred method for limiting the scope of a preference. With respect to real estate, LAL permits losses from one item of real property to be applied against income from all other items of real property. This is seriously objectionable because it vastly prefers those persons who have developed a stream of real estate income against which losses could be taken and discriminates against those persons who have other kinds of income against which the losses would not be available. It is impossible to understand why a preference intended to stimulate future investment in real estate should be more beneficial to persons who have one kind of income resulting from prior activity rather than another.

5. LAL and the Minimum Tax are not applicable to corporations; true structural reform would make unavailable to corporate taxpayers as well as individual taxpayers benefits which are not economically justified; indeed, the failure to limit preferences in corporations will probably lead to using them to shelter income deflected to them from individual taxpayers.

The Tax Committee is opposed to the enactment of the Minimum Tax provisions of the Tax Reform Act whether LAL is or is not enacted.

Except for the 20,000–40,000 exemption, the Minimum Tax simply does not impact more heavily upon those persons who excessively reduce their tax liabilities through the use of preferences. Taxpayer A with $200,000 of taxable income after giving effect to $40,000 of preferences pays a 14% tax on his preferences; taxpayer B with no taxable income after $240,000 of preferences pays a 14% tax on his preferences. Taxpayer B pays a larger amount of tax but each taxpayer buys one dollar of preferences for 14¢.

Such a flat rate does not deter a 70% taxpayer from trying to eliminate all of his taxable income any more than it deters a 70% taxpayer from trying to eliminate part of his income. Unless the 14% tax is intended to prohibit the use of preferences, which it would not, it simply does not operate the way it should. What it really does is decrease the benefits flowing from the exercise of preferences and deals with the first problem—whether the cost of the preferences is justified by its benefits—rather than with the second problem—whether a particular taxpayer has excessively reduced his tax liabilities.

The Tax Committee recommends that the second problem, the execssive use of preferences, be solved by requiring each taxpayer to defer such portion of his deduction or exclusion benefit as is equal to the excess of his preferences over a designated percentage of his taxable income computed without giving effect to such preferences. Thus, assume a taxpayer had 100 of normal taxable income after 200 of preferences, and that 50% were the designated percentage. The taxpayer would be required to defer 50, the excess of his 200 of preferences over 150. The deferred preferences would be deductible in future years subject, of course, to the same limitation of the deduction of preferences. Under such a system the habitual over-user of preferences would in effect lose benefits attributable to his excess preferences; if a person's use were not inordinate, determined by comparing the amount of his preferences with his income over a period of time, the proposal in effect would result in a deferral rather than a disallowance.

The Committee recommends this alternative because

1. It is simple (a draft of statutory provisions is attached to the Committee report dealing with Limitation on the Use of Tax Incentives).

2. It effectively prohibits the excessive use of preferences by denying them rather than by merely subjecting them to a 14% tax, a price which a 70% taxpayer might well be willing to pay. (Examples are attached to the Committee report on Limitation on the Use of Tax Incentives.)

3. It does not impose a direct burden on the preferences themselves, while the Minimum Tax would impose such a burden on all preferences beyond the minimum amount exempted from such tax.

The Tax Reform Act is awesome in its complexity. Much of this is attributable to familiar causes, the major of which is probably the use of the Internal Reve-

nue Code to influence economic behavior and not merely to collect revenue in an equitable manner.

However, the Tax Reform Act shows an alarming proliferation of narrow legislative solutions to narrow current problems. Thus, allocation of purchase price is a problem which arises other than in connection with sports franchises and the appropriate treatment of nonrecourse debt is not a problem limited to the film, cattle and oil and gas industries. Broad principles of general application should be developed. Patent abuses should be left to the courts.

There also seems to be a somewhat exaggerated pursuit of the relatively inconsequential. Thus, although recapture of foreign losses is appropriate to the effective operation of the foreign credit mechanism and is consistent with the philosophy of the overall limitation, the reduction of foreign tax credits by proposed Section 904(f)(1)(B) is inconsistent with that philosophy, redundant and unfair while the generation of income by proposed Section 904(f)(3) seems to be entirely gratuitous and even outrageous.

A relatively new concept of dubious merit which will vastly complicate the Code suggests that one's method of accounting and therefore the tax treatment of one's interest in a business should depend upon whether one is in that business full or part time. Preferences and preferential methods of accounting are created to stimulate and reward the investment of funds and it seems difficult to understand why a full-time participant's investment should have difference tax consequences than an investment by a part-time person.

Preferences arise because of the relative differences in the tax burdens imposed upon different kinds of activities. The creation of further complex rules creating further distinctions in the tax treatment of various kinds of income and various kinds of taxpayers will generate further preferences.

Many provisions of the Internal Revenue Code are not fully understood by taxpayers, their advisers or representatives of the Government and indeed many of the provisions are not susceptible of understanding, much less sound application in the real world.

Unfortunately the Tax Reform Act does not adequately deal with and indeed in many ways compounds existing problems of tax preferences and complexity.

Proposal for Limitation on the Use of Tax Incentives

I General Statement

The Committee on Taxation of the Association of the Bar of the City of New York (the "Tax Committee") believes that the LAL and Minimum Tax Provisions of the proposed Tax Reform Act of 1975 ("House Bill") are egregiously deficient in the manner in which they deal with the problems they are supposed to solve.

Those problems simply stated are first, the existence of tax preferences which are not justified by the benefits which they produce and second, the excessive use of such preferences by taxpayers who thereby inordinately reduce taxable income.

It is clear that the combination of LAL and the increased and revised Minimum Tax will inhibit the use of tax preferences. But it is equally clear that this will be accomplished in an excessively complicated, random and nonselective manner by submitting all tax preferences, no matter how conceived or determined or useful, to the same LAL burden and to the imposition of an across-the-board excise tax at a flat rate. The effect will be to postpone indefinitely the intensive review of tax preferences which is so urgently required and to impose on all persons who avail themselves of such preferences beyond a minimum amount, a tax at a flat rate, no matter how great the tax saving from the use of such preferences, whether such saving is viewed relatively, in proportion to the income of the user, or absolutely.

The Committee submits that what is required in the first instance is a selective and careful consideration of each preference, its cost, its effectiveness as an incentive, and the social desirability of the conduct which it encourages. If it is determined that the preference is not justified because the social desirability of the resulting conduct is not commensurate with its cost or is overbalanced by attendant dislocations in the tax system—the preference should be eliminated or appropriately reduced. Thus accelerated depreciation or the deduction of intangible drilling expenses might be terminated or modified, either by providing

preferential treatment only for a portion of the expenditure, by reducing the rate of accelerated depreciation, or by spreading the deduction for intangibles over a period of several years.

Determining whether a preference is justified or whether it should be eliminated or modified for failure to produce benefits commensurate with cost or effectiveness, is beyond the competence of the Tax Committee. The Committee believes, however, that no preference should exist unless it is demonstrably socially desirable, and that this can be determined only if there is a careful and selective testing of all preferences. The Committee believes that superimposing LAL on items of tax preference is cumbersome, complex and erratic; and will unfortunately delay indefinitely the kind of review of tax preferences which is really required.

Whether or not Congress undergoes a thorough review of preferences, or enacts LAL, the Tax Committee believes that the second problem, the excessive use of preferences, should be curbed by requiring each taxpayer to defer such portion of his deduction or exclusion benefit as is equal to the excess of his preferences over a designated percentage of his taxable income computed before giving effect to preferences. This limitation is intended to prevent a taxpayer from sheltering an inappropriately large percentage of his taxable income. As will be demonstrated by the following example it is a far more appropriate and effective deterrent than the minimum tax proposed by the Tax Reform Act:

EXAMPLE

	Present law	H.R. 10612	Tax committee
Gross income	5,000,000	5,000,000	5,000,000
Preferences other than itemized deduction	4,000,000	4,000,000	4,000,000
Adjusted gross income	1,000,000	1,000,000	1,000,000
Itemized deduction	1,000,000	1,000,000	1,000,000
Taxable income	0	0	0
Addition for deferred tax preferences			2,000,000
Taxable income	0	0	2,000,000
Income tax	0	0	1,370,000
Minimum tax	299,997	604,000	
Total	299,997	604,000	1,370,000

Note: For illustrative purposes, we have asssumed that the appropriate percentage is 50 percent. Whether this percentage should be increased or decreased, or made progressive, requires a policy determination on which the committee expresses no view.

The deferred portion would be deductible in future years subject, of course, to the same limitation on the deduction of preferences. Under such a system habitual over-user of preferences would in effect lose a substantial portion of the benefits from such preferences; if a person's use were not inordinate, determined by comparing the amount of his preferences with his income for a period of time, the proposal would in effect result in a deferral rather than disallowance. The Committee believes this would be appropriate.

The Committee has also considered a second limitation on the amount of preferences. This would require the taxpayer to defer a portion of his preference benefits equal to a designated percentage[1] of his preferences, if this second limitation resulted in a greater deferral than that referred to above.

The Committee does not recommend the adoption of the second limitation because it does not believe that an across the board reduction in tax preferences is appropriate if the amount of preferences is not inordinately large in proportion to the taxpayer's income. However, as a policy matter, if it should be concluded that if such a limitation is desirable, the Commission believes that the 20% deferral would be simple and appropriate.

Attached is a draft of proposed legislation, a technical explanation and a series of examples which compare the impact of the Tax Committee proposal with the results to be anticipated under the Tax Reform Act of 1975.

[1] For illustrative purposes, we have assumed that the appropriate percentage is 20%. Whether this percentage should be increased or decreased, or made progessive, requires a policy determination on which the Committee expresses no view.

II. COMMENTS ON THE TAX REFORM ACT OF 1975

The rationale for the tax shelter provisions of the House Bill are stated on the first page of the report of the House Committee on Ways and Means ("Ways and Means Report") as follows:

"Tax reform is one of the highest priorities of the American people. They are demanding that all individuals and corporations bear a fair share of the tax burden and that it not be possible for high-income persons to avoid paying income tax entirely. The Tax Reform Act of 1975 takes strong action to achieve this goal. It reduces the important tax shelters and requires individuals to pay at least some minimum tax on their preference income. The bill cuts back or repeals many tax preferences entirely . . .

"The committee also believes that it is important to simplify the tax law and forms so that the public can better understand the law and need not make as much use of professional tax preparers as is true today."

Our Committee agrees with these goals. However, we fault LAL and a strengthened minimum tax as the means of accomplishing these goals because we find that those concepts are inadequate to achieve the announced objectives.

Simply stated, as indicated by the Ways and Means Report, the aims are as follows:

(1) Simplify the tax law;

(2) Make it impossible for high-income persons to avoid paying tax entirely, by requiring individuals to pay some minimum tax on preference income;

(3) Require all individuals and corporations to bear a fair share of the tax burden; and

(4) Cut back on or repeal tax preferences.

Our Committee believes that these goals are best served by reform provisions which are not inconsistent with these stated objectives. Reform provisions should not unnecessarily complicate the law. They should apply fairly and equitably to all taxpayers. They should comport with the progressivity of our taxing system. The LAL and minimum tax provisions do not satisfy these standards.

A. General objections to LAL and minimum tax

We believe that both minimum tax and LAL are incorrect in their approach toward "reducing the important tax shelters." Consequently, this report is designed to comment generally on the inadequacies of these two concepts, while also suggesting an alternative approach designed to (a) limit or eliminate the benefits of specific "tax preferences", while (b) prohibiting excessive utilization of those that remain, and (c) if necessary, providing for an overall reduction of all remaining "tax preferences".

1. *Failure to achieve basic tax reform.*—Perhaps our basic objection to minimum tax and LAL is that they fail to effect any basic reform of those provisions which are no longer justifiable. Both of these provisions operate against all tax preferences without considering the propriety of any. We believe that Congress can and should make a policy review of all tax-favored investments to determine whether the reason for originally adopting the tax incentive is still valid. If Congress determines that the revenue loss from a tax preference is greater than the economic or social benefit, the preference should be repealed or reduced.

Thus, we believe that each of these items should be considered separately since different policy justifications apply to individual provisions. The tax incentives swept into the LAL and minimum tax provisions differ from one another either because (a) they were adopted for different policy reasons (for example, the tax incentives for low income housing are most certainly different than those involving sports franchises), or (b) they accomplish different tax results (such as deferring income, accelerating deductions or conferring rate benefits by changing ordinary income into capital gains).

A major drawback to LAL and minimum tax is that most of the incentives remain, to be used by taxpayers in circumstances where they would not be affected by either of these two provisions (i.e. private corporations). A far more preferable course would be to cut back the benefits of, or repeal, those tax incentives for all taxpayers which have outlived their usefulness, retaining, perhaps in modified form, those which are deemed, as a policy matter, to retain some validity.

2. *Failure to prohibit excessive use of tax preferences.*—Neither LAL nor minimum tax effectively deals with the excessive use of tax preferences. For example, under LAL, a real estate operator may still effectively shelter virtually all of his income from real estate sources[2] (which may be his only source of income subject to tax), while an investor in oil properties would still be entitled to intangible drilling deductions to offset potentially substantial amounts of income produced from the same interest in oil property. Moreover, as explained below, the 14% minimum tax may not effectively deter these taxpayers from avoiding excessive amounts of income tax.

3. *Failure to achieve simplification.*—On page 7 of the Ways and Means Report, it is recognized that "the complexity of the tax system for the average American is also a serious and growing problem." The LAL provisions, which are designed to "reform" the tax shelter provisions, if anything, add significantly to this complexity. The difficulty in reporting and administration of LAL will be substantial for a schedular system of taxation will be required for a significant number of items of income and deductions. Furthermore, any provision which requires ten full pages of statutory material, and 60 pages of Committee Report to explain is guaranteed to complicate, rather than reform, the law.

4. *Failure to require all taxpayers to bear a fair share of the tax burdens.* The whimsical nature of the minimum tax will be described in greater detail below. But any provision for imposing a flat 14% excise tax without regard for the benefit achieved will assuredly be inequitable in its application. Moreover, LAL, because of its non-application to corporations, is likely to result in an increase in private company utilization (personal holding companies as well as regular business corporations) of the tax incentives denied individuals. This can hardly result in *all* individuals and corporations bearing a *fair share* of the tax burden.

B. Specific objections—Minimum tax

Our objections to the minimum tax include the fact that

1. it is an erratic levy imposed on a list of items which are quite diverse;

2. as it is augmented, the need for complex basis adjustments becomes more pressing;

3. we see no real benefit to establishing layers of special taxes, when other legislative remedies are available;

4. the minimum tax represents legislative "overkill" if other structural reforms which have been proposed, or are already part of the House Bill, are adopted;

5. it would be counterproductive to impose an excise tax on an investment made to gain a benefit intended as an incentive because that benefit was realized; and

6. it fails to deal with excessive use of tax shelters.

1. The minimum tax imposes a flat 14% tax on a list of items that are quite diverse and accomplish disparate results for taxpayers. Because of the diverse nature of these preferences, the imposition of the 14% tax accomplishes unfair and, in some sense, whimsical results. This can be seen by analyzing the benefits available through these tax preferences:

Rate reduction.—The long-term capital gains deduction (§ 57(a)(9)) and to some extent qualified stock options[3] (§ 57(a)(6)) effect a rate change. Similarly, the excess of percentage depletion over cost depletion (§ 57(a)(8)) to the extent that it remains available to small producers, effectively reduces the rate of tax upon oil related income. The benefit to the taxpayer is realized in the year the income is realized and is never recaptured.

Timing benefits.—Those tax preference items dealing with deductions, such as accelerated depreciation on real property (§ 57(a)(2)) and leased personal property (§ 57(a) (3) and (13)), amortization of certified pollution control facilities (§ 57(a)(4)), amortization of railroad rolling stock (§ 57(a)(5)), amortization of on the job training and child care facilities (§ 57(a)(10)), intangible drilling and development expenses (§ 57(a)(12)), construction period interest and taxes on real estate (§ 57(a)(14)), and amortization of certain player contracts (§ 57(a)(15)) all effect an immediate deduction subject in

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[2] The reason this occurs is because of the amendment on the House floor permitting aggregation of real estate interests.

[3] Qualified stock options also effect a timing benefit, comparable to accelerated deductions.

most cases to potential future recapture as ordinary income. As explained in another section of this report, the recapture rules vary from item to item. However, in all cases but construction period losses, some recapture is possible,[4] and perhaps likely. But this recapture may vary from the following year to many years after the deduction, may be total or only partial and, in some cases, may be totally avoided by an intervening death.

Miscellaneous.—The excess itemized deduction provision of § 57(a)(11) is not related to any particular item of income or investment and therefore cannot be compared to any of the prior categories. It is a pure excise tax on excess personal deductions.

The imposition of minimum tax on items effecting a rate reduction mitigates this reduction. Thus, the 14% tax on the long-term capital gains deduction effectively increases the capital gains rate to 42%. If the purpose of imposing this tax is to achieve this revenue producing result, a far more direct and effective method would be to simply reduce the long-term capital gain deduction after the first $50,000 of net long-term capital gain to 40% of the excess of net long-term capital gains over net short-term capital losses. Similarly, percentage depletion on oil could be reduced to 17.6%, etc.

The imposition of a 14% minimum tax on deferral items, however, is quite a different matter. Tax deferral without interest cost is, of course, valuable. The 14% excise tax becomes a toll charge for that timing benefit. This is quite different than simply increasing the tax rate on a capital gain since the cost is related to the period of time for which the deferral is achieved. But the imposition of the 14% tax as a toll charge is erratic and in many cases whimsical. For example, two taxpayers owning identical pieces of equipment and claiming identical methods of accelerated depreciation in Year 1 would have an identical tax impact under the minimum tax. The first taxpayer, however, may sell or dispose of the property, perhaps involuntarily, in Year 2 thereby potentially recapturing every dollar of tax benefit gained by the depreciation in Year 1. The second taxpayer, on the other hand, may hold the property for an extended period of time and recapture the gain, if ever, many years later.

There is little justification for both taxpayers being subject to the same toll charge in Year 1. This distortion is exaggerated if the property were subject to recapture under § 1250 and by merely holding for an extended period, the second taxpayer gains a rate reduction in addition to his timing benefit.[5] And if the basis in the property was increased because the second taxpayer died during the period of ownership, the recapture would be totally avoided. In all of these situations, both taxpayers would have paid an identical 14% tax but would have achieved widely disparate benefits.

2. As the tax increases, basis adjustments as a mitigation for the penalty aspects, at least for timing differences, will likely be advocated. The House Bill does not propose any basis adjustments. Our Committee would prefer that because of added complexity, basis adjustments be avoided. But not at the cost of imposing penalty taxes. Therefore, we recommend that other approaches to this problem be adopted by Congress to avoid the necessity of considering these complex mitigating basis adjustment provisions.

3. Our Committee also objects to the minimum tax as a means of "cutting back on tax preferences" since additional tax measures, such as the minimum tax, tend to be maintained long after they have served the purpose for which they were adopted. The House Bill demonstrates that Congress is capable of dealing directly with tax preferences on a policy basis. Nevertheless, the minimum remains. For example, in the Tax Reduction Act of 1975, percentage depletion was repealed for many producers. Similarly, the House Bill repeals provisions dealing with qualified stock options and § 184, providing for the rapid write-off of railroad equipment, expired on December 31, 1975. Nevertheless, each of these items remains a tax preference.

4. Moreover, augmenting the minimum tax is also a case of legislative "overkill". Many of the provisions of Title II, as well as LAL itself, will serve to reduce the benefit of tax shelters. The minimum tax may then merely duplicate the

[4] In those cases where no recapture or only partial recapture is achieved, a rate reduction, in addition to a timing benefit, may be achieved.

[5] This exaggeration always exists for construction period interest and real estate taxes which are never recaptured at ordinary income rates.

Congressional effort. If LAL and the various provisions of Title II dealing with tax shelters are effective, then the minimum tax merely becomes a penalty. As previously indicated, our Committee endorses individual review of various tax-favored investments and recommends that the effort contained in Title II be expanded to include all tax-favored investments. Once this course has been effectively followed, the minimum tax will become an anachronism.

5. The minimum tax is also counterproductive in that it penalizes a taxpayer for investing to gain the benefits of various provisions which Congress specifically adopted as incentives. The Ways and Means Report clearly points out this anomaly. Section 102 of the House Bill expands and extends the tax incentive provided by § 167(k). In explaining the special rapid depreciation provisions for rehabilitation expenses under § 167(k), the Ways and Means Report states at page 181:

"In the Housing and Community Development Act of 1974, the Congress expressed its desire to stimulate construction in low- and middle-income housing to eliminate the shortage is this area. However, the special tax incentive for rehabilitation expenditures for low-income rental housing under present law expires on December 31, 1975. Without this incentive the remodeling of many high-risk low-income projects may be curtailed. In order to avoid discouraging this rehabilitation, your committee believes that the special depreciation provision for low-income housing should be extended."

Thus, in a bill designed to "eliminate excessive tax incentives" and foster "economically sound investments" Congress extends another tax incentive to stimulate investment where it is recognized that "without this incentive, the remodeling of many high-risk . . . projects may be curtailed." It would appear to be counterproductive to expand a tax incentive to foster investment and at the same time subject that investment to a 14% excise tax. If Congress determines that the incentive is too great, it would be far more effective to reduce the incentive by simply requiring the rapid amortization to be spread over 72 months rather than 60 months. This would be preferable to retaining the 60 month write-off and then subjecting the accelerated benefit to a 14% excise tax subject to all of the vagaries described above.[6]

6. Finally, the minimum tax is objectionable in that it fails to deal with an expressed concern of Congress, i.e. excessive use of tax preferences by individuals, reducing the tax burden to a mere fraction of what would otherwise be owed absent the tax shelter provisions. The schedules attached demonstrate that higher bracket taxpayers can avoid large amounts of tax while paying only a relatively small minimum tax. This does not really satisfy the stated objective that all taxpayers carry a fair share of the tax burden. In fact, strengthening the minimum tax may merely make tax preferences more of a rich man's game. Taxpayers with large amounts of income might well choose to pay a 14% minimum tax rather than the 70% maximum rate whereas taxpayers with a 50% maximum rate or less may not. Our Committee believes that a principal means for requiring all taxpayers to pay a fair share of the burden within the progressive tax structure is to limit the amount of tax preference items which any one taxpayer can utilize in any particular year. This would augment taxable income, taxable at rates up to 70%, rather than merely imposing a flat 14% tax. The minimum tax does not accomplish this goal.

C. Specific objections—LAL:

Our Committee also objects to LAL as a principal means for accomplishing reform of tax shelters. In the first place, LAL adds an entirely new level of complexity to an already over-burdened statue. These complexities include schedularizing many categories of income, substantial definition problems such as "construction period", "item of property", etc., allocation questions with respect to expenditures that many conceivably be allocated between classes of property, elaborate recordkeeping requirements which prove particularly burdensome for small developers and investors with investments which previously required little or no major accounting.

The provisions of Title I also demonstrate another risk of attempting to apply an overall concept to investments which differ materially from one another. LAL provides detailed rules for each industry. And these rules differ markedly from

[6] The examples attached demonstrate this approach.

investment to investment. For example, the treatment of classes of property for real estate (which provides for the aggregation of all property), oil (which is ostensibly limited to a property-by-property basis but in reality covers all wells drilled on a specific piece of property which might be quite vast) and equipment leasing (which appears to be limited to each individual item of property) are quite different in their scope. Moreover, construction interest in real estate is included in the LAL concept while it is excluded for the farm industry. Similarly, certain industries are subject to LAL for what could be described as mere accounting losses (i.e. the excess of accelerated depreciation over straight-line on real estate and personal property) while other industries are subject to LAL on the amortization of real economic cost (i.e. application of LAL to the amortization of film costs or player contracts).

It is not the function of our Committee to evaluate whether these differing rules for each investment are justifiable. We endorse this Congressional effort of dealing specifically with each separate tax incentive to the extent that it evidences a policy review by Congress of the policy for each of these tax incentives. However, we object to the imposition of an entirely new overlay of complex rules when it would be possible to exercise similar policy judgments on the basis provisions themselves.

Moreover, basic reform would result in modification of the incentives for all taxpayers. LAL, however, is designed to affect only individuals. This will permit taxpayers with large enough interests to incorporate those interests thereby totally avoiding the reforms embodied in LAL.

Our Committee also objects to the fact that proposals, such as LAL or minimum tax, have the effect of freezing the existing provisions of the Code. Structural reform will require Congress to examine the policy implications of each of the incentives with the potential of achieving simplification through elimination of those provisions that are no longer required. LAL, on the other hand, merely attempts to diminish the incentive on a selective basis without considering the justification for it. The end result is the shelter remains, and taxpayers will strive to use it.

III. COMMITTEE PROPOSAL

Our Committee has attempted to deal with all of these considerations in formulating a proposal to replace LAL and the minimum tax. The ends which we attempted to achieve are:

(1) Simplicity;

(2) Require all individuals to pay a fair share of the overall tax burden; and

(3) Review policy implications of all tax incentives.

We attach to this report proposed statutory provisions and a technical explanation of the bill which includes illustrative examples of the results sought to be achieved. While we prefer the proposal to be considered as an alternative to both LAL and the minimum tax, we also suggest that it be adopted even if it replaces the minimum tax only.

Implicit in this proposal would be policy review of each of the tax incentives which now comprise the list of tax preferences. To the extent it is determined that these tax incentives had outlived their usefulness or should be diminished in any respect, appropriate amendment of the particular provision is favored. In order to demonstrate the effect of basic reform, we have assumed in the examples that the tax preference item is entirely represented by depreciation claimed under § 167(k) and that a policy judgment is rendered that such a write-off should be over 72 months rather than 60 months. It is our view that any revenue raising requirement which the reform provisions are supposed to produce can be satisfied by this type of basic structural reform. For example, increasing the capital gains rate effectively to 42% will raise substantial revenues. Similarly, lengthening write-off periods for accelerated depreciation, cutting back on depletion allowances, etc. could easily produce revenues far in excess of that which is produced by a 14% minimum tax. Moreover, the percentage of income limitation described below will itself produce revenues in that it will effectively prohibit the overutilization of tax preferences to shelter inordinate amounts of income otherwise subject to the income tax.

A second aspect of our proposal would be to limit the amount of tax preferences which any taxpayer could claim by requiring all taxpayers to defer that portion

of all tax preferences claimed in a particular year which exceeds a percentage of the taxpayer's taxable income for that year determined without allowance for tax preferences ("percentage of income limitation").

This percentage of income limitation is designed to prohibit the excessive use of tax preferences by any single taxpayer. As previously explained, neither LAL nor minimum tax achieves this result. This would limit the amount of tax preferences, if they exceed $10,000, to 50% of taxable income computed without allowance for such preferences.[7] In other words, a taxpayer's allowable tax preferences in any year cannot exceed the income upon which he calculates his tax. To demonstrate the operation of basic reform plus this percentage of income limitation, as compared to tax burdens under the present law and under the House Bill, we have developed three fairly simple hypothetical situations. Example 1 considers a typical upper bracket taxpayer with $100,000 of earned income with a modest amount of tax preferences. Example 2 shows a high bracket taxpayer with $200,000 of earned income and excessive tax preferences. Example 3 demonstrates a dramatic reduction in tax liability.

We believe that this proposal has several distinct advantages. First, it is simple to administer. In its desire to create "tax equity" Congress repeatedly has passed statutes that react to discreet problems, and in so doing has rendered the Internal Revenue Code so complex that even experts are unable to determine the meaning of many of the provisions. Our Committee believes that if reform can be achieved simply, without adding new terms and concepts to the Code, this, in and of itself, will be a major accomplishment.

Second, the percentage of income limitation imposes an added tax burden progressively, at graduated rates, in proportion to the size of the taxpayer's income and for reasons related to meaningful tax reform (i.e. the prohibition of excessive utilization of tax incentives).

Third, our proposal, by seeking review of the various tax incentives, will result in an appropriate policy review of each of the varied tax incentive provisions. Those that remain, following such review, should be allowed to foster investment without further penalties. But our proposal also prohibits overutilization of those tax incentives which Congress chooses to retain, without terminating their effectiveness.

Finally, our proposal also recognizes that many tax preferences provide timing benefits, as distinguished from permanent reductions in tax liability. To the extent that these timing benefits are preserved, we believe that deferral, rather than imposition of an additional excise tax, should be the consequence of excessively sheltered income. This permits a determination by reference to the use of shelters over a period of time rather than within the structures of annual accounting concept. The Committee's proposal does not permit a carryback of preferences or an accumulation of unused preferences to be used in determining the amount of permissible preference deductions; it merely permits a carryforward of preferences which would excessively reduce tax liability in any year.

Our Committee has also reviewed the possibility of other approaches if Congress determined not to pursue the basic reform of the tax incentive provisions which we are recommending. While we much prefer the course previously described in this report, we have nevertheless concluded that an alternative to the minimum tax is preferable if the purpose is to raise revenues by making all tax preferences less attractive. This alternative would require each individual to defer to following years a given percentages[8] of all items of tax preference. The amount deferred in any given year would be the greater of the "percentage of income limitation" described above or the 20% deferral which we are suggesting as an alternative. In the attached statutory material the 20% deferral provisions are set forth, but stricken through.

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[7] The percentages and the $10.000 exclusion are used for illustrative purposes. They may be modified, made proportional or otherwise varied.

[8] We have chosen a 20% deferral since this would potentially subject deferred items in a 70% bracket to an income tax equal to the 14% minimum tax rate.

	Amount	Present law	House bill	Committee proposals: Tax reform and 50 percent cap	20 percent alternative deferral or 50 percent cap: 20 percent	50 percent
Example 1:						
Income	$100,000			$100,000	$100,000	$100,000
Preferences [1]	40,000			33,333	40,000	40,000
Adjusted gross income	60,000			66,667	60,000	60,000
Itemized deduction	16,000			16,000	16,000	16,000
Taxable income	44,000			50,667	44,000	44,000
Deferred tax preference					8,800	
Adjusted taxable income					52,800	
Income tax		$14,060	$14,060			
Minimum tax		300	5,600			
Total		14,360	19,660	17,260	18,460	
Carryover					8,800	
Example 2:						
Income	200,000			200,000	200,000	200,000
Preferences [1]	130,000			108,333	130,000	130,000
Adjusted gross income	70,000			91,667	70,000	70,000
Itemized deduction	26,000			26,000	26,000	26,000
Taxable income	44,000			65,667	44,000	44,000
Deferred tax preferences				21,333	26,000	43,000
Adjusted taxable income				87,000	70,000	87,000
Income tax		14,060	14,060	37,400		37,400
Minimum tax		9,300	18,200			
Total		23,360	32,260	37,400		37,400
Carryover				21,333		43,000
Example 3:						
Income	5,000,000			5,000,000	5,000,000	5,000,000
Preferences [1]	3,500,000			2,916,667	3,500,000	3,500,000
Adjusted gross income	1,500,000			2,083,333	1,500,000	1,500,000
Itemized deduction	500,000			500,000	500,000	500,000
Taxable income	1,000,000			1,583,333	1,000,000	1,000,000
Deferred tax preferences				666,667	700,000	1,250,000
Adjusted taxable income				2,250,000	1,700,000	2,250,000
Income tax		670,000	670,000	1,546,000		1,546,000
Minimum tax		280,000	490,000			
Total		950,000	1,160,000	1,546,000		1,546,000
Carryover				666,667		1,250,000

[1] Presumed to consist entirely of accelerated depreciation under sec. 167(k), which for purposes of the example of basic tax reform, is assumed to have been extend to a 72-mo. writeoff.

NOTE.—This draft has not been reviewed by the Committee. Stricken through material is to be ignored unless alternative 20% limitation on preferences is to be employed.

STATUTORY AMENDMENTS

The following amendments are necessary to effectuate the proposal:

1. Section 63(a) shall be amended in its entirety to read as follows:

"(a) *General Rule*—Except as provided in subsection (b), for purposes of this subtitle the term 'taxable income' means gross income, plus, in the case of a taxpayer other than a corporation, the addition for tax preferences defined in Section 59(a) minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following)."

2. Section 63(b) shall be amended to read as follows:

"(b) *Individuals Electing Standard Deduction*—In the case of an individual electing under section 144 to use the standard deduction provided in part IV

(sec. 141 and following), for purposes of this subtitle the term 'taxable income' means adjusted gross income, minus—
(1) such standard deduction
(2) the deductions for personal exemptions provided in section 151; and
(3) the deduction for preference carryovers defined in section 59(b)."
3. The following new Section 189 is inserted after Section 188.

"SEC. 189 DEDUCTION FOR PREFERENCE CARRYOVERS

There shall be allowed as a deduction the deduction for preference carryovers defined in Section 59(b)."
4. The following new Section 59 is inserted after Section 58:

"SECTION 59 DEFINITIONS CONCERNING LIMITATIONS ON TAX PREFERENCES

(a) Addition for Tax Preferences.—The addition for tax preferences shall be [the greater of]—
[(1)] the excess, if any, of such taxpayer's taxable preferences (as defined in subsection (c)) for the taxable year over 50% [*] of such taxpayer's adjusted taxable income (as defined in subsection (d)) for the taxable year [, or
[(2) 20% of such taxpayer's taxable preferences (as defined in subsection (c) for the taxable year)].
(b) *Deduction for Preference Carryovers.*—The deduction for preference carryovers shall be so much of the preference carryover (as defined in subsection (e)) as does not exceed [the lesser of]—
[(1)] the excess, if any, of 50% [*] of such taxpayer's adjusted taxable income (as defined in subsection 59(d)) for the taxable year over the sum of such taxpayer's items of tax preference (as defined in section 57) for the taxable year [, or]
[(2) 80% of such preference carryover (100% of such preference carryover in the case of a taxpayer whose preference carryover does not exceed $10,000 [*] ($5,000 [*] in the case of a married individual who files a separate return)).]
(c) *Taxable Preferences.*—The term 'taxable preferences' shall mean an amount equal to the sum of a taxpayer's items of tax preference (as defined in section 57) for the taxable year, if such sum exceeds $10,000 [*] ($5,000 in the case of a married individual who files a separate return); if such sum does not exceed $10,000[*] ($5,000 [*] in the case of a married individual who files a separate return), such taxpayer's 'taxable preferences' shall be zero.
(d) *Adjusted Taxable Income.*—The term 'adjusted taxable income' means the amount by which the sum of—
(A) the taxpayer's gross income for the taxable year, and
(B) his items of tax preference for the taxable year, exceeds the sum of the deductions (other than the deduction for preference carryovers as defined in section 59(b).
(e) *Preference Carryover.*—The 'preference carryover' for any year shall be the addition for tax preferences for the preceding year plus the preference carryover for such preceding year, minus the deduction for preference carryover for such preceding year."
5. Section 172(c) (relating to the definition of a net operating loss) is amended by substituting the following for the last sentence thereof:
"Such excess shall be computed with the modifications specified in subsections (d) and (l)."
6. Section 172(l) is redesignated as Section 172(m) and the following new section 172(l) is inserted after Section 172(k):
"(l) *Tax Preferences.*—In the case of a taxpayer other than a corporation, the net operating loss for any taxable year shall be decreased by amount equal to the excess of such taxpayer's taxable preferences (as defined in section 59(c) (1) over the sum of the items of tax preference (as defined in section 57) which are otherwise not disallowed pursuant to subsections (d) (2) and (d) (4) of this section) in computing the amount of the net operating loss."

[* These amounts and percentages are used for illustrative purposes only; they may be varied or made progressive without effecting a change in the general operation of the proposal.]

NOTE.—This technical explanation assumes that the 20% alternative limitation will not be employed. If it were to be employed the statement, of course, would have to be modified.

TECHNICAL EXPLANATION

The underlying purpose of this proposal is the disallowance of excessive tax preferences in the computation of taxable income. Any preferences so disallowed are deferred and carried forward indefinitely, and thus available to reduce taxable income in subsequent years, subject to similar limitations on the excessive use of preferences. Only upon his death will a taxpayer lose at least the opportunity to utilize previously deferred preferences.

By permitting unlimited carryovers, this procedure eliminates the need for complex adjustments to basis on account of disallowed preferences, such as accelerated depreciation. Although the amount of gain recognized on the disposition of an asset may exceed the deductions which a taxpayer has previously utilized to reduce his taxable income (*e. g.*, a portion of accelerated depreciation has been deferred), the fact that such deductions are available to reduce taxable income in subsequent years tends to eliminate any unfairness inherent in the current taxation of gain. The availability of the unlimited carryover thus obviates the need for a complicated mechanism to trigger previously deferred deductions on disposition of the underlying asset. By eliminating any necessity for determining the exact amount of any given item of tax preference which has been deferred, the proposal permits an undifferentiated "basket" carryover of deferred preferences, thus avoiding a great deal of complexity.

The amendments to section 63 illustrate the basic operation of the proposal: excessive current preferences are added to taxable income, while previously deferred preferences may be deducted if current preferences are not excessive.

Section 59(c) defines "taxable preferences" as excluding all items of tax preference if the sum of such preference is less than $10,000. This "safe harbor" is provided in order to avoid application of the proposal to a taxpayer who has not sheltered "too much" income.

Sections 59(a) and 59(d) in effect require the addition to income and the deferral of items of tax preference to the extent that they would reduce a taxpayer's income below 50% of what it would have been without such preference items.

Section 59(e) defines the deduction for preference carryovers as in effect being the excess of all items of tax preference in prior years over those which have been allowed.

Section 189 allows a deduction for any such preference carryovers to the extent that such preference carryovers together with any current preferences do not exceed 50% of the taxable income computed without such preference items.

Because this proposal provides a vehicle for the independent carryover of tax preferences, the amendments to section 172 serve to remove all items of tax preference from the calculation of the net operating loss for a taxable year, except in the case of a taxpayer who is within the $10,000 safe harbor. New section 172(l) eliminates from the calculation of the net operating loss all preferences which are not otherwise disallowed by section 172(d). This has the effect of decreasing the net operating loss which would otherwise result by the amount of all preferences, including the "spread" on stock options. Thus, the net operating loss for a year will consist solely of non-preferential items and disallowed preferences will be carried forward separately. Since allowances of current preferences and preference carryovers is based on taxable income before application of section 59, the net operating loss carryover is "primary" and can, in the event of a carryback, oust otherwise allowable preferences.

U.S. PORTFOLIO INVESTMENTS OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS [10]

Summary of section

Under present law, interest received from any United States resident or from certain U.S. governmental authorities, and dividends received from domestic corporations, by nonresident aliens and foreign corporations are, in

[10] Section 1041 was deleted from the Bill on the floor of the House. However, it is understood that this decision may be reconsidered by the Senate Finance Committee.

general, included in the gross income of the foreign recipient.[11] Such interest or dividend is either subject to the normal U.S. net income tax rates if it is effectively connected with the conduct of a trade or business within the United States[12] or, if it is not so effectively connected, it is generally subject to a 30% U.S. withholding tax or lower treaty tax rate.[13] Moreover, if such interest or dividend is subject to U.S. income tax, an individual holder of the obligation or stock may be subject to U.S. estate tax.[14]

In general, Section 1041 of H.R. 10612 would add Code Section 897 and amend Code Sections 861, 872, and 883 to exclude such interest (including original issue discount) and dividends from gross income, thereby exempting such amounts from tax and eliminating U.S. withholding tax thereon. To qualify, the interest or dividend must not be effectively connected with the conduct of a trade or business within the United States and, in the case of dividends and interest received from a corporation and interest received from a partnership, certain conditions relating to ownership of the payor must be met.

In addition, Section 1041 would amend Code Section 2105 to remove from the definition of property within the United States, subject to the U.S. Estate tax, stock or debt obligations the dividends or interest on which (if received by the decedent at the time of his death) would be eligible for the exclusion from gross income under Section 872(b)(4).

Finally, Section 1041 would continue without an expiration date the present time-limited treatment of interest on certain bank deposits as non-U.S. source income.[15]

Reason for section 1041 according to the report of the House Ways and Means Committee

The proposed amendment has two purposes. First, it is intended to enhance the ability of U.S. corporations to raise capital in foreign markets by eliminating the imposition of a U.S. withholding tax on interest. The Committee Report notes that international bond issues are often exempt from withholding taxes imposed by foreign governments and that lack of a broad exemption under present U.S. tax law has made it difficult in some cases to trade U.S. obligations in international bond makets.[16] The Committee Report also indicates that, in order to satisfy foreign lenders, U.S. borrowers often have to agree to reimburse holders of its debt obligations for any U.S. withholding tax which may be due. This has the effect of increasing the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.[17]

One factor which has made it more difficult for U.S. borrowers to obtain funds from foreign markets was the June 30, 1974, termination of the Interest Equalization Tax ("IET"). Prior to such termination, under certain circumstances, U. S. borrowers were able to secure an exception to the 30% U.S. withholding tax by electing to have the U.S. obligations subject to the IET.[18]

In addition, it is now unclear the extent to which U.S. corporations will be able to use international finance subsidiaries to obtain funds from foreign markets; due to the issuance by the Internal Revenue Service of Rev. Rul. 74-464.[19] This ruling revoked, retroactively to June 30, 1974, a series of rulings by the Service dealing with international finance subsidiaries which had held that a five-to-one debt-equity ratio was acceptable to the Internal Revenue Service, in that context.

Second, the change is intended to attract foreign capital to United States investment, particularly petro dollars.[20]

Analysis of proposed amendment

The exclusion from gross income applies to interest or dividends, received from a U.S. person, unless (i) the payment is "effectively connected," (ii) the

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[11] Internal Revenue Code of 1954, as amended [hereinafter cited as "Code"], §§ 872(a), 882(b), 861(a)(1), 861(a)(2).
[12] Code §§ 871(b), 882(a), 864(c).
[13] Code §§ 871(a)(1)(A), 881(a)(1), 1441–42.
[14] Code § 2104(c).
[15] Code §§ 861(a)(1)(A), 861(c).
[16] H. Rept. 94–658, 94th Cong., 1st Sess. [hereinafter cited as "H. Rep."] 236–37 (1975).
[17] Ibid.
[18] An election under now-terminated § 4912(c) produced an elimination of tax under Code § 861(a)(1)(G).
[19] 1974–38 I.R.B. 10. See also Rev. Rul. 74–620, 1974–52 I.R.B. 13.
[20] Rep. 237.

recipient is a controlled foreign corporation, or (iii) there exists certain disqualifying foreign ownership of the United States payor. Disqualifying ownership of a corporate payor exists only if *both* of the following tests are met:

(*a*) more than 50% of the total combined voting power of all classes of stock of the payor corporation entitled to vote is owned by foreign persons, and

(*b*) the recipient of the payment owns 10% or more of such total combined voting power.

Special rules are provided for determining the constructive ownership of stock for this purpose.

Similar disqualifying percentage ownership rules are provided with respect to interests in the capital or profits of a partnership to preclude availability of the exclusion. In applying the 10% and 50% ownership tests, the proposed amendment provides specific attribution rules similar to but different from those in Code Section 318 for determining what constitutes direct and indirect ownership.

DISCUSSION OF PROPOSED AMENDMENT

We approve the proposed amendment for reasons stated below. However we do have certain criticisms of the proposed draft, also discussed below.

AFFIRMATIVE COMMENTS

We approve the general method chosen to effectuate the proposed amendment. It would straightforwardly exempt the income in question from U.S. tax (by amending Code Sections 872(b) and 883). Prior efforts to eliminate U.S. tax have often been directed at source-of-income rules.[21] We believe the method adopted by Section 1041 to be superior to source-rule changes, because it does not distort artificially other attributes of the income in question.

We also endorse Section 1041 because it tends to eliminate inequalities in the current treatment of certain taxpayers. Although withholding is normally required on payments of interest and dividends by U.S. borrowers, it is often possible for the well-advised foreign investor, or the substantial U.S. borrower, to avoid the requirement. The foreign investor can often eliminate U.S. withholding on interest by making his investment through an appropriate treaty-country entity.[22] Substantial U.S. corporations can eliminate withholding on interest or dividends by using an international finance subsidiary having very substantial capital.[23] Thus, the current withholding requirements may usually be avoided by the well-advised or substantial taxpayer. The proposed amendment would make the exemption available equally to all taxpayers. This would be in keeping, also, with the most recent legislative expression of policy in this area.[24]

CRITICAL COMMENTS

The captions of Section 1041 and proposed sections 872(b)(4) and 883(c) describe the proposed exclusions as limited to "portfolio investments." Adoption of the prohibition against the recipient owning a 10%-or-more interest is assumed to have been intended to effectuate that limitation. If the House was solely seeking to limit the exemption to portfolio investors, however, the question of whether the issuer is more than 50% foreign owned should have been irrelevant.

In fact, the exclusion as drafted is limited not so much on the basis of portfolio investment as foreign control of the payor corporation.[25]

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[21] E.g., Code § 861(a)(1)(G), dealing with international debt financings by U.S. companies, transformed the source of interest from U.S. to foreign. See also Code §§ 861(a)(1)(A) and 861(c) dealing with interest on U.S. bank deposits.

[22] See Rev. Rul. 75-23, 1975-3 I.R.B. 33.

[23] Before July 1974, such subsidiaries needed only ⅕th as much capital as debt. Rev. Rul. 69-377, 1969-2 C.B. 231 (interest—domestic subsidiary); Rev. Rul. 69-501, 1969-2 C.B. 283 (interest—foreign subsidiary); see also Rev. Rul. 72-337, 1972-2 C.B. 580 (dividends). These rulings were revoked in 1974. Rev. Rul. 74-464, 1974-38 I.R.B. 10; Rev. Rul. 74-620, 1974-52 I.R.B. 13. Since then, only a handful of U.S. international debt offerings have been concluded, in each case based on counsel's opinion that withholding would not be required, and in each as a result (at least in part) of the very substantial capital contributed to the international finance subsidiary by its parent.

[24] Code §§ 4912(c), 861(a)(1)(G), and 2104(c). The last was amended in 1973, to eliminate estate tax on obligations of this sort..

[25] Indeed, the 10% requirement appears to serve essentially an administrative function, that being to eliminate the necessity of a true portfolio investor having to ascertain the extent of foreign stock ownership of the payor. Obviously, the purpose of the provision would be severely limited if the investor had such a burden.

The 50% foreign ownership test seems to be motivated by a policy decision to assist U.S.-controlled domestic entities in raising foreign capital, and at the same time discourage foreign investment in foreign-controlled domestic entities. Adoption of such a discriminatory policy against foreign-controlled U.S. domestic corporations that pay full U.S. corporate income taxes seems to us questionable. The dual test is also complex. Accordingly, we recommend that the ownership test be based solely on the recipient's ownership percentage, and that the foreign control test be eliminated. It would be perfectly appropriate for Congress to increase the recipient's permissible percentage from 10% to 50% or even more. It should be noted, in this regard, that the exemption under Section 861(a) (1) (G) from withholding and taxability for interest paid on debt obligations of U.S. borrowers who had made an election under Section 4912(c) was not limited to portfolio investors of the U.S. borrower.

Similar questionable policy objectives may have been involved in limiting the exclusion to payments by United States persons" and "domestic corporations." The exclusion does not apply to payments by non-U.S. persons who are residents of the U.S. (either individual or corporate) whose interest payments or dividends are treated in whole or in part as U.S.-source income.[26] The policy reasons behind the exclusion, including the encouraging of investment of foreign capital in the U.S., suggest that the exclusion should reach all payments by obligors whose payments are treated as U.S.-source income.

In addition, the limitation of the proposed exclusion to interest and dividends paid by U.S. persons is objectionable as a technical matter because it introduces a new concept into the provisions of the Code relating to withholding on payments of interests, where a new concept is not necessary. Sections 1441 and 1442 of the Code currently provide for withholding on fixed or determinable income which is from sources within the United States. Under Section 861(a) of the Code, interest and dividends paid by a foreign corporation is considered to be from U.S. sources (in whole or in part) if 50% or more of the gross income from all sources of such foreign corporation, for the three-year period ending with the close of its taxable year preceding the payment, was effectively connected with the conduct of a trade or business within the United States.[27]

In addition, interest paid by a resident alien individual is U.S. source income unless less than 20% of the gross income of such individual is derived from sources within the United States for such three-year period.[28] Therefore, the current provisions of the Code reflect a judgment that, for purposes of withholding on dividends and interest, foreign corporations and alien individuals with the required percentage of gross income from U.S. sources are to be treated the same as U.S. payors. In the absence of a policy reason to the contrary (and, as stated above, there appears to be none), we believe that the existing structure of the Code should be preserved and, accordingly, that the proposed exclusion should be applicable to all dividends and interest from sources within the United States rather than just to such payments by U.S. persons.

In general, the attribution rules in Section 1041 provide that an interest in an entity (*viz.* stock in a corporation; a capital or profits interest in a partnership; a beneficial interest in a trust or estate) is considered as being owned proportionately by its shareholders, partners, or beneficiaries. If 50% or more in value of the stock in a corporation is owned directly or indirectly by or for any person, the corporation is considered as owning the interests owned directly or indirectly by or for that person. An interest in an entity owned directly or indirectly by or for a partner or a beneficiary of an estate or trust is considered as being owned by the partnership, estate, or trust.

An interest in an entity owned directly or indirectly by or for a person who is considered the owner of any portion of a trust is considered as being owned by the trust. However, an interest in an entity considered under these rules as being owned by a partnership, estate, trust, or corporation is not considered as being actually owned by such entity to make another the constructive owner of such stock.

The attribution rules differ from Code Section 318 in three respects. First, there are no family attribution rules as in Code Section 318(a)(1)(A). Thus, a nonresident alien who owns 100% of the voting power of a U.S. corporation and receives interest from such corporation could transfer his stock to a member

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[26] E.g., Code §§ 861(a)(1)(D), 861(a)(2)(B).
[27] *Ibid.*
[28] Code § 861(a)(1)(B).

of his family and still obtain the benefits of the proposed amendment. Second, there are no attribution rules provided with respect to options, such as provided in Code Section 318(a)(4). Thus a nonresident alien could acquire an option which upon exercise would give him 100% beneficial ownership of a U.S. corporation, provide capital by way of loans, and receive the benefit of the new exclusion with respect to interest received. It seems appropriate to apply the family and option attribution rules of Code Section 318 for purposes of determining partnership or stock interests under the new provision. The third difference between Code Section 318 and the proposed attribution rules is that under Section 318 stock is attributed from a corporation only to a 50%-or-more shareholder. The proposed rules have no percentage limitation.

It does not seem necessary or desirable to add yet another set of attribution rules to the more than a dozen already in Internal Revenue Code.[29] It would be far simpler (and more comprehensive) to adopt the attribution rules of Code Section 318 in toto, perhaps with the simple proviso that "Section 318(a)(2)(C) shall be applied without regard to the 50% requirement."

Finally, there seems to be a drafting defect in the attribution rules contained in proposed Code Section 872(c). That Section must deal with not only stock (as does Section 318), but also with certain partnership interests. This is required because interest paid by a partnership is only exempt when paid (a) by a partnership in which U.S. persons own at least half of the capital and profits interests, or (b) to a foreign person who owns less than 10% of such interests in the partnership.[30]

However, by contrast, interest paid by a trust or estate is exempt regardless of the foreign recipients' beneficial interest in the payor trust or estate. The attribution rules accordingly must trace both stock ownership (for testing exemption of corporate interest or dividends) and interests in partnerships (for testing exemption of interest paid by partnerships). There is no need to trace beneficial interests in trusts or estates, since interest paid by a trust or estate is exempt even if paid to the sole (foreign) beneficiary.

It therefore appears that proposed Code Section 872(c)(4)(C) should be deleted as unnecessary. Attribution of stock or partnership interests will still occur—from or to trusts or estates—under the proposed attribution rules.

Our final suggestion relates to problems of U.S. withholding agents. If the exclusion of interest and dividends from gross income depends on the recipient's stock ownership in the U.S. payor, and the status as foreign or domestic of the recipient and other shareholders of the payor, the U.S. payor may be placed in a difficult position with respect to ascertaining the percentage of ownership of its stock held by the recipient and other foreign shareholders. If the U.S. payor inadvertently fails to withhold because it is not aware of the stock ownership status of the recipient or its other foreign shareholders with sufficient precision, it might become liable for the tax which was not withheld.[31]

In order to lessen this burden on U.S. obligors, it is suggested that a statutory provision be adopted which would exculpate a U.S. obligor, and its withholding agents, if any, from liability for failing to withhold if they acted in good faith based on the information which was then available to them. Alternatively, the Treasury Department could adopt regulations which would permit the withholding agent to act upon the basis of an appropriate certificate furnished by the recipient of the interest or dividend income and the stock ownership records of the U.S. payor as of a specific date to establish ownership requirements.[32]

PROPOSALS RE FOREIGN TAX CREDIT CONTAINED IN H.R. 10612

Part III of Title X of H.R. 10612, as passed by the House of Representatives in December, 1975 (the "Bill"), contains several provisions relating to the allowance and computation of the foreign tax credit. The four basic changes effected by this Part are:

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[29] A list of such sections would include Code §§ 276(c), 302(c), 304(b)(1), 304(c)(2), 318, 341(d), 425(d), 544, 554, 958, 1235(d), 1246(b), 1371(c), 1563(e), and 6046(c). This list is not exhaustive.

[30] Proposed new Code §§ 872(b)(4)(C), 883(c)(3).

[31] Code § 1461.

[32] Compare Regulations §§ 1.1441-5(a), 1.1441-4(a)(2), authorizing reliance, respectively, upon information furnished in Form 1078 and Form 4224. See also Rev. Rul. 70-175, 1970-1 C.B. 183, authorizing reliance upon information furnished in Form 1001.

1. to provide for "recapture" of over-all foreign losses in computing the limitation on the credit for subsequent years;
2. to alter the effect of capital gains and losses on the limitation;
3. to mandate use of the "over-all" limitation on the credit, thus ending the optional use of the "per-country" alternative; and
4. To require dividends from less developed country corporations to be "grossed-up", as dividends from other foreign corporations currently are.

The New York City Bar Association Tax Committee has identified a number of substantial substantive and technical problems seriously affecting the first two of these changes, as well as a major policy question relating to the "over-all" limitation on the foreign tax credit. We also note that a policy judgment is involved in the fourth change, which would remove preferential treatment currently extended to investments in less developed countries.

Section 1032—The "Recapture" of foreign losses

When a taxpayer experiences a loss from operations in a foreign country for a taxable year, the effect on his U.S. tax depends upon his circumstances. If the taxpayer has taxable income from other foreign sources (in excess of the loss), the effect is two-fold: the loss reduces taxable income as a whole and taxable income from foreign sources. This means that his U.S. tax before credit is reduced and, if he is operating under the "over-all" limitation on the credit, his limitation on the credit is reduced.[33] If he has paid foreign taxes to other countries, these are fully available as credits—subject to the reduced limitation.

If, on the other hand, the taxpayer has no other foreign-source income for the taxable year of the loss (or income in an amount less than the loss), the effect is single: the loss reduces taxable income and the U.S. tax. Assuming that the taxpayer has foreign-source taxable income in the followng year (either from the country in which the loss was incurred or another) and pays foreign tax on that income, the foreign tax is fully creditable; and the limitation on the credit is computed only by reference to the foreign-source and over-all taxable income for that following year, so that the earlier loss is not reflected in any way.

While the Ways and Means Committee's Report, in referring to the "tax benefit derived from the deduction of these losses" (H.R. Rept. No. 94–658, 94th Cong., 1st Sess. 228, hereinafter cited as "Comm. Rept."), is not clear, in fact the only advantage gained by the second taxpayer referred to above is that by having his loss in one year and his profit in another—rather than both together—he escapes a reduction in the limitation on the foreign tax credit.

Viewed in this light, Section 1032 represents a case of legislative over-kill. Proposed Section 904(f)(1)(A) treats an amount of subsequent year, foreign-source income equal to the loss as U.S.-source income, thus effecting a reduction in the limitation on the credit comparable to that which would have occurred if the income and the loss had been "blended" into the "over-all" limitation in a single taxable year. However, proposed Section 904(f)(1) goes on—in Subparagraph (B)—to disqualify for credit purposes an amount of foreign taxes paid in the subsequent year. No comparable disadvantage is suffered by the taxpayer recognizing his loss in the same year as his income.

Appendix 1 illustrates the comparative penalty paid by the taxpayer whose losses and income fall into two years. As can be seen from the Appendix, under current law the taxpayer realizes a larger foreign tax credit ($78) when he realizes an over-all foreign loss in Year 1 and foreign income in Year 2 than he would have, had the loss been netted against the subsequent income in the same year. The effect of the recharacterization of $100 of foreign-source income earned in Year 2 under proposed Section 904(f)(1)(A) is to eliminate this benefit and produce the same result as if all transactions occurred in one year—a credit of $48 and a carry-over of $30. If proposed Sections 904(f)(1)(A) and (B) are both applied, however, the taxpayer is penalized, since a credit of only $39 is allowed in Year 2 and there is no carry-over.

Under current law, any taxpayer who pays taxes at high effective foreign tax rates is allowed credits at rates up to the effective U.S. tax rate and is per-

[33] In addition, under existing law, the foreign tax credit for foreign taxes paid by the taxpayer in the same year to other foreign countries may be maximized because, under the per-country limitation, the denominator of the limitation fraction (world-wide income) is reduced by a net loss in a foreign country while the numerator (separate foreign country income) is unaffected.

mitted to carry over the excess credit to later years. Proposed Section 904(f)(1)(B) would be an arbitrary exception to this concept; it would take excess foreign losses from an earlier year and apply them in conjunction with current foreign income to disqualify all or part of the foreign taxes paid (or deemed paid[34]) in the current year. There is no relationship to the U.S. tax saved in the earlier year. In fact, the disqualified taxes are levied in different years, perhaps by different countries and possibly at totally different rates. And if the foreign tax is paid because the foreign country involved did not allow net operating loss carry-overs, the taxpayer, after giving effect to net operating loss carry-over, has paid a tax on such foreign income at an extremely high effective rate—especially where the subsequent income from the loss country is recharacterized under proposed Section 904(f)(1)(A).

The single sentence in the Committee Report explaining the reason for Subparagraph (B) is unilluminating; but we understand that it was included on the rationale that the United States would be improperly deprived of revenue where a foreign loss was deducted from taxable income in Year 1 (thus reducing U.S. tax) but foreign income derived in Year 2 did not give rise to U.S. tax because the foreign country involved, if it does not allow loss carry-overs,[35] imposes tax in that year and the foreign tax credit offsets the U.S. tax. Suppose, for example, that a U.S. corporation derives $200 of taxable income from U.S. sources in Year 1. In the same year, its foreign branch has a loss of $100. Its taxable income is $100 and its tax $48 (ignoring surtax exemption). In Year 2, the corporation again has U.S.-source taxable income of $200; however, its foreign branch has taxable income of $100 and pays a tax equal to $48 to the foreign country in which it is located (because that country allows no loss carry-over).

Absent the proposed foreign loss recapture provisions, the corporation could claim a $48 foreign tax credit, thus limiting its U.S. tax in Year 2 to $96. In Year 1, the recognition of the foreign loss has reduced the U.S. tax by $48, but in Year 2 this amount is not recouped, because the foreign country has imposed a creditable tax.

This effect is obviated by the application of proposed Section 904(f)(1)(A); in Year 2, the corporation's Section 904 limitation is adjusted to zero, so that no foreign tax credit is allowable in that year. Nevertheless, we understand the rationale to be, the $48 foreign tax will be available under Section 904(d) as a carry-over to Year 3 and thereafter, so that the U.S. effects "recoupment" in Year 2, but "un-recoups" in any subsequent year (within the carry-over period) when the corporation has sufficient taxable income from foreign sources (and foreign tax credits, otherwise allowable, less than the Section 904 limitation).

In our view, this line of reasoning is unconvincing. Even in the case given, what has happened is that the taxpayer has suffered, by U.S. standards, an extremely high rate of foreign tax. This has been caused by the foreign country's denial of a loss carry-over, but that is only one among a host of reasons why a foreign tax rate may be high.[36] If the foreign country in which the branch sustaining the loss is located *does* allow a loss carry-over and imposes no tax in Year 2, then the otherwise creditable tax which will be disallowed will be a tax paid to another foreign country, presumably having nothing to do with the earlier loss, which would be available as a credit and for carry-over under Section 904(d) if the loss had never occurred. Most importantly, no tax would

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[34] The interrelationship of proposed Section 904(f)(1)(B) and the carry-back and carry-over provisions of Section 904(d) may achieve particularly anomalous results. Under Section 904(d), if a taxpayer has excess foreign taxes from a year prior to an over-all foreign loss year, these excess foreign taxes are carried over and "deemed to have been paid" in the year or years in which the over-all foreign loss is recaptured. However, proposed Section 904(f)(1)(B) would disallow such credit in the proportion that recharacterized income bears to foreign-source income in the year of recapture. An example of this peculiarity would be to assume a foreign tax credit carry-over of $100 from Year 1, an over-all foreign loss of $4 in Year 2, and foreign-source income of $2 in Year 3. 50% of the foreign tax carry-over from Year 1, or $50 would be disallowed in Year 3 as a result of the interrelationship of Section 904(d) with proposed Section 904(f)(1)(B).

[35] Where the foreign country allows the loss carry-over to be utilized only partially in each year(*e.g.*, only 10% of the loss may be used to reduce taxable income in each future year), the foreign tax in Year 2 would be reduced somewhat, but the effect in that year, at least, would be substantially similar to a disallowance.

[36] Of course, where the carry-over of the loss is not disallowed but merely limited, the elevation of the foreign tax rate is only a question of timing.

have been disqualified for credit or for carry-over if the $48 foreign tax had not been paid in Year 2 to the foreign country in which the loss occurred but paid in Year 1 to another foreign country and in that year the corporation had at least $100 of other foreign-source taxable income. (*Cf.* Appendix 1).

Once the limitation of proposed Section 904(f)(1)(A) has been applied, the effect on the U.S. tax of a foreign loss is the same whether the loss is in one year and the income in another or both income and loss occur in the same year. When proposed Section 904(f)(1)(B) is then applied, however, the effect is to single out the tax payer who has only a single foreign operation or whose income flows time out so that he is at an over-all foreign loss for a taxable year, and to put him alone in the position of having to suffer U.S. "recoupment" of the effects of the loss.

We see nothing unique enough about the over-all foreign loss situation to justify such a result. Rather, we believe that consistency and equity require rejection of the "disqualification" rule embodied in proposed Section 904(f)(1)(B).

We are aware, of course, that all of the comments we have addressed above to proposed Section 904(f)(1) could also be made about Section 907(d), which applies to foreign oil-related income and was obviously the model for this proposal. In principle, perhaps, the two provisions are not different. We believe, however, that the allowance of current deductions for intangible drilling expenses and the resultant pattern of oil industry operations, in which—assuming large and on-going exploratory and drilling operations—substantial and sometimes consistently recurring foreign losses can combine with extremely high (and arguably artificial) foreign income taxes, makes that industry a special case. While we have not examined any data, we would expect to find that in foreign operations generally, the "blending" of foreign loss with foreign income in the same year is the rule and the over-all foreign loss case the exception, occurring usually in cases of genuine economic distress or possibly as the result of unusually severe doses of mis-timing of income and expense.

Disallowance or deferral.—It has been suggested that proposed Section 904(f)(1)(B), as written, is ambiguous as to whether the specified amount of foreign tax is disqualified for credit only in the year in which the over-all foreign loss is "recaptured" or permanently. The statute can be read to accomplish mere deferral since it reads:

"The amount of . . . tax paid or accrued (or deemed to have been paid) to foreign countries . . . for such succeeding taxable year . . . shall be reduced . . ."

Under the carry-over provisions of Section 904(d),[57] a foreign tax credit disallowed under proposed Section 904(f)(1)(B) "for such succeeding year" (*i.e.*, the year of the recapture of the foreign loss) may be "deemed paid" in a subsequent year.

If the proposed provision effected only a deferral, obviously many of the comments made above would be inapposite or less germane. However, the Committee Report appears to indicate that the words "shall be reduced . . . for such succeeding year" in proposed Section 904(f)(1)(B) spell a permanent disallowance of that portion of the foreign tax paid, or deemed paid, in the year in which the over-all loss is recaptured. See, for example, the language at page 228 of the Committee Report, which reads:

". . . In addition, since the loss reduced U.S. taxes on income from U.S. sources in a prior year, no foreign tax credit or deduction is to be allowed with respect to the foreign income which is treated as income from sources within the United States. The amount of the taxes allowable as a credit is to be reduced in the proportion the income treated as from domestic sources is of total foreign income (before recharacterization) for succeeding years."

This suggests that the Congress intended to permanently disallow the amount determined under proposed Section 904(f)(1)(B). We do not believe that that provision should be applied at all; if it is to be, a deferral, rather than permanent disallowance, would soften its impact; if a permanent disallowance is nevertheless to be introduced, this should at least be made clear.

Proposed section 904(f)(2)—Unused capital and operating losses.—Another problem with these provisions as presently written is that the definition of "over-

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[57] Section 904(d) provides that "any amount by which such tax . . . exceeds the applicable limitation . . . shall be deemed paid . . . in the [year of the carry-back or carry-over]".

-all foreign loss" set forth in proposed Section 904(f)(2) takes into account capital losses, although the taxpayer may be unable to use them because of the limitation of Section 1211, and net operating losses which expire unutilized. Also, while Section 1034 of the Bill carefully takes into account the lower rate generally accorded capital gains when dealing with computation of the limitation fraction of Section 904, Section 1032 totally ignores that fact in defining "overall foreign loss." A tax benefit rule comparable to that applied under Section 111 in case of inclusion of an income item as a result of the recovery of a previously deducted item, *i.e.*, bad debts, should be applied to these provisions.

Proposed section 904(f)(3)—Effect of dispositions of foreign business property.—Both the intent and effect of this provision (and its counterpart in Section 907(f)) are highly obscure. Many of the members of the Committee have read the subsection as effecting only a modification to the operation of subsection (1)—that is, to alter the limitation on the credit and, if subparagraph (B) of subsection (1) is to be applied, the amount of creditable foreign taxes. Such a reading would be consistent with the general effect of the proposed subsection (f), which is to alter the otherwise allowable amount of foreign tax credit. Moreover, the reference in the subparagraph to "taxable income from sources without the United States" is indicative of a function extending only to Section 904.

We understand, however, that this provision is meant to alter the rules for the recognition of income or gain. Then it constitutes in effect an amendment of Section 61 and, possibly, several other Sections of the Code. Assuming that it is fair, wise and Constitutional to regard a gift or a contribution to capital, for example, as giving rise to the recognition of income to the contributor, we nevertheless believe that minimal fairness requires appropriate amendments to the income inclusion sections and not the burial of a radically new income concept in the provisions limiting allowance of the foreign tax credit.

Moreover, the language of proposed Section 904(f)(3)(A)(i), particularly the phrase ". . . shall be deemed to have received and recognized taxable income . . .", requires clarification. The "received and recognized" language is dissimilar to that used under analogous circumstances elsewhere in the Code, e.g., in Section 453(f) (". . . gain . . . shall result . . ."). More importantly, it is unclear whether the intent or effect is to create ordinary income, short- or long-term capital gain or to make this dependent on what kind of income or gain would have resulted from a taxable sale or exchange. It is possible to read the provision to mean that an otherwise taxable sale which the taxpayer elects to report on the installment basis under Section 453 is to be denied installment treatment, a result for which we doubt the justification, if it is intended.

There are other severe substantive and technical problems with the provision. An otherwise taxable sale or exchange of property outside the United States gives rise to taxable income from sources without the United States without reference to Paragraph (3). Thus, in a recapture situation, 50 percent of the appropriate amount will already have applied to recapture loss under Paragraph (1) (since subparagraph (3)(A)(i) appears to specify that it is to be applied after Paragraph (1) has been applied "for the taxable year"). Paragraph (3) would then require 100% of the same gain to be applied again.[38]

We also find no provision for stepping up the basis of assets disposed of in otherwise non-taxable transactions, an omission which clearly can lead to duplicative taxation without any apparent revenue protection purpose.

Finally, we believe that permitting an exception to this recapture rule only in the case of a Section 381(a) transfer to a domestic corporation is needlessly restrictive and harsh. For example, Sections 367 and 1491 (particularly as it is proposed to be amended by Section 1015 of the Bill) can be allowed to police the transfers to foreign entities to which they apply. Moreover, various kinds of transactions which occur in the ordinary course of business or are beyond the taxpayer's control trigger recapture in a seemingly harsh and unnecessary manner. Examples of such transactions would be transactions otherwise tax-free under Section 1031 (like-kind exchanges), Section 1033 (involuntary conversions) and Section 1038 (reacquisitions of real property) and normal retirements of depreciable property.

Even with some amelioration, this disposition rule is draconian. The assets disposed of may, of course, have nothing to do with the loss to be recaptured; and while one can hypothesize a case in which a taxpayer (by disposing of all or

[38] As to problems of integration of this provision with the capital gains provisions added by Section 1034 of the Bill, see *infra* p. 18 et seq.

substantially all of his foreign income-producing assets) could put himself in a position never again to realize any foreign-source income, we believe that such cases would be the exception, rather than the rule. We are not convinced that the essential revenue protection could not be achieved through Section 367 and Section 1491 enforcement (combined, perhaps, with a special rule to deal with Section 351 transactions involving domestic corporations), while permitting the broad classes of asset dispositions to proceed, and over-all losses to be recaptured against continuing foreign income received, in the normal course.

Failure to deal with overall U.S. loss.—A fundamental defect with the recapture of overall foreign loss concept as a whole is that in fairness it should be, and is not, symmetrical. It does not concern itself with the burden suffered by a U.S. taxpayer with foreign-source income and U.S.-source losses. Appendix 2 demonstrates that a taxpayer can suffer severe tax burdens if he finds himself in this situation. Aggregating the two years in that example, the taxpayer has a net of $100 of foreign-source income and $0 of $U.S.-source income. Yet, the taxpayer has been forced to pay $48 of foreign taxes in the first year and $48 of U.S. taxes in the second year, with no credit available for the $48 of foreign taxes. This is the mirror image of the problem the recapture of over-all foreign loss provisions are designed to deal with, and to mirror provision should be adopted. Thus, in later years, a U.S. taxpayer who has suffered an over-all U.S. loss should be entitled to calculate the foreign tax credit limitation by recharacterizing U.S.-source income subsequently earned as foreign-source income in a manner comparable to that prescribed by proposed Section 904(f)(1)(A).

Miscellaneous.—From an administrative standpoint, it would seem advisable to require the recapture of the foreign loss only within a reasonable period, perhaps 10 years. It is doubtful that this would leave open any significant avoidance opportunities.

Section 1034—Treatment of capital gains

This provision would require the netting of U.S.-source capital losses against foreign capital gains and the reduction of both the numerator and denominator of the Section 904 fraction to reflect the reduced rate of tax imposed on the capital gains of corporations. In addition, long-term capital gain from most sales abroad of personal property would be excluded entirely in computing the numerator of the fraction.

In general, the netting and reduction rules seem appropriate in most, if not all, instances.[39] The major defect with the netting concept is that it is a one-way street. As indicated above with respect to ordinary losses (see pp. 15–16), a taxpayer can suffer a double tax detriment when net U.S. source capital losses are used to offset foreign source gains, but net U.S.-source gains realized in a later year are not taken into account. Here, again, a "mirror image" type of recapture rule would appear to be appropriate.

Serious substantive and technical problems arise from proposed Section 904 (b)(3)(B). Assuming that a provision of this type is to be enacted, its relationship to proposed Section 904(f)(3), dealing with recapture of over-all foreign losses upon the disposition of certain foreign business assets, ought to be clarified. If property is sold at a gain in a transaction to which both proposed Section 904(b)(3)(B) and proposed Section 904(f)(3) apply, it is not clear whether (a) the exclusion provided by the first section operates to prevent a triggering of the latter; (b) proposed Section 904(f)(3) overrides proposed Section 904(b)(3)(B) so that the gain is included in foreign-source income even though the latter provision would otherwise exclude it; or (c) the gain is first excluded from the numerator of the Section 904 fraction under proposed Section 904(b)(3)(B) (though included in the denominator) and then again treated under proposed Section 904(f)(3), with the result that a second reduction of the numerator (and inclusion in the denominator?) occurs.

[39] The adjustment made in proposed Section 904(b)(2)(A)(i) to reflect the corporate capital gains rate does not and cannot take into account the effect of the surtax exemption. This is insignificant for large corporations but not for smaller taxpayers. Thus, a taxpayer with $40,000 of U.S.-source ordinary income and $40,000 of foreign-source capital gains will be paying tax at an effective rate of 20.75% on the ordinary income and an effective rate of 30% on the capital gain, not the 48% and 30% rates assumed by the proposed Section. The only way to avoid this anomaly is to provide for the separate calculation of a limitation for capital gains under the current Section 904(f), a proposal discussed further below. Moreover, there may be cases where a net operating loss carry-over or carry-back offsets the capital gain involved (*i.e.*, a *Chartier Real Estate* type of situation) in which the reduction would not be appropriate.

The reason for proposed Section 904(b)(3)(B) is stated in the Committee Report as follows:

"... [T]he source of income derived from the sale or exchange of an asset is determined ..., if the asset is personal property, by the place of sale (i.e., the place where title to the property passes). In [such a] case, taxpayers presently can often exercise a choice of the country from which the income from the sale of a tangible [sic] personal property asset is to be derived. It has thus been possible, in some cases, for a taxpayer to plan sales of personal property (including stocks or securities) in such a way as to maximize his use of foreign tax credits....

"Since most countries (including the United States) impose little, if any, tax on sales of personal property by foreigners if the sales are not connected with a trade or business in that country, the present system permits taxpayers to plan sales of their assets in such a way so that the income from the sale results in little or no additional foreign taxes and yet the amount of foreign taxes they can use as a credit against their U.S. tax liability is increased." (Comm. Rept. at 231-2.)

We question whether, in light of the legislative purpose thus disclosed, proposed Section 904(b)(3)(B) is addressed to the correct category of transactions. The class of long-term capital gains seems at once too narrow and too broad. It is too narrow in the sense that there are several kinds of transactions giving rise to short-term capital gain (or ordinary income) which belong in any "tainted" class as much as long-term gains. For example, short-term gain on stock, securities, commodities or foreign currency or gain on the sale of stock in a collapsible corporation, taxable as ordinary income under Section 341, clearly ought not as such to be distinguished from capital gains.

At the same time the category is too broad, in that it includes in the "tainted" class gain on the disposition of assets which are connected with the conduct of a business in a foreign country. Where a taxpayer disposes of an asset which has been used in a business conducted abroad, we see no basis for concluding that he is "trafficking" in foreign-source gains, any more than where he derives foreign-source ordinary income in the conduct of the business. Once the adjustment has been made under proposed Section 904(b)(2) to reflect the U.S. treatment of capital gains, we see no way in which any further special treatment of business-related income can be justified by reference to U.S. capital asset concepts. In particular, the fact that in some relatively infrequent cases, the sale of foreign business-related assets may be arranged to minimize or eliminate foreign taxes is not a rational basis for "tainting" such transactions, since such arrangements may be undertaken with respect to either ordinary or capital assets. The over-all limitation in effect treats foreign income and foreign taxes as unitary items, and we can see no justification for a relapse into a per country type of test in the case of capital gains.

Based on the foregoing, we recommend that proposed Section 904(b)(3)(B) be recast so that its application does not depend upon whether a sale of personal property gives rise to long-term capital gain but rather on whether the type of asset involved is such that it can fairly be said that foreign sales of such assets are likely to have been motivated by a purpose to manipulate the credit limitation, rather than to serve other purposes. Inventory and other property described in Section 1221(1) (whether or not foreign-related) should not be "tainted." Possibly other tangible assets should not be. Stock and securities (or an interest in a partnership) constituting a direct investment interest might be excepted. Perhaps gains "effectively connected" under the rules of Section 864(c) and the regulations issued thereunder to a foreign branch should not be "tainted." There are doubtless many formulations which could be developed, and we urge that consideration be given to the development of a satisfactory one along those lines.

Once the class of "tainted" transactions is established, there remains the question of what happens to the gains falling within that category. In principle, there are three solutions. The first—the approach taken in proposed Section 904(b)(3)(B)—is a "source rule" approach; the "tainted" gains never constitute foreign-source income for credit purposes. The second is a "rationing" approach; for example, gains would be taken into account as foreign-source income only in an amount (if less than the gain) equal to some multiple (e.g., twice) of the foreign tax paid on the transaction. The third is a "separate limitation" approach, analogous to that now employed in Section 904(f) with respect to certain interest and DISC income.

Of the three, we believe that the "rationing" approach is interesting but complex, since difficulties will be encountered in many cases in isolating the foreign tax paid on specific transactions, particularly where the foreign rate is progressive or otherwise variable, and in the case of individuals (or small corporations) in determining an appropriate multiple of the tax to be included. The "source rule" approach has conceptual appeal. (In effect, the legislative concern is the manipulability of a flexible source rule to make "foreign" gains having little or no foreign contact in an economic sense.) It has the defect, however, of absolutely denying credit in cases where substantial foreign taxes are in fact paid on "tainted" gains. The "separate limitation" approach avoids this defect (and, incidentally, solves the anomaly for the small corporation referred to in the footnote on p. 17, *supra*). Its only defect is that it unfairly denies the "averaging" effect of the over-all limitation to a taxpayer who happens to pay a high rate of tax on a single foreign-source gain (as in the case where a foreign country taxes at ordinary income rates a transaction which the U.S. deems to give rise to capital gain). If, however, the category of "tainted" transactions is properly defined to exclude foreign business assets and direct investment interests, we believe that this type of "excess credit" case will prove unusual enough in practice to make the "separate limitation" approach clearly preferable to the "source rule" approach.

Section 1031—Policy considerations bearing on repeal of the per-country limitation

As previously noted, under the per-country limitation, a taxpayer is able to gain two distinct advantages from a foreign loss. First, he reduces U.S. taxable income, thereby reducing his U.S. tax, while foreign tax credits attributable to foreign taxes paid by the taxpayer in the same year to other foreign countries are maximized, because the foreign loss reduces the denominator of the limitation fraction (over-all income) while leaving unaffected the numerator (the separate foreign country income upon which the foreign tax is levied). Secondly, when the loss operation becomes profitable in subsequent years, a credit is allowed for taxes paid on that profit. Section 1031 attempts to obviate this double advantage by simply repealing the per-country limitation.

Repeal of the per-country limitation could be justified as an appropriate policy judgment. However, the Ways & Means Committee Report on the Bill while it takes note of the double advantage referred to above, does not contain any policy discussion which supports outright repeal as the appropriate solution. While this subject is obviously an appropriate matter to be dealt with by any meaningful tax reform, other methods are available for solving this problem; and it is unsatisfactory to propose a solution which embodies important policy judgments, without the benefit of any discussion of the policies involved.

Background.—The repeal of the per-country limitation would bring the foreign tax credit limitation of Section 904 full circle to the provisions of Sections 228(a) and 238(a) of the Internal Revenue Code of 1921. Since that time, the Congress has vacillated between the over-all and per-country limitations or some combination thereof, adding the per-country limitation to the over-all limitation in 1932, then applying the per-country limitation exclusively under the 1954 Code, and finally in 1961 allowing the taxpayer the option of either the per-country or over-all limitation. Originally, under the 1954 Code, the per-country limitation was applied exclusively because "the effect of the [over-all] limitation is unfortunate because it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years." Sen. Rept. No. 1622, 83rd Cong., 2d Sess. 106 (1954). However, in 1961 Congress introduced the over-all limitation as a relief provision, since (except in the case where losses in one foreign country fully offset profits earned in another) the over-all limitation provides the advantage of utilizing income derived in countries with low tax rates to maximize the credits flowing from income earned in countries with high tax rates.

Discussion.—The elimination of the per-country limitation would eliminate the double benefit of utilizing losses domestically to reduce the U.S. tax while maximizing the numerator of the foreign tax credit limitation. However, the result is accomplished at the price of substituting one anomaly for another. As previously mentioned, the per-country limitation reduces taxable income from all sources (the denominator) while leaving intact taxable income from the country with

profits (the numerator). The over-all limitation accomplishes the reverse by reducing the numerator by 100% of the foreign loss. See Appendix 3 for a demonstration of the effect of these limitations.

The over-all limitation combines all foreign operations to determine effective foreign tax rates. Thus, in effect, it arbitrarily assumes that all foreign operations are related when, in fact, they may be totally unrelated. This is no more logical than the equally arbitrary, contrary assumption implicit in the per-country limitation. Not only is this not logically required, but it also may inhibit companies from commencing new businesses abroad—this being the reason why the 1954 Code mandated the per-country limitation. Finally, there may be substantial inequities [40] in assuming that losses from a business in one foreign country should be offset entirely against the profits of a separate business in another foreign country, rather than a third business operated in the U.S.

On the other hand, the per-country limitation, in allocating all losses against U.S. income (as also demonstrated by the example in Appendix 3), is equally arbitrary and illogical. Absent an analysis of the facts of each case to ascertain actual relationships—a wholly unworkable concept—a far more equitable rule would be to require the income from each country in which a profit is derived to bear an appropriate portion of foreign losses. In this way, a more effective and equitable determination of the effective rate of tax in each country (which is the real purpose of the limitation provisions) could be made. Appendix 3 demonstrates that under either the per-country limitation or the over-all limitation, the effective rate of tax embodied in the ultimate foreign tax credit after reflecting a foreign operating loss bears no relationship to the effective rate of post-credit U.S. tax liability on the U.S.-source income. For example, in Appendix 3, the U.S.-source income is $400. Under the over-all limitation. the taxpayer pays $192 of U.S. tax, an effective tax rate of 48%. However, in Country B, which also imposes a tax at a rate of 48%, taxpayer has received a credit of only $48 on $200 income or an effective tax rate for credit purposes of 24%. The per-country limitation, on the other hand, also distorts the effective rate of post-credit U.S. tax on U.S.-source income. Again in Appendix 3. on a per-country basis, the U. S. taxpayer pays $144 tax on $400 of U.S.-source income, or an effective rate of only 36%, while the credit of $96 on $200 of foreign-source income reflects an effective tax rate of 48%.

The limitation provisions are intended to allow a foreign tax credit at a rate no greater than that of the U.S. tax imposed on foreign income. This purpose would be more aptly effectuated if the post-credit effective rate of U.S. tax on U.S.-source income were comparable to the effective rate of tax by which the credit is itself calculated. This is achieved under the allocation of loss provision. If loss is allocated as described, the post-credit U. S. tax in Appendix 3 is $160 on U.S.-source income of $400 (or an effective rate of 40%). This is exactly comparable to the rate at which the credit is allowed ($80 with respect to $200 of foreign-source income, or 40%). It should also be noted that this would be the result under either limitation if all losses and income had been realized in one year. Therefore, a loss allocation approach would appear to arrive at the most equitable result. In fact, Section 1051 embraces this loss allocation; in determining the amount of the "phantom credit" to be allowed under proposed Section 936 for possession income, losses from foreign sources are to be allocated between U.S.-source and possessions income. See Comm. Rept. at 257. Thus, it would appear appropriate to allocate any foreign loss to income from each particular country by comparing it to income from all countries, in a manner comparable to the allocation of consolidated tax liability in Section 1552(a)(1).[41] See Appendix 3. See also Reg. Section 1.963–4(b)(2).

A further provision which should be added to this allocation of loss provision is a recaptured rule comparable to proposed Section 904(f)(1)(A). Thus, if on

[40] The basic inequity can be demonstrated by assuming in the Appendix 3 that the taxpayer never earns any income in Country A. Taxpayer would effectively pay $288.00 tax on $500.00 net income because of a loss in a business in Country A which may be totally unrelated to the one carried on in Country B. Moreover, he never gets the benefit of the Country B carry-over, because it imposes tax at an effective rate of 48%.

[41] An alternative method of making this allocation would be to calculate the foreign tax credit limitation on a per-country basis by using the foreign country's income as a numerator and by using total income (without reduction by operating losses in any foreign country) as a denominator. This results in the same loss allocation described in the text. However, it is somewhat more difficult to trace income in future years for purposes of recapture.

a per-country basis loss is allocated to another country, subsequent income generated by the loss country should be characterized as having its source in the country (including the U.S.) to which the loss was allocated.[42] In the example in Appendix 3, this would involve redesignation of one-third of the first $100 of the income of Country A in Year 2 to Country B, since Country B was allocated one-third of the loss in Year 1. Similarly, two-thirds of the income of Country A in Year 2 would be redesignated as U.S.-source income. Thus, the Country B tax would be subject to credit only to the extent of $.48, the balance to be carried over to a later year.

The principal difficulty with this kind of loss allocation proposal is that it is far more complex than a simple over-all limitation with a loss recapture rule comparable to that proposed in the Bill. However, it is far more equitable and permits a U.S. taxpayer the greatest protection against bearing two taxes on the same income, which is the purpose of the foreign tax credit. Moreover, it would provide adequate protection against the double advantage achieved by utilizing foreign losses which Section 1031 was designed to stop.

This Committee is concerned with proposals which unnecessarily burden the Code with complex and difficult rules of administration. However, in this instance, it appears to be far more equitable to permit the retention of the per-country limitation with the loss allocation rule proposed above, rather than to require use of the over-all limitation. We recognize that the record-keeping and tracing necessary to accomplish this allocation might be difficult for many taxpayers. Since the provision would be elective (over-all would still be available for a taxpayer who did not want to undertake the complex tracing rules) a taxpayer would not be subject to any serious disadvantage compared to the situation which he would have faced had the per-country limitation been repealed in its entirety. Further mitigation of this complexity would be provided by allowing a taxpayer, after he files his tax return on a per-country basis, to switch to the over-all limitation so that the complex loss allocation rules would not serve as a trap on audit.[43]

APPENDIX 1

	Year 1		Year 2		Composite (assuming all transactions occurred in a single year)	
	Income	Tax	Income	Tax	Income	Tax
Country A	$100	$48	0		$100	$48
Country B	(200)		$100	(1)	(100)	0
Country C	0		100	$30	100	30
United States	400		300		700	
Aggregate	300		500		800	
	Credit[2]	Carryover	Credit[2]	Carryover	Credit[2]	Carryover
Presec. 904(f) credit	0	$48	$78	0	$48	$30
Credit applying only sec. 904 (f)(1)(A)	0	48	48	$30	48	30
Credit applying both secs. 904(f)(1)(A) and (B)	0	48	39	(3)	48	30

[1] Country B has a net operating loss carryover rule comparable to the U.S. rule. Therefore, although it levies a tax at a 48 percent rate, no tax is payable in year 2 in that country.
[2] Overall limitation.
[3] $39 if subpar. (B) of proposed sec. 904(f)(1) effects only a deferral, rather than a permanent disallowance.

[42] It should also be noted that if the per-country limitation is retained in the form described in this memorandum, the over-all loss recapture rules of proposed Section 904(f)(1)(A) should be extended to cover situations in which a taxpayer incurs foreign losses in a per-country limitation year (but not over-all foreign losses) and, in a later year in which income is earned in the loss the country, switches to the over-all limitation. Recharacterizing the income in the manner described in this memorandum would prohibit a taxpayer from manipulating the two limitation provisions to his advantage.

[43] This Committee considered but rejected as far too complex a mitigation provision which permitted the per-country limitation to apply without loss allocation to taxpayers whose gross income, foreign-source income, or foreign tax credit falls below certain prescribed limits.

APPENDIX 2

	Year 1		Year 2	
	Income	Tax	Income	Tax
Country A	$100	$48		
United States	(200)		$200	
Aggregate	(100)		[1] 100	
U.S. tax:				
Precredit		0		48
Postcredit		0		48
Aggregate taxes paid:				
Foreign		48		
United States				48

[1] After NOL carryover.

APPENDIX 3

	Year 1		Year 2	
	Income	Tax	Income	Tax
Country A	($100)		$101	$48.48
Country B	200	$96		
United States	400		400	
Aggregate	500		501	
U.S. Tax:				
Precredit		240		240.48
Credit overall		(48)		(48.48)
Credit per country		(96)		(48.48)
Country A				(.48)
Country B (with loss allocation)		(80)		(16.00)
Aggregate taxes paid:				
Overall credit		288		240.48
Per country credit		240		240.00
Per country credit (with loss allocation)		256		272.48

COMMENTS ON PROPOSED ADMENDMENTS TO SECTION 956(B) OF THE INTERNAL REVENUE CODE CONTAINED IN H.R. 10612

Description of current law

Section 951(a)(1)(B) of the Internal Revenue Code taxes the United States shareholder of a controlled foreign corporation (hereinafter called a "CFC") on any increase from one year to the next in the amount of a CFC's earnings invested in United States property. Thus, for example, if at the end of its preceding fiscal year a CFC had no earnings invested in United States property but at the end of the current year has $100 so invested, a United States shareholder owning all the CFC stock would be required to include $100 in income in the same manner as if the invested funds has been repatriated to him as a dividend.

At present, Section 956(b) of the Internal Revenue Code defines "United States property" to include stock and debt of a United States person, tangible property located in the United States, and intangible property (such as patents and trademarks) acquired or developed by the CFC for use in the United States. With respect to debt, the statutory language of Section 956(b)(1)(C) currently refers to "an obligation of a United States person." Treasury Regulations Section 1.956-2(d)(2)(ii), however, modifies the statutory definition to exclude any indebtedness (*other* than indebtedness arising in connection with the sale or processing of property) which is either collected or matures within one year from the time incurred. The reason for modifying the statutory language is not stated. We understand, however, that when the regulation was drafted there was concern that if short-term or even demand indebtedness were treated as United States property, a broad range of normal business dealings, including dealings in the short-term money markets, would be disrupted at the end of the taxable year of a CFC, since the United States shareholder might have to "clean out" all of the CFC's receivables, deposits, prepayments and the like to avoid a taxable inclusion.

In addition, the one-year rule may act to prevent tax avoidance. It is possible that, absent the regulation, a CFC which had paid foreign tax at an effective rate higher than the U.S. rate would make a short-term loan to its United States (corporate) shareholder on the last day of the taxable year. Since that loan would be treated as a dividend, the taxpayer would be able to use the excess foreign tax credit generated in respect of that dividend against, say, low-taxed foreign source income from other CFCs.

Section 956(b)(2) currently excepts from the definition of "United States property" certain United States investments whose holding by a CFC is not considered to justify taxation. Those include bank deposits, property purchased for export, indebtedness arising in connection with the sale or processing of property (hereinafter called "Sales Receivables"), transportation equipment, assets attributable to certain insurances contracts, and amounts equal to earnings on which the CFC has paid United States corporate tax.

Present Section 956(c) provides that, if a CFC guarantees or pledges property to secure the obligation of a United States person, it shall be considered to have acquired such obligation.

Description of significant proposed changes

Under Section 1021 of H.R. 10612, as passed by the House of Representatives in December, 1975 (hereinafter called the "Bill"), stock and debt would be considered United States property only if it were stock or debt of a United States shareholder of the CFC; tangible property would be considered United States property whether or not located in the United States but only if leased to or used by a United States shareholder; and intangible property such as trademarks and patents would be eliminated from the category of United States property altogether.

The narrowing of the definition of "United States property" makes three and a portion of a fourth of the six exceptions provided by Section 956(b)(2) superfluous; and these items—obligations of the United States, property purchased for export, transportation equipment, and assets attributable to certain insurance contracts—would accordingly be eliminated. In addition, the exception for Sales Receivables would be restricted to receivables which have a maturity of less than 12 months or are outstanding for less than 12 months.

As a conforming amendment, Section 956(c) would be changed to provide that only a pledge or guarantee of the obligation of a United States shareholder, and not that of an unrelated United States person, would constitute the acquisition of an obligation.

In determining whether stock or debt is that of, or whether tangible property is used by, a United States shareholder, status as a United States shareholder is to be determined with the application of the Section 958(b) attribution rules, with some modification. The chief difference between these attribution rules and the attribution rules of Section 958(b) is that under the proposed rules stock owned by a shareholder, partner, or beneficiary which is not a United States person could be attributed to his corporation, partnership or estate or trust, respectively.

General comments

The new amendments represent a change in the philosophy of Section 956. Until now, repatriation of funds by investment in the United States has been considered a sufficient ground for ending the deferral of United States tax on CFC earnings. Under the Bill, the concept is that deferral should end only when the repatriated funds are made available to the United States shareholder; as stated by the Report of the House Ways and Means Committee,[44] such availability constitutes an "effective repatriation" of the earnings.

The change is prompted by balance of payments considerations. The House Ways and Means Committee Report states that Section 956 in its present form may have a detrimental effect upon our balance of payments by encouraging CFCs to invest their profits abroad. "For example, a foreign corporation looking for a temporary investment for its working capital is, by this provision, induced to purchase foreign rather than U.S. obligations."[45] The inducement offered by present Section 956 to purchase foreign obligations as temporary investments of working capital, however, is limited in three significant respects:

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[44] H. Rept. No. 94-658, 94th Cong. 1st Sess., p. 216 (1975).
[45] *Ibid.*

First, Section 956 applies only if the investment exists on the last day of a CFC's taxable year;

Second, Section 956 does not apply either to loans of less than 12 months' maturity or to bank deposits;

Third, Section 956 does not deter investments by a CFC whose effective foreign tax rate is similar to that of the United States, since United States tax on any Section 956 dividend would be fully offset by a foreign tax credit.[46]

Thus, although the Committee does not make any substantive recommendation, it does point out that changing Section 956 for balance of payments considerations will primarily encourage long term investment by low-taxed CFCs rather than short-term investments or investments by those in highly-taxed industrialized countries. The Bill's amendment represents a hybrid position between present Section 956, under which repatriation of funds to the United States is treated as a distribution to the shareholder, and the non-statutory principles of constructive dividend treatment, under which the shareholder is treated as receiving a distribution only if the funds made available to him by the corporation are not intended to be repaid.

A second general consideration is whether, if tangibles used by the United States shareholder of a CFC are considered to be effectively repatriated to the United States shareholder, a similar rule should not be prescribed for intangibles such as patents and trademarks. The Bill would eliminate these from the definition of United States property even if used by such shareholder.

A third category of general concern relates to whether the statutory provision treating as United States property any property leased to, or used by, a United States shareholder will in practice be harsh on unsuspecting taxpayers. For example, a parent corporation's incidental use—perhaps overseas—of a subsidiary's property could give rise to a taxable inclusion. Moreover, it appears that even a short-term lease of property to a United States shareholdeer would give rise to a taxable inclusion based on the entire basis of the property. We suggest that consideration be given to ameliorization of this provision in two respects. The first would be an exception under which the lease or use of property would not be taken into account if it lasted for less than 12 months. (This would be consistent with the definition of "obligation," which permits loans of cash for less than 12 months.) The second would be a rule under which the amount of the taxable inclusion in cases of relatively short-term leases would be based on the rental value of the property for the term of the lease, if less than the adjusted basis of the property. In either case, we believe that attempted abuse of the exceptions through a consistent pattern of renewals or repetitive use of property could be adequately dealt with through generalized "substance" concepts.

Technical comments

The Committee has the following technical comments:

1. Section 956(b)(2)(A), excepting bank deposits from the term "United States property," seems largely unnecessary, since it would apply only where the bank is a United States shareholder of the CFC.[47]

2. Section 956(b)(2)(B), as amended by the Bill, would except from the term "United States property" an obligation of the United States shareholder arising in connection with the sale or processing of property only if such obligation does not have a maturity in excess of 12 months or has not been outstanding for a period in excess of 12 months. This applies to Sales Receivables the 12-month limitation under which the existing regulations exclude from the category of United States property all obligations except Sales Receivables. However, whereas the present regulations use the 12-month limitation to restrict the scope of Section 956, the 12-month limitation in the Bill's amendments restricts the scope of an *exception* to Section 956 and thus expands its application beyond that of present law. For example, a CFC selling a generator to its

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[46] If the effective rate of foreign tax on the CFC substantially exceeded the United States tax rate, the Section 956 transaction could create an excess foreign tax credit. However, in such a situation, the U.S. shareholder might also use Section 956 to create appropriate inclusions from low-taxed CFCs, "washing down" the rate of creditable foreign tax.

[47] Moreover, if the rule of the present regulations is continued (see points 2 and 3), a deposit withdrawn (collected) within one year would not constitute United States property.

United States shareholder might well have payment terms of more than 12 months. So long as the terms are ordinary and necessary, the Sales Receivable would be excluded under present law but not under the amendment.

3. The 12-month limitation on the statutory term "obligation" in present Section 956(b)(1)(C) is set forth only in the regulations. Putting a 12-month limitation in the statute with respect to the exception for obligations which are Sales Receivables, but not putting one in the statute with respect to "obligations" generally, could create an implication that the present limitation in the regulations is not intended to be continued. We believe that the original reasons for the limitation continue to be valid. Accordingly, we suggest either that the 12-month limitation be made explicit both under Sections 956(b)(1)(B) and (b)(2)(B), as amended by the Bill, or that the limitation be deleted from (b)(2)(B).

4. Section 1021(b) of the Bill makes certain changes in the constructive ownership rules for purposes of Section 956(b)(1). To be consistent, those changes should be made also for Section 956(b)(2) and 956(c). For example, owing to the nonapplication of Section 958(b)(4) for purposes of Section 956(b)(1), under the present version of the Bill the attribution rules will be more encompassing for purposes of Section 956(b)(1) than for the other two sections. This could mean, first, that a receivable which was an obligation of a United States shareholder for purposes of Section 956(b)(1) would not be an obligation of a United States shareholder for purposes of Section 956(b)(2) and would therefore not be excluded as a Sales Receivable, even though it otherwise met the terms of that exclusion.

Similarly, if the definition of "United States shareholder" is more expansive for purposes of Section 956(b)(1) than for purposes of Section 956(c), a CFC might not be taxed on its guarantee of an obligation of a person because, under the attribution rules applicable to Section 956(c), such person is not a United States shareholder. By contrast, since the person would be a United States shareholder under the attribution rules applicable to Section 956(b)(1), there would have been acquisition of United States property had the CFC acquired such obligation directly. For this reason, we suggest that Section 1021(b) of the Bill be amended to apply its attribution rules to all three subsections of Section 956.

5. Under the proposed changes in the attribution rules, a person can be considered a United States shareholder for purposes of Section 956 despite the fact that no United States shareholder who is taxed as a result of such attribution has an interest in the "United States shareholder" which obtained the funds. For example, assume that X, a CFC, is 60 percent owned by Smith, a United States person, and 40 percent owned by Daudet, a French person. Assume further that Daudet owns 100 percent of the stock of Inc., a United States corporation. X loans money to, and thereby acquires an obligation of, Inc. By reason of the Bill's attribution rules, Inc. is considered to own the X stock owned by Daudet and is therefore a "United States shareholder" as to X. As a consequence, the loan from X to Inc. is considered the acquisition by X of an obligation of a United States shareholder, Inc., although the only United States shareholders who is taxed—Smith—owns no interest whatever in Inc. To prevent that result, it is suggested that the relevant language of Section 1021(b) of the Bill be amended to read as follows:

"Paragraph (4) shall not apply for purposes of section 956(b) and (c) if, without the application of such paragraph, the person who is not a United States person is owned by any United States shareholder; and section 318(a)(3) shall not. . . ."

6. The effective date provisions in Section 1021(d)(1) of the Bill provide that the amount of a CFC's investment in United States property at the end of the year preceding the effective date will be deemed to include only those items encompassed by the new definition of "United States property." The reason for this is not clear. If, for example, as of the year-end preceding the effective date a CFC held bonds of an unrelated United States corporation in the amount of, say, $100, the United States shareholder will already have been taxed on such $100. If the CFC were thereafter to distribute the $100 to its United States shareholder, that amount—having been already taxed—would be excluded from income under Section 959. If, rather than distributing funds, the CFC changes its United States investment from debt of an unrelated corporation to debt of a related one, there seems to be no justification for again taxing the $100 as

an increase in investment in United States property. This would be the result under the Bill, since the amount of investment in United States property at the end of the preceding year would exclude debt of an unrelated corporation and would therefore be zero. The $100 loaned to the parent at the end of the first year for which the Bill became effective would therefore represent an increase in earnings invested in United States property, although the investment in United States property would not exceed the amount previously taxed to the United States shareholder. For this reason it is suggested that the last sentence of Section 1021(d)(1) of the Bill be deleted.

NEW YORK CITY BAR ASSOCIATION TAX COMMITTEE PROPOSALS RE POSSESSIONS CORPORATIONS CONTAINED IN H.R. 10612

Part V of Title X of H.R. 10612, as passed by the House of Representatives in December 1975 (the "Bill"), contains several modifications of the tax exemption afforded to possessions corporations. The basic changes effected by this Part are:

1. *Limitation on Exemption.*—The exemption is limited to income derived from the active conduct of a business within a possession and other income derived from the possession which the taxpayer affirmatively demonstrates is attributable to the investment of funds obtained from the active conduct of a business within such possession. Income derived by a possessions corporation from foreign non-possession sources will become subject to tax. The limitation on the exemption from taxation is accomplished by means of a hypothetical tax credit providing that possessions corporations are entitled to a credit against income tax of an amount equal to the portion of the tax attributable to active business income and qualified investment income from possessions sources.

2. *Repatriation of Earnings.*—Dividends from possessions corporations are made eligible for the dividends-received deduction provided by section 243 of the Internal Revenue Code (the "Code"). Accordingly, the Bill would permit the current repatriation of earnings free, or substantially free, of United States tax. Under existing law, accumulated earnings could be repatriated free of U.S. tax upon a dissolution qualifying under section 332 of the Code or the disqualification of a subsidiary otherwise entitled to join in the filing of consolidated returns.

3. *Consolidated Returns.*—Corporations must file an election to achieve the status of a possessions corporation and once the election has been filed, the status is maintained for a period of ten years. Under the Bill, a possessions corporation may not join in a consolidated return. However, the election procedure permits a corporation to join in the filing of a consolidated return in its early years of operation where losses are available for use in the consolidated return, and to thereafter file the election when those operations become profitable. Any such losses are included ~~within~~ foreign losses that are recaptured out of future foreign-source income under section 1032 of the Bill.

COMMENTS

Utilization of Tax Credit.—As a technical matter, the statutory scheme adopted by the Bill to effect the limitation on the exemption may produce unintended results and introduces unwarranted complexity. It seems more appropriate to address the problem directly as an exclusion from gross income, rather than through a hypothetical tax credit. The exclusion approach finds support in the current provisions of section 931 of the Code.[48]

Under existing law and regulations, possession-source losses may not offset United States-source income of a possession corporation. However, the use of a credit would appear to permit the offset of possession-source losses against non-possession source income, thus producing within the possessions corporation the potential double tax benefit which the Bill attempts to eliminate (for years after an effective election) with respect to the *Burke Concrete Accessories* result in the consolidated return context. The following example indicates the result under the credit approach and the present law:

[48] Utilization of the credit rather than exclusion results in an increase in both the gross and taxable income of possessions corporations which may create unintended results under other Code provisions which were geared to these concepts, such as the charitable contribution deduction and the period of limitation on assessment and collection contained in section 6501(e)(1).

Example 1.—A possessions corporation has taxable income of $100X, consisting of taxable income from United States sources of $200X and possession-source losses of $100X. The result under the Bill and under present law is as follows:

THE BILL		PRESENT LAW	
Taxable income	$100X	Taxable income	$200X
Tax	48X	Tax	96X

(No credit would be applicable.)

If the exclusion approach had been retained, the result would be the same as under present law.

As a partial balance to the foregoing result, the House Ways and Means Committee Report provides that in determining income from possessions sources, losses from non-possession sources are to be taken into account by allocating such losses between possessions and non-possession source income. The allocation requirement is not provided for in the Bill and thus constitutes an unfortunate example of legislating by Committee Report. Even if such an allocation requirement were provided in the Bill, it would add a degree of complexity which would be unnecessary if an exclusion approach is adopted.

Moreover, the use of a credit (permitting possession-source losses to reduce non-possession source income) require the continuing application of the recapture rules contained in proposed section 904(f) discussed below.[49] While the recapture rules might be necessary if the present exclusion were retained to account for the situation where start-up losses were utilized in the consolidated return, under the exclusion approach the complex recapture provision would be unnecessary except in the context of such start-up losses.

Loss Recapture.—Section 1032 of the Bill adding section 904(f)(1) is designed to recapture foreign losses which reduce United States taxable income by treating an equivalent amount of future foreign-source income as from domestic sources, thereby eliminating the foreign tax credit attributable to such income. The recapture provision is only triggered in the case of a taxpayer who sustains an over-all foreign loss for any taxable year and proposed section 904(f)(2) generally defines an over-all foreign loss as the amount by which gross income for the taxable year from foreign sources is exceeded by the deductions apportioned or allocated thereto.

The combining of the provision for the recapture of possession-source losses with the general foreign tax credit recapture provision does not achieve the purpose of the loss recapture provision with respect to the proposed section 936 credit. This is true because proposed section 904(f)(1) is only triggered where a taxpayer sustains an overall foreign loss for a taxable year.

Example 2.—A possessions corporation has taxable income of $100X, consisting of taxable income from foreign non-possession sources of $200X and possession-source losses of $100X. The result under the Bill is as set forth in Example 1 above, subject to allowable foreign tax credits. Accordingly, possession-source losses have offset income subject to United States tax. However, since there was no over-all foreign-source loss for the year, the possession-source losses which reduce taxable income would not be recaptured under section 904(f).

Since the section 936 credit is extended only to possession-source income, the recapture provision should apply to possession-source losses regardless of whether the taxpayer incurred an over-all foreign loss.

The mechanism which proposed section 904(f) utilizes to effect recapture—the conversion of foreign-source income into U.S.-source income—recaptures a loss by denying an appropriate amount of section 936 credit, since income must be foreign-sourced in order to enter into the credit computation. Where the taxpayer corporation has both qualifying possessions income and non-qualifying foreign-source income in the year of recapture, a determination must be made whether the "recapture amount": (a) first reduces the qualifying income; (b) reduces non-qualifying income first (and foreign taxes paid with respect thereto) and then reduces qualifying income; or (c) reduces each category pro rata.[50] Moreover, it is possible that this decision depends upon whether the loss arose from possessions activities or from other foreign sources.

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[49] Moreover, as discussed below, the recapture provisions are only applicable in the context of an over-all foreign loss.

[50] Although proposed section 904(f) could literally be read to do so, we assume that the total "recapture amount" will not be utilized both to reduce the section 904(a) fraction and to reduce the section 936 creditable amount.

The Committee Report merely states that losses incurred "in a possession"—either before or after a section 936 election is made—"are to be recaptured if the corporation subsequently has income eligible for the Section 936 credit, or if the corporation has any income eligible for the Section 901 tax credit." (Comm. Rept. at 258.) Depending upon the rate of foreign tax paid by the corporation on non-qualifying income, the effect of recapturing against one category of income may be substantially different from that of recapturing against the other. Accordingly, clarification of these ordering or application rules is required.

Application of the loss recapture rule as presently drafted to a possessions corporation raises a serious problem. No section 936 credit is allowable unless 80 percent of the corporation's gross income was derived from sources within a possession for a three-year period (or the shorter period since the commencement of possessions operations). Recharacterization of taxable income as U.S. source income may imply that "gross income" is similarly recharacterized; any other result would be at best confusing and would appear to conflict with existing Code concepts. The recharacterization of income under proposed section 904(f), accordingly, may withdraw exemption not only with respect to the "recapture amount" but with respect to all income of the corporation where the recharacterization applies to more than 20 percent of the corporation's relevant gross income.

Qualified Possession-Source Investment Income.—The Report of the House Ways and Means Committee contains a clear legislative policy to exclude from the tax exemption the earnings on foreign investments outside the possession where the trade or business is being conducted. However, there is also an equally clear statement of legislative policy that the possessions not lose a significant source of capital which they presently have available to them for their own economic development. The requirement of an affirmative demonstration by the taxpayer that investment income is attributable to the investment in such possession (for use therein) of funds derived from the active conduct of the trade or business in such possession (or from such investment) appears extremely burdensome and may encourage the repatriation of the accumulated earnings of the possessions corporation. This appears to be at odds with the legislative purpose. Of particular concern is the statement in the Committee Report that funds placed with an intermediary, such as a bank, will be treated as invested in a possession only if it can be affirmatively demonstrated that the bank invested the funds within the possession. In most normal banking transactions such an affirmative showing would be impossible. If a possessions bank is to be "looked through," it seems that any sort of investment in the stock or debt of a multi-national corporation organized in the possession would also be subject to question.

Rather than imposing a requirement of an affirmative showing on the part of the taxpayer, it would appear preferable to permit the normal source rules to be applicable to most situations. Some modification of these rules might be considered where funds are invested in an intermediary that is known to serve only as a conduit. Alternatively, the usual source rules could be applicable to possessions corporations where a given percent (*e.g.*, 75%) or more of the gross income of such corporation is derived from the active conduct of a trade or business within the possession. If a possessions corporation failed to meet that test, perhaps the affirmative showing suggested by the proposed Bill could be imposed.

COMMENTS WITH RESPECT TO PROPOSED SECTION 1042 OF H.R. 10612 AMENDING SECTIONS 367(A) AND 1248 OF THE INTERNAL REVENUE CODE

I. Section 367

Present law

Section 1042(a) of H.R. 10612 would amend § 367(a) of the I.R.C. in several respects. Section 367(a) now provides that for purposes of determining the extent to which gain will be recognized in transactions otherwise coming within the non-recognition provisions of §§ 332, 351, 354, 355, 356 and 361 of the Code, a foreign corporation will not be considered to be a "corporation" (*i.e.*, and gain will be recognized if corporate status is essential to non-recognition), unless prior to the exchange it establishes to the satisfaction of the Commissioner that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Problems

The amendments to § 367(a) were intended, according to the Report of the House Ways and Means Committee, to deal with several problems as follows:

(1) Undue and sometimes needless delays in consummating business transactions, as a result of having to obtain a ruling prior to closing;

(2) Unsuspected tax consequences resulting from the consummation of exchanges without the knowledge of United States shareholders of a foreign corporation, and thus without a prior ruling;

(3) The necessity that the Commissioner feels to impose a "toll charge" on certain exchanges without a present tax avoidance purpose, because of his seeming inability, short of a closing agreement, to defer the tax until a more appropriate subsequent event;

(4) The lack of an opportunity for an impartial determination by the courts; and

(5) The inability of taxpayers to determine the tax effect of their own transactions from the statute or "clear and certain" accompanying regulations.

Proposed changes

In response to these problems § 1042(a) of the Tax Reform Bill of 1975 (H.R. 10612) would change § 367 in several major aspects. While the transactions covered by § 367 would be the same as those presently covered, meeting the non-tax-avoidance requirement would be accomplished by one of two methods depending upon the type of transaction involved. An exchange which involves a transfer of property from the U.S. (*e.g.*, a transfer of property from the U.S. to a foreign corporation in a § 351-type transaction, a liquidation of a U.S. subsidiary into its foreign parent, an acquisition of a U.S. corporation's assets by a foreign corporation in a "C" reorganization, etc.) will continue, as a general rule, to require a favorable ruling from the Service before nontaxable treatment will be granted.

However, the request for ruling can be filed at any time up to 183 days after the beginning of the exchange. More importantly, the Service is empowered to issue regulations under which designated types of "out-bound" transfers will not be subject to the ruling requirement. The Service will be able to establish guidelines in this area which will be definitive, rather than merely indicative, as is the case with the present guidelines.

In all other transactions, there will no longer be any ruling requirement. Instead, the Service will be required to issue regulations specifying the conditions under which such transactions will be accorded tax-free treatment. These regulations are to specify the gain which must be recognized currently, that which may be deferred and the extent to which basis and earnings and profits must be adjusted. Until these regulations can be issued, these "other" transactions will be treated in the same manner as transfers of property outside of the U.S.

The reason for the distinction is not clearly articulated. The statement is made that "(t)ransactions in the first group generally include those transactions where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale, while transactions in the second group primarily include those where the statutory purpose in most cases is to preserve the taxation of accumulated profits of controlled foreign corporations."

Finally, Congress would create a procedure for declaratory judgments before the Tax Court in situations involving requests for rulings under § 367, i.e., those involving "outbound" transfers. Under this procedure, the taxpayer would be able to obtain judicial review of an unfavorable determination on the tax-avoidance issue or of the conditions which must be met by the taxpayer before a favorable ruling will be issued.

Comments on proposal

1. Problems 1 and 2—Advance ruling

The elimination of the advance ruling requirement from § 367 ostensibly would alleviate the problem of unnecessary delay in obtaining the required ruling. However, from a practical viewpoint it seems unlikely that many taxpayers would take advantage of this aspect of the proposal, since there would be no guarantee that a favorable ruling would be obtained. Any advantage gained by

being able to consummate the transaction in advance would certainly be outweighed by the risk of receiving an unfavorable response. Indeed, it seems likely that in most cases the present practice of taxpayers of applying for the ruling in advance will be unaffected by this change. Of course, where business considerations require a transaction to be consummated by a particular date, elimination of the advance ruling requirement will help. In addition, it also seems unlikely that the elimination of the advance ruling requirement will have much effect upon the problem of unknowing U.S. shareholders. Where a transaction requiring § 367 clearance takes place without the knowledge of U.S. shareholders, there is no guarantee nor even probability that they will become aware of it within the 183-day period.

In light of these considerations and no stated special need to treat "outbound" and "other" transfers differently, it would make more sense to treat "outbound" transfers transactions covered by § 367 in the same manner as "other" transactions, i.e., by establishing "clear and certain" regulations as to the kinds of transactions which will be treated favorably, and under what terms and conditions.

The types of transactions and property which will or will not be accorded non-recognition treatment, and the conditions under which "toll charges" will or will not be a condition to such treatment in "outbound" transfers, can be as well delineated in regulations, or preferably by statute (see infra), as in the case of transfers of property into the U.S. The collection of a tax or "toll charge" imposed by statute or regulation in a situation involving a complete removal from the U.S. presents no greater problem than presently exists in such a situation where the advance ruling requirement is merely ignored. Without the elimination of all required rulings, the problems of undue delay and uninformed shareholders cannot be solved. The Internal Revenue Service has many years of experience dealing with § 367, as witnessed by the workable guidelines it established under Rev. Proc. 68–23. Accordingly, it is no longer necessary to delay promulgating specific rules relating to "outbound" transfers, on which taxpayers could rely for purposes of planning transactions. The present proposal permits continual delay and does not insure that regulations will ever be promulgated. If new problems arise, the regulations can be amended, or rulings can be sought. A general requirement of a ruling is an anachronism that should be eliminated.

2. Problem 3—Toll charge procedure

The problem of the Service's inability to defer a "toll charge" until a more appropriate subsequent transaction is met by authorizing the issuance of regulations in those cases where no deferred ruling can be required. In such cases, the regulations are to provide the circumstances under which amounts must be currently included in income or deferred for inclusion at a later date. "Clear and certain" deferral regulations would indeed meet the "toll charge" problem and provide a distinct improvement over the existing situation. The express authority to issue regulations should enable the Commissioner to eliminate the requirement of prior unanimous shareholder agreement to the imposition of a § 1248 tax that now exists in numerous of the Revenue Procedure "guidelines" sections. In fact, it is hoped that the regulations under the proposed amendment would provide deferral of a § 1248 tax in a number of cases where such deferral is not now available under the guidelines.

It is just this transfer of legislative responsibility to the Commissioner, however, which is perhaps the most troublesome aspect of the proposed legislation. Congress seems to have recognized this problem. An earlier version of proposed § 367(b)(1) provided that a foreign corporation would be treated as a corporation in a situation not involving an outbound transfer "except to the extent provided in such regulations as the Secretary deems to be necessary or appropriate to prevent the avoidance of Federal income taxes." (Emphasis added.) In the present version of the proposal those words have been changed to read: "except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes." (Emphasis added.) The flavor of the provision appears to have been changed significantly, especially in light of the statement in the Committee Report that the regulations prescribed under § 367(b)(1) will "be subject to normal court review. . . ." Clearly, what is "necessary or appropriate" is to be governed by judicial standards, rather than Service discretion.

Accordingly, it makes more sense for Congress to determine for itself what is "necessary or appropriate." While courts can be relied upon to make an independent determination as to what is or is not "necessary or appropriate" in a particular situation, there will almost certainly be a lack of uniformity of decision. Each judge will have a slightly different view of what he feels is "necessary or appropriate." Moreover, the complexity and policy issues inherent in the Subpart F, § 1248 and other provisions which bear on the determination will be alien territory for most of the judiciary.

This situation is substantially the same as would arise if instead of the present provisions governing the taxability of corporate liquidations, organizations and reorganizations (§ 331–368) the Code contained a simple provision authorizing the Service to make regulations based on a set of subjective criteria.

3. Problems 4 and 5—Judicial Review

The inability to obtain a judicial review would be cured under the proposal by providing for a declaratory judgment procedure. Of course, this procedure would not be necessary if rulings were no longer required. It is true that, after a while, the review of the Service's rulings or of its failure to rule should become standard fare for the Tax Court and some clear rules may begin to appear. Moreover, it will provide for judicial review which is otherwise lacking at this point. Unfortunately, there is no guarantee that these decisions will reflect Congress' views of what is a "reasonable" exercise of Service discretion. If they do not, then pressure will again be placed upon Congress to undo the mistaken judicial authority by statute. In view of this, the enactment into law of specific guidelines, as proposed above, seems to be the only logical course.

If the declaratory judgment procedure is to be adopted, it should first be modified in several respects. First of all, the petitioner should not be required to begin the exchange in order to gain the privilege of filing suit. He will not have been required to do so prior to submitting the request which resulted in the adverse ruling upon which the suit is based. If this requirement has been inserted into the statute solely to insure that the Tax Court reviews only "actual controversies", then as a practical matter it is superfluous. Taxpayers would probably not incur the generally substantial legal costs involved in submitting and following up § 367 ruling requests, unless they plan to proceed with the transfer in the event the response is favorable, especially in view of the fact that the various operative documents must be drafted for submission with the ruling request. The Committee Report suggests that one way of coping with this "all or nothing" approach of the statute is to effect a conditional transfer, i.e., one which would become completely consummated only upon issuance of a favorable decision by the Tax Court. Assuming that this approach comports with the Tax Court's ideas as to when an exchange is considered to have "begun", it still may not solve the dilemma. It just may be that certain exchanges which are so conditional, regardless of the effects of § 367, will not qualify for tax-free treatment under the particular non-recognition section of Subchapter C which governs the underlying transaction, due to their conditional nature. There could also conceivably be problems under local law.

Secondly, the petitioner may have to wait 270 days before being allowed to file suit. Certainly, 180 days is ample time for the Service to decide whether or not it will issue a ruling.

Finally, the class of "petitioners" is open only to the "transferee or transferor" of the stock or other property involved. There may be situations in which adequate protection of the shareholders' interests in this regard may be insured only if they are also given the right to institute a suit. After all, they are the ones who ultimately stand to gain or lose depending upon the outcome of suit. Of course, to avoid frivolous suits, the privilege probably should be limited to "United States shareholders" as that term is defined under § 951(b).

4. Additional Problems

(a) *Failure to net gains and losses.*—A problem under § 367 which is untouched by the present proposal involves the applicability of that section to "gain" situations only. The effect of § 367 in certain situations is to impose a tax which is in excess of the amount which would have been imposed if the particular non-recognition section involved had not applied, irrespective of the effects of § 367. For example, in a "C" reorganization under which all of the assets of a U.S. corporation are acquired in exchange for the voting stock of a

foreign corporation, the non-recognition protection provided by § 361 is applicable only to appreciated assets where the requirements of § 367 are not met.

Accordingly, it is possible for the acquired corporation to incur a tax greater than the tax it would have incurred had its assets been sold for cash, since failure to qualify under § 367 would not alter non-recognition with respect to the losses. It is difficult to imagine that Congress could have intended this result. Since the evil which § 367 aimed at involves the availability of non-recognition provisions to situations pregnant with tax avoidance possibilities, the penalty should be no greater than that whch would result from treating the particular transaction in question as if those provisions had not been enacted.

(b) *Retroactivity.*—One major change in this area is the granting of relief to certain taxpayers who entered into exchanges after 1962 which ran afoul of the § 367 requirement. While there may be equity in permitting these taxpayers to obtain retroactive relief it would appear that similar equity would apply for all periods. Although Subpart F income may not arise prior to 1962, earnings and profits and basis are affected. For example, § 956 of the Code applies to total earnings and profits for all years. Similarly, the toll charge on liquidations is not limited to post-1962 earnings and profits.

(c) *Definitions.*—From a technical point of view, there are a number of problems with the proposed amendment of § 367. The following terms or concepts are not defined and otherwise have no clearly established meaning in the Code:

(1) "Property"
(2) "Beginning of the exchange".

If the term "property" includes stock of a domestic corporation which is a party to the exchange, proposed § 367(a), and the need for a deferred ruling, might be read to apply to transfers of property which are basically into the U.S., but where stock of U.S. corporation is transferred as consideration to a foreign person. Examples would include a "C" or "D" reorganization in which the assets of a foreign corporation are acquired by a domestic corporation, or a "B" reorganization where a domestic corporation acquires control of a foreign corporation from a foreign corporate shareholder of the acquired corporation. This clearly seems contrary to the intent of the proposed legislation. Section 317 excluding stock of a distributing corporation is not applicable to Part III of Subchapter C.

The Committee Report only provides that "an exchange will not be considered to begin with a board of directors or similar decision, but with the transfer of assets." What constitutes a "transfer of assets" sufficient to begin the exchange is not indicated.

II. Section 1248

Present law

Under § 1248(a), any gain derived from the sale or exchange of stock of a foreign corporation by a U.S. shareholder, who actually or constructively owned 10% or more of stock of the corporation at any time within the previous five years, is treated as a dividend to the extent that earnings and profits of the corporation accumulated during the period it qualified as a controlled foreign corporation under § 957(a) are attributable to that stock. Certain amounts are excluded from the earnings and profits of a controlled foreign corporation for this purpose.

These include amounts previously included under § 951 or § 551 [51] in the income of its shareholders, gain realized (but not recognized by virtue of § 337) by the foreign corporation in a sale of its assets in the course of a complete liquidation, certain earnings and profits of less developed country corporations, income effectively connected with the conduct of a U.S. business (if it is not subject to a reduced rate by treaty) and certain earnings and profits of foreign investment companies. In addition, where certain criteria are met, the U.S. shareholder who disposed of stock in a controlled foreign corporation, and who is therefore taxable with respect to its earnings and profits, must also include in his income certain earnings and profits of lower-tier controlled foreign corporations. Finally, § 1248(e) provides for similar treatment of certain transactions with respect to the stock of domestic corporations which were formed to hold stock of foreign corporations.

[51] Section 1248(d)(1) mentions only income included under § 951. However, Reg. § 1.1248-3(e)(3) corrects this obvious oversight by also excluding amounts previously included in the income of the U.S. shareholder under § 551.

Problem

Because dividends treatment is accorded by § 1248(a) only in cases where gain is recognized, certain nontaxable sales or exchanges remain unaffected by that provision. The typical case involves the sale by a domestic holding company of its shares in a controlled foreign corporation in the course of a complete liquidation. By virtue of § 337, gain is not recognized on the sale. Consequently, § 1248 (a) never comes into play and the shareholders of the U.S. corporation receive the earnings and profits of the controlled foreign corporation, not otherwise taxed by the U.S., in a transaction qualifying for capital gains treatment. Similar results may be achieved by a distribution of the shares of the controlled foreign corporation to U.S. shareholders.

Proposed changes

To close this loophole, Congress proposed that transactions of certain domestic corporations in the shares of controlled foreign corporations which would otherwise receive nonrecognition treatment under § 311, § 336 or § 337 be treated in the same manner in which sales or exchanges are treated under § 1248(a). Section 1042(a) of the proposed bill would amend § 1248 adding a new subsection (f) requiring dividend treatment in those transactions to the extent of the excess of the fair market value of the stock over its basis or to the extent of the earnings and profits attributable to the shares disposed of, whichever is less.

Two limiations are placed upon this treatment. First, proposed § 1248(f)(2) exempts from dividend treatment distributions of stock of a foreign corporation where the recipient is treated as if it had held the stock for the period held by the transferee and satisfies the stock ownership requirement of § 1248(a)(2) immediately after the distribution. For example, proposed § 1248(f)(1) would normally apply where a domestic corporation received stock of a foreign corporation in a transaction to which § 332(a) applied. However, if § 334(b)(1) applies to the transaction, the distributee of the stock will be considered to have held the stock of the foreign corporation during the period held by the transferor. Consequently, § 1248(f)(2) would protect the unrecognized gain from dividend treatment as long as the distributee meets the stock ownership requirements of § 1248(a)(2) with respect to that foreign corporation.

A second limitation is provided by § 1248(f)(3). Under that provision unrecognized gains in certain § 337 transactions will not be subject to the dividend treatment of proposed § 1248(f)(1), provided § 1248(e) applies with respect to the transaction. This limitation is designed to avoid taxation under both § 1248(e) and proposed § 1248(f).

Comments on proposal

1. Continued Overlap

A number of difficulties exist with respect to the proposal. In spite of the limitation placed upon the operation of § 1248(f)(1), there still is an overlap with § 1248(e). Where stock of a controlled foreign corporation is distributed to the shareholders in liquidation of a domestic corporation formed to hold stock of the foreign corporation, both § 1248(e) and proposed § 1248(f)(1) could apply to the transaction. Surely, double taxation was not envisioned. The interrelationship between proposed § 1248(f) and § 1248(e) in all sales, exchanges, liquidations or distributions should be clarified, preferably by combining into a single rule covering all the situations contemplated in both subsections.

2. Continued Opening

More importantly, the intended effect of proposed § 1248(f)(1) may be easily thwarted by the interposition of a foreign corporation between the domestic corporation and the income-earning foreign corporation. When stock of the lower-tier foreign corporation is to be sold, a complete liquidation plan can be adopted by the first-tier corporation. A § 337-type sale of the stock of the lower-tier corporation results in no addition to the earnings and profits of the first-tier corporation by reason of § 1248(d)(2). Consequently, even though the distribution of the proceeds to the domestic shareholders would be subject to dividend treatment of § 1248(f)(1), the earnings and profits attributable to the stock upon which the distribution would be made, i.e., the stock of the intermediate corporation) would be negligible.

3. Other Areas to Cover

Since Congress proposes to amend § 1248 for the purposes noted above, it seems appropriate for it to take up other problems in the application of that section.

For example, since gain subject to § 1248(a) is treated as a dividend, the sale of the stock of a foreign corporation by a domestic corporation can inadvertently result in the latter being classified as a personal holding company, even though it would not have been so classified had the foreign corporation's earnings been distributed as earned.[53] This problem, present in a taxable sale or exchange of a foreign corporation's stock under the existing section 1248, would be exacerbated by the new subsection 1248(f), which would create dividends in transactions where otherwise no gain is recognized, and which would remove escape valves which have prevented the existing problem from surfacing.

The basic purposes and structure of the personal holding company provisions would seem to call for the exclusion of 1248 deemed dividends from the definition of personal holding company income. This is particularly true where the deemed dividends arise in an otherwise nontaxable transaction. At the very least an averaging approach should be adopted to avoid the effect of bunching all of the foreign corporation's post-1962 earnings as personal holding company income in one taxable year of the domestic corporation.

Another problem results from the application of § 551(b) in the year of sale. Where one U.S. shareholder of a foreign personal holding company is redeemed out completely before the end of the year, that shareholder picks up as a dividend his prorata share of the earnings and profits of the corporation accumulated until the date of the redemption. However, there appears to be no adjustment in the current earnings and profits of the corporation for the current year to reflect this "deemed dividend" for purposes of § 551(b). Section 562(a) provides that the dividends paid deduction to § 561(a)(1) is applicable only to "dividends described in section 316." Consequently, the remaining U.S. shareholders must include in their incomes at the end of the year under § 551(b) their pro rata share of the corporation's entire undistributed foreign personal holding company income for the current year, including those curent earnngs which were taxed as a dividend under § 1248(a) to the shareholder redeemed out earlier in the year.

Surely, Congress did not intend this result. The problem could be easily rectified either by allowing for a reduction in the corporation's earnings and profits of the curent year to reflect the amount attributed to the stock of the redeemed shareholder or by allowing a dividends paid deduction under § 561 in respect of that amount.

Analysis of Section 1101 of H.R. 10612 Relating to DISCs

Present Law

Present law provides for a system of tax deferral for Domestic International Sales Corporations or DISCs. The profits of a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed to them. However, each year, a DISC is deemed to have distributed income representing fifty percent of its profits thereby subjecting that income to current taxation in its shareholders' hands. In this way, the tax deferral which is available under these provisions is limited to fifty percent of the export income of the DISC. This deferred income is taxed to the shareholders when distributed, when the shareholder sells his stock or when the corporation no longer qualifies as a DISC. The DISC provisions, enacted as part of the Revenue Act of 1971, were enacted to provide incentives which, it was hoped, would increase U.S. exports, improve the balance of payments and increase jobs in the United States by discouraging the establishment of foreign subsidiary manufacturing operations.

To qualify as a DISC, 95% of a corporation's gross receipts for a taxable year must be "qualified export receipts" and 95% of its assets must be represented by "qualified export assets' 'at the close of the taxable year. Under section 995 (b)(2) of the Code, when a DISC becomes disqualified, its shareholders are deemed to have received a taxable distribution in equal installments on the last

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[53] Substantial arguments can be made that gain included in gross income as a dividend under 1248 does not constitute a dividend for personal holding company purposes. The Treasury position to the contrary, however, is implicit in proposed Regulation Section 1.543-12(b)(1).

day of each of the ten years following the year of disqualification (but not more than the number of preceding consecutive taxable years during which the DISC was qualified).

SUMMARY OF LEGISLATION COMPUTATION OF DISC BENEFITS

The major change set forth in H.R. 10612, The Tax Reform Bill of 1975, is in the computation of DISC benefits. In general, DISC benefits would be allowed only to the extent that the DISC's export gross receipts for the taxable year exceed 75 percent of its base period export gross receipts. From 1976 through 1980, the base period would be the taxable years 1972, 1973 and 1974. Beginning in 1981, the base period would move one year forward each year.[53] The three year averaging concept accommodates the problem that would otherwise confront companies whose exports fluctuate from one year to another. Companies whose total DISC benefits are less than $100,000 per year would not be subject to the new base period method of computation but would be permitted to calculate their DISC benefits under present law.

The means chosen for implementation of this base period method is the addition of a new category of deemed distributions from a DISC to its shareholders. Under this procedure, prior to computation of the deemed distribution under present law (one-half of the taxable income of the DISC), the taxable income attributable to the "adjusted base period export gross receipts" is to be deemed distributed to the shareholders.

The "adjusted base period export gross receipts" is equal to 75 percent of the "average export gross receipts" for the base period which in turn is the average of the export gross receipts for the three-year based period. As earlier explained, the bill provides for a five-year grace period before the three-year base period begins to move. In the case of taxpayers having short taxable years in the base period as well as short current taxable years, the Secretary is to prescribe regulations for determining export gross receipts in those years. To illustrate operation of the base period method, if a DISC had taxable income of $1,000 for 1978 and taxable income attributable to its "adjusted base period export gross receipts" for 1972–74 of $400, the deemed distribution would be $700 ($400+½ ($1,000–$400)).

The bill also includes three special rules to deal with situations where a corporation has an interest in more than one DISC or where a DISC and the underlying trade or business giving rise to the DISC income have been separated. The purpose of these rules is to insure that in every year the "base period export gross receipts" which are attributable to a DISC for purposes of deemed distributions are appropriately matched with the current period export receipts of the DISC. These rules also prevent taxpayers from creating multiple DISCs or trading DISCs to reduce deemed distributions attributable to "base period export gross receipts".[54]

The first rule provides that if more than one member of a controlled group of corporations qualifies as a DISC in the current or base period year, the amount deemed distributed to shareholders as taxable income attributable to "adjusted base period export gross receipts" is to be determined by aggregating taxable income, current year export gross receipts and base period export gross receipts of the commonly owned DISCs. This aggregation is to be accomplished under rules prescribed by the Secretary.

The second rule provides for the situation where the ownership of a DISC and the underlying trade or business which gives rise to the export gross receipts of the DISC are separated. This rule requires that the person acquiring the trade or business from the DISC must be treated as having, in any DISC in which it has an interest, an amount of additional gross receipts for base period years equal to export gross receipts in base period years of the DISC attributable to that trade or business. The effect of this provision is to provide a double attribution of base period export gross receipts in cases when a DISC is separated from the underlying trade or business through a tax-free reorganization or through a sale of the underlying trade or business since the DISC as well as the new owner of the trade or business must take into account the same base period export receipts.[55]

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[53] The House of Representatives, in approving the Tax Reform Bill of 1975, rejected an amendment which would have provided for a base period which would start to move in 1979.

[54] H. Rept. No. 94–658, 94th Cong., 1st Sess., 266 [hereinafter cited as "H. Rep."].

[55] H. Rep. at 267.

A third rule is provided to apply to situations where a person owns a partial interest in a DISC.[56] Under this rule, if a person has had an interest in more than one DISC (either simultaneous ownership or ownership of one DISC during the base period and ownership of the second DISC during the current year) then, to the extent provided in Regulations prescribed by the Secretary to prevent circumvention of the Rules for deemed distributions, amounts equal to that shareholder's pro rata portion of the "base period export gross receipts" of DISCs owned during the base period are to be included in "base period export gross receipts" of DISCs currently owned by the shareholder. If the first two rules apply, the Committee Print stated that this third rule would generaly not be applicable.[57]

A small DISC exception is also provided. DISCs with adjusted taxable income in the current taxable year of $100,000 or less are not subject to the new base period rules. The exception is phased out on a 2 for 1 basis so that DISCs with taxable income of $150,000 or more receive no benefit.

The base period rules are to apply to taxable years beginning after December 31, 1975.

COMMENTS ON THE PROPOSED LEGISLATION GENERAL

It should be noted that an incremental approach similar to the one adopted in the Tax Reform Bill of 1975 was rejected by the Senate Finance Committee when it considered implementing the DISC provisions in the Revenue Act of 1971.[58] More specifically, the concept of a base period coupled with 100% deferral was dropped in favor of no base period with 50% deferral.[59] The Senate Finance Committee rejected the incremental approach largely for the following reasons:

1. In an incremental system, there would be no way to identify firms which are struggling to maintain their existing export level in the face of increased foreign competition; and
2. In an incremental system, there are great administrative difficulties including record keeping as well as choosing an appropriate base in which to measure incremental performance.[60]

In the President's 1961 Tax Recommendations to the Congres, an incremental approach was set forth relating to his investment tax credit proposal. More specifically, the proposal provided for a greater percentage of tax credits for investment in excess of a taxpayer's current depreciation allowance.[61] By adopting this position, the President's proposal would base the amount of the credit on the past history of the taxpayer's depreciable investments. This provision was not adopted in the House, Senate or Conference Committee versions of the Revenue Act of 1962.[62] It apparently was not adopted for reasons similar to those involving the rejection of the incremental approach for DISC in the Revenue Act of 1971.[63]

The current proposal involves a substantial additional burden on taxpayers due to the necessity to prepare and keep records which are not presently required. For example, a taxpayer filing its 1980 tax return in 1981 would have to compute its base period by reference to its export experience in 1972, 1973 and 1974. This entails preparing and keeping records relating to its export transactions which relate to years going back nine years prior to the year in which the return is filed.

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[56] Ownership of five percent or more of the stock in the DISC constitutes a partial interest.

[57] H. Rep. at 268.

[58] Senate Report No. 92-437. 92d Cong., 1st Sess. (1971), *reproduced in,* 1972-1 Cum. Sess., *reproduced in,* 1972-1 Cum. Bull. 644, 666 (Conference Committee adopted Senate Sess., *reproduced in,* 1972-1 Cum. Bull. 644, 666 (Conference Committee adopted Senate version which rejected the House's incremental approach).

[59] The House of Representatives proposal provided for full deferral for export income attributable to sales in excess of 75 percent of the average gross receipts of the Corporate group to which the DISC belonged for the years 1968. 1969 and 1970. H. Rept. No. 92-533, *reproduced in*, 1972-1 Cum. Bull. 498, 499, 503, 540, 542.

[60] Hearings on H.R. 10947, Senate Comm. on Finance, 92d Cong., 1st Sess., 46, *reproduced in*, 6 BNA Tax Mgt.—Primary Sources. § 901.14 (1971) (Testimony of John A. Connally, Secretary of the Treasury). *See also* Senate Rept No. 92-437, *supra* note 5, at 565, 609.

[61] President's 1961 Tax Recommendations. Hearings before the Comm. on Ways and Means, 87th Congress, 1st Sess., vol. 1, pp. 6, 23-29.

[62] H.R. Rep. No. 1447, 87th Cong., 2d Sess., *reproduced in*, 1962-3 Cum. Bull. 405, 411-20, 503-25; S. Rep. No. 1881, 87th Cong., 2d Sess., *reproduced in*, 1962-3 Cum. Bull. 707, 716-27; Conf. Rep. No. 2508, 87th Cong., 2d Sess., *reproduced in,* 1962-3 Cum. Bull. 1129, 1140-43.

[63] *See* Hearings on H.R. 10947, *supra* note 6, at 46 (Testimony of Connally).

The proposed legislation also favors newly organized DISCs. For example, a DISC beginning operations in 1975 would have no base period export gross receipts for five full years. In 1981, the base period will begin to include the first year in which the DISC had export gross receipts. As a result, these DISCs would be entitled to the full 50% deferral until 1981. DISCs commencing operations later than 1975 would be entitled to the full 50% deferral for an even longer period. All other DISCs would be placed on an incremental basis for taxable years beginning after December 31, 1975.

A corporation with a newly organized DISC might have had large export sales for years in which the DISC was not in existence. In this case, DISC benefits would not be affected by the export history of the corporation until the base period includes the first year of the DISC's existence. As a result, a taxpayer with large export sales and no DISC in the base period would not be as adversely affected by the incremental approach as would a taxpayer who had the same export history and a DISC in the base period. Since the incremental approach is aimed at rewarding those taxpayers who increase their export activity, this inequity should be corrected.

QUALIFYING DISTRIBUTIONS

Under present law, if a DISC has taxable income from nonqualifying receipts, one-half of such income is deemed distributed under section 995(b) (1) (D) of the Code, and, if a deficiency distribution is made under section 992(c) (1) (A) of the Code, such distribution is "the portion of such corporation's taxable income attributable to its gross receipts which are not qualified export receipts for such year . . . ." Section 996(a) (2) (A) of the Code provides that such a qualifying distribution is treated as having been made first out of accumulated DISC income. The effect of these provisions, taken together, is the immediate taxation of 150% of the income from nonqualiyfing receipts. This "double counting" problem was recognized by the Ways and Means Committee in its consideration of H.R. 17488, the Energy Tax and Individual Relief Act of 1974, and is discussed in its Committee Report. H. Rep. No. 93-1502, 93rd Cong. 2d Session, 143-144. In order to eliminate this problem, section 331(b) of H.R. 17488 would have amended section 996(a) (2) of the Code to provide that one-half of any deficiency distribution would be treated as having been made first out of accumulated DISC income and that the remaining one-half would be treated as having been made first out of previously taxed income. More specifically, Section 331(b) amended Section 996 (a) (2) by adding at the end thereof the following new sentence: "In the case of any amount of any actual distribution made pursuant to Section 992(c) which is required to satisfy the condition of Section 992(a) (1) (A), the preceding sentence shall apply to one-half of such amount, and paragraph (1) shall apply to the remaining one-half of such amount."

However, H.R. 17488 was never reported out of the House Rules Committee. Legislation encompassing Section 331(b) of H.R. 17488 does not appear to have been reproposed in the 94th Congress. Therefore, it is suggested that Section 331(b) be included in the Tax Reform Bill of 1975.

DETAILED CRITICISM OF CERTAIN PROVISIONS

(i) *Special double attribution rule for separation of a DISC and its underlying trade or business*

The Tax Reform Bill of 1975 proposes to add a new section to the Internal Revenue Code, Section 995(e) (8), which is a special double attribution rule applicable to situations in which there is "a separation of the ownership of the stock in the DISC from the ownership of the [underlying] trade or business" giving rise to the export gross receipts of the DISC. This rule requires a person owning the underlying trade or business after the separation of that trade or business from the previously related DISC to be treated as having in any DISC, in which such owner has an interest, an additional amount of export gross receipts attributable to such trade or business.[64] Double attribution will result in that the export base period gross receipts will not only remain with the previously related DISC but the same gross receipts also will be attributed to the new owner of the underlying trade or business.

[64] Int. Rev. Code of 1954, Proposed § 995(e) (8) (A).

There is no definition of what is meant by the words "separation of the ownership of the stock in the DISC from the ownership of the trade or business which (during the base period) produced the export gross receipts of the DISC." The House Ways and Means Committee's Report on the Bill states that double attribution will result if there is a sale of the underlying trade or business or if there is a tax free reorganization in which the DISC and the underlying trade or business are separated.[65] The purpose of this rule is to make sure that the owner of the underlying trade or business does not establish a new DISC with zero base period export gross receipts.[66]

Initially, it should be noted that subparagraph (A) of the proposed section attributes the additional export gross receipts to the "persons who own the trade or business." If a corporation sells the underlying trade or business then it appears that the new owner of the business has these additional export gross receipts even though it might not have a DISC. While one assumes that no tax consequences will ensue to that owner owing to these "hanging" receipts until he creates a DISC, the statute should be reworded to make that point clear.

Furthermore, the statute provides in proposed section 995(e)(8)(A) that "the persons who own the trade or business during the taxable year shall be treated as having had additional export gross receipts during the base period attributable to such trade or business." However, the statute does not provide the means for computation of these attributable base period gross receipts. The Committee Print does provide that these attributable receipts shall be "equal to export gross receipts in base period years, of the DISC attributable to that trade or business."[67] This computation problem should be dealt with in the statute.

To deal with the hanging and computation problems, subparagraph (A) of proposed section 995(e)(8) should be reworded by inserting the following underlined words and deleting the following bracketed words: "separation of the ownership of the stock in the DISC from the ownership of the trade or business which (during the base period) produced the export gross receipts of the DISC, then the persons who own the trade or business during the taxable year shall be treated as having [had] *in any DISC in which the owners of the trade or business have or acquire an interest an* additional *amount* of export gross receipts [during the base period attributable to such trade or business] *for base period years equal to the export gross receipts in the base period years of the DISC attributable to the trade or business.*"

Furthermore, if a corporation which has a DISC subsidiary chooses to incorporate the underlying trade or business, then it appears that the newly incorporated division will have additional exports gross receipts even though it has no interest in the DISC. While these receipts would appear to be "hanging" in mid-air, it might be argued that these receipts should be added to the export gross receipts of the existing related DISC. However, proposed section 995(e)(7), which provides for aggregation of base period gross receipts for controlled groups, is specifically worded to apply only to cases involving multiple DISCs and therefore would appear to furnish a strong argument against aggregating the incorporated division's export gross receipts with those of the DISC. If the attribution rules of section 318 were applicable to subparagraph (a) (they do not appear to be applicable)[68] then there would be no separation in the incorporation case since the ownership of the stock in the DISC would be attributed to the person owning the underlying trade or business.[69]

An exemption is provided to the double attribution rule in cases:

"(i) Where the stock in the DISC and the trade or business are owned throughout the taxable year by members of the same controlled group, and

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[65] H. Rept. at 267.

[66] H. Rep. at 267.

[67] H. Rep. at 267.

[68] Proposed section 995(e)(9)(B) only makes the attribution rules of section 318 applicable to proposed section 995(e)(9)(A).

[69] Int. Rev. Code of 1954, § 318(a)(3)(C). If the attribution rules were not applicable to subparagraph (A) then one would be confronted with the situation where the creation of a second DISC after incorporation of a division would lead to the combined effect of double attribution and the controlled group provision. *Compare* H. Rep. at 268 n. 3 (creation of a second DISC in which the related DISC assets of the first DISC are placed at the time of incorporation would not lead to double attribution). However, this appears to be an academic question since the parent can still utilize the initial DISC rather than establishing a second DISC to export the products of the incorporated division.

(ii) to the extent that the taxpayer's ownership of the stock in the DISC for the taxable year is proportionate to his ownership during the taxable year of the trade or business." [70]

A major problem with the separation rule is illustrated by the following fact pattern. A parent corporation owns all the stock of a DISC and of another subsidiary which produces the export gross receipts of the DISC. If the attribution rules of section 318 do not apply to subparagraph (A), then it would appear that the ownership of the stock in the DISC is separate from the ownreship of the trade or business. This follows because the export subsidiary owns the trade or business but does not (unless section 318 applies) own the stock of the DISC. As a result, if the parent chooses to sell either subsidiary, a "separation" will not result since a separation existed prior to the sale. Therefore, double attribution of the base period export gross receipts can never exist in this case. This would appear to be in direct contradictiton to Congressional intent.[71] If the attribution rules of section 318 were applicable to subparagraph (A), then under section 318(a)(3)(C), the stock in the DISC would be constructively owned by the other subsidiary prior to the sale. Therefore, a separation would occur and double attribution would result if either subsidiary is sold. However, the Bill as presently drafted does not provide for application of section 318 to this case. Rather, the section 318 attribution rules appear to apply only to proposed section 995(e)(9)(A) which deals with the abuse potential of shareholders who own interests in multiple DISCs.

Another problem wtih this provision is presented by the following fact pattern. A corporation acquires the stock of another corporation which owns all the stock of a DISC and of another subsidiary which produces the export gross receipts of the DISC. If the constructive ownership rules of section 318 do not apply, the ownership of the stock in the DISC is separated from the ownership of the trade or business before the stock of the parent is acquired by the purchasing corporation and double attribution will not result. However, in this case, the conclusion is sound but the reasons for it are illogical. There should be no double attribution because the relationship between the DISC and the underlying trade or business is not disturbed [separated] by the transaction. The Committee Print reaches a similar conclusion based on the premise that a separation occurred but the exemption under subparagraph (B) prevents double attribution.[72] If the attribution rules of section 318, specifically section 318(a)(3)(C), are applicable to subparagraph (A) of subparagraph 9 of proposed section 995(e), then a "separation" would not ensue because the ownership of the stock of the DISC and the ownership of the trade or business would both be owned by the subsidiary which produced the export gross receipts both before and after the transaction.

If the Committee Print is correct and the transaction resulted in a "separation", then subdivision (ii) of subparagraph (B), which provides an exemption from "separation", would only be met if the attribution rules of section 318 were applicable to subparagraph (B). However, the Bill as drafted does not appear to apply the section 318 attribution rules to either subparagraph (A) or (B) of subparagraph 8 of proposed section 995(e) of the Code. Accordingly, the Bill should be amended to apply the attribution rules to both subparagraphs (A) and (B) of subparagraph 8 of proposed section 995(e) of the Code.

It should also be noted that the "separation" provisions raise the question whether there is a "separation" if a corporation which operates an export division and also owns the stock of a related DISC sells one of several plants or assets producing export gross receipts or sells 50% of the stock of its DISC. Do these transactions result in a "separation"? If so, does the exception provided by subparagraph (B) of subparagraph 8 of proposed section 995(e) prevent double attribution. It appears that subparagraph (B) does not apply to the latter situation but might apply to the former situation.[73]

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[70] Bill § 1101(a)(3); Int. Rev. Code of 1954, Proposed § 995(e)(8)(B).
[71] H. Rep. at 267–68.
[72] H. Rep. at 267–268.
[73] However, if one treats the transferred assets as constituting a "trade or business" then it would appear that the subparagraph (B) exemption does not apply to a sale of assets. Proposed section 995(e)(8)(A) states that the "*persons* who own the trade or business" receive the additional export gross receipts. This could be interpreted to lend support to the conclusion that a sale of a portion of the assets result in the addition of a new owner to whom some share of the additional export gross receipts are to be attributed.

Thus, if a corporation sells 50% of the stock of the DISC, it appears that its DISC will keep its "export gross receipts" and its seller parent corporation will have additional "export gross receipts" which will "hang" in a way similar to the incorporation situation discussed earlier.[74]

The exemption provision relating to double attribution set forth on page 12, *supra*, also requires certain clarifying amendments. The words "the taxpayer's" should be substituted for "his" and the words "which gives rise to the base period export gross receipts of the DISC" should be added at the end of subsection (ii) of subparagraph (B) of subparagraph 8 of proposed section 995(e).

(ii) Termination of DISC benefits for certain products and treatment of producers' loans made after termination of those benefits

Products sold for use as military equipment and agricultural products not in surplus in the United States would be eliminated from the favorable treatment accorded Domestic International Sales Corporations. This provision would be effective for sales, exchanges and other dispositions made after October 2, 1975 in taxable years ending after that date. However, an exemption to this effective date is provided for sales, exchanges and other dispositions made after October 2, 1975, but before October 3, 1978, which are made pursuant to a fixed contract.

The effective date of October 2, 1975 for the provisions contained in section 1101(b) of the Bill which would eliminate DISC benefits for agricultural and military goods should be changed. If section 1101(b) is enacted later this year, a substantial period of time—crossing two taxable years of most DISCs—will have elapsed between the October 2, 1975 tentative decision of the Ways and Means Committee and the date of enactment. As stated by the Committee on Tax Policy of the Tax Section of the New York State Bar Association:

"The real effect of retroactivity during this period [between the time a tax proposal is announced and the date of its enactment] is to create a period in which no governing law exists. Although the taxpayer may be on notice of a proposed change, he cannot be sure that the law will be changed. The taxpayer is, therefore, at a loss to ascertain the controlling law applicable to his conduct during such period. At best the situation is ambiguous—the taxpayer is on notice that he can no longer rely on existing law but neither can he be sure the law will be changed. The vast number of legislative changes which are proposed with retroactive effect, but never enacted, accentuate the problem. Moreover, if the mere announcement of the proposed change can effectively and immediately alter conduct, then as a practical matter the law has been changed already, albeit constitutionally such a change cannot be made without the approval of the legislature."

Comm. on Tax Policy, Tax Section, N.Y.S. Bar Ass., *Retroactivity of Tax Legislation*, 29 The Tax Lawyer 21, 24–5 (1975) (footnote omitted).

If the October 2, 1975 effective date is retained, even those agricultural and military DISCs which have attempted to remain qualified by trying to comply with the terms of the proposed legislation could be disqualified as DISCs for 1975. For example, a buy-sell agricultural DISC which ceased to purchase inventory in October 1975 but which had a substantial existing inventory of export property on October 2, 1975 might not be able to dispose of such property without failing the gross receipts test. The DISC might also be unable to dispose of the property prior to the end of its taxable year, thereby failing the assets test.

Commission DISCs could also be disqualified for 1975. For example, if a DISC's supplier's agreement provides that it is entitled to a commission on all export sales, the Internal Revenue Service might take the position that commissions must be accrued by the DISC on sales occurring after October 2, which accruals could be sufficient to result in the DISC's failure to meet the gross receipts test. Further, if commissions accrued with respect to non-qualifying sales were treated as constituting an asset at year-end, the DISC might be unable to meet the assets test. This accrual problem would, of course, exist for 1976 as well, so that changing the effective date to January 1, 1976, for example, would not eliminate the problem.

The forced disqualification of DISCs that would result from the October 2, 1975 effective date (or any other retroactive effective date) is inconsistent with

[74] *See* pp. 10–12, *supra*. If the amendment to subparagraph (A) proposed on pages 11–12, *supra*, is adopted then this problem becomes more acute since additional export gross receipts will be attributed to the DISC of the seller corporation.

other provisions in Bill section 1101 which are intended to enable DISCs whose goods are being denied DISC benefits to continue their DISC qualification with respect to their previously accumulated DISC income. See Bill section 1101(c) (discussed below) which would amend section 993(d)(2) of the Code for the purpose of permitting a DISC whose goods are being denied DISC benefits to continue to make producer's loans (and thereby remain qualified as a DISC). A more appropriate and consistent effective date provision would exclude military and agricultural goods from DISC benefits beginning with the first day of the DISC's taxable year beginning after the date of enactment of the legislation.[75]

Section 1101(c) of the Bill provides a special rule for handling producers' loans made after termination of DISC benefits. By its terms, this provision modifies section 993(d)(2) (relating to the definition of a producer's loan) of the Code by inserting after "of property which would be export property," the following: "(determined without regard to subparagraph (C), (D), or (E) of subsection (c) (2))."

However, this provision fails to modify section 993(d)(1)(C) of the Code which requires the loan to be: "made to a person engaged in the United States in the manufacturing, production, growing, or extraction of export property (referred to hereinafter as the "borrower")...."

As a result, producers' loans made after October 2, 1975 would appear to cease qualifying as qualified export assets if the borrower still manufactures the excluded products. Thus, if the proposed legislation is enacted with an October 2, 1975 effective date, DISCs which make producer's loans after such date and before enactment of the Tax Reform Bill of 1975 may lose their DISC benefits. This apparently inadvertent omission should be corrected.

If the above amendment is made then producer's loans made by a DISC to manufacturers of certain excluded products (hard minerals, oil and gas, agricultural products, products whose export is limited by federal law) will continue to qualify as qualified export assets under Code Section 993(b)(5). However, it is noted that apparently by inadvertence, Bill Section 1101(c) does not provide for continued qualification for producer's loans made to manufacturers of military products.[76]

For purposes of computing the base period export gross receipts of a DISC, an adjustment is to be made to reduce the base period export gross receipts of that DISC to reflect the elimination of DISC benefits for products excluded under code section 993(c)(2).[77] This proposed adjustment does not include reference to products that have been excluded under code section 993(c)(3). Under section 993(c)(3), the President, by Executive Order, can exclude articles that are in short supply domestically. Omission of reference to section 993(c)(3) should be corrected in the Bill.

In the case of a disqualification of a DISC, DISC benefits for prior years are to be recaptured.[78] Where a shareholder in a DISC sells his stock in the DISC, DISC benefits for prior years are generally recaptured to the extent of the gain.[79] The Committee Print provides that export gross receipts for base period years prior to any sale or disqualification are to be reduced on a pro-rate basis to the extent of the recapture.[80] However, the Bill does not provide for this adjustment. As a result, proposed section 995(e)(2) should be redrafted to cover these recapture situations.

RECOMMENDATION

We hope that the above comments suggest the extent to which Bill Section 1101 would add a layer of complexity to existing DISC legislation. Such complexity will significantly add to the burden of taxpayers who attempt to maintain DISC benefits for their export operations and to the Internal Revenue Service which is obligated to administer the new provisions. If it is thought desirable to con-

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[75] The Tax Reduction Act of 1975 excluded energy products and products subject to export controls from the definition of export property. The effective date of such legislation, March 18, 1975, represented the date of the floor amendment in the Senate excluding these products from DISC benefits, not the date of a tentative decision by a committee. More importantly, this legislation was enacted on March 29, 1975, only eleven days after the floor amendment was proposed.

[76] In discussing Bill Section 1101(c), the Report of the House Committee on Ways and Means expressly gives an example of this subsection's applicability to military products. H. Rep. at 271.

[77] Bill § 1101(a)(3): Int. Rev. Code of 1954, Proposed § 995(e)(2). *See generally.*

[78] Int. Rev. Code of 1954, § 995(b)(2).

[79] Int. Rev. Code of 1954, § 995(c).

[80] H. Rep. at 267.

tinue the DISC tax incentive for exports but at a reduced level it would be far simpler to reduce the DISC deferral percentage from 50% to some lesser percentage.

The CHAIRMAN. Our next witness is Mr. T. Howard Rodgers, president, Santa Fe Natural Resources, Inc., and president, Domestic Petroleum Council.

STATEMENT OF T. HOWARD RODGERS, PRESIDENT, DOMESTIC PETROLEUM COUNCIL, AND PRESIDENT, SANTA FE NATURAL RESOURCES, INC.

Mr. RODGERS. On behalf of the Domestic Petroleum Council, I want to thank you for the opportunity to be present this morning.

My name is T. Howard Rodgers. I am here in two roles today, as president of the Domestic Petroleum Council, a relatively new association of small- and medium-sized oil companies, and as president of Santa Fe Natural Resources, Inc., a member of the Domestic Petroleum Council. The membership of the council has asked me to present our position in favor of a 12-percent investment credit for intangible drilling costs and geological and geophysical costs related to exploratory oil and gas wells incurred in the United States.

A description of the Domestic Petroleum Council accompanies this statement. As our description indicates, the overriding concern of the council is with the discovery and production of new sources of oil and gas in the United States. While we have members with some refining and marketing capacity, the focus of the organization is on production. To this end, I am appearing today to emphasize the critical need for a Government policy toward the industry that fosters the investment and capital growth necessary to finance the search for oil and gas reserves in the United States, and to indicate our support for a proposal which appears to effectively implement this policy.

Our support for an investment credit for intangibles and geological and geophysical costs related to exploration is based on one very straightforward consideration. If this country desires to expand the search for domestic oil and gas reserves, more money must be spent to do it than is currently available to the industry. We feel the investment credit is a logical and effective way of channeling more money into this exploration. Structured properly, the investment credit would provide a substantial additional incentive for exploration, as well as guaranteeing that the dollars provided are actually spent in the search for oil and gas.

We believe that this Nation must increase its production of oil and gas here at home and ease its dependence on foreign oil. Domestic production, as well as known reserves, have been declining, and the amount of imported oil has been rising. Between 1971 and 1973, even while exploration expenditures were up from $3.9 billion to $8.14 billion, proved oil and gas reserves fell, from 35.77 billion barrels of oil to 32.15 billion, and from 252.8 trillion cubic feet of gas to 224.0 trillion. With an even larger upturn in 1974 capital expenditures for exploration, the known reserve figures have decreased for that year, while foreign import figures, from 1971 to 1974 have risen from 3.93 million barrels a day to 6.19 million.

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The President, Congress, and most of the American people recognize this as a serious problem. The question is how to solve it. While conservation measures and alternative fuels provide some relief, the only guaranteed way to reduce foreign oil dependence is to drill more wells in the United States, find better ways to get the oil out of wells already drilled, and do whatever is necessary to increase domestic production. To this end, the oil industry must have the necessary financial resources; and that is why we have come to you today.

The enormous capital requirements for stepped up exploration will have to be met both from the oil industry itself and from outside investors as well. Historically, the industry has relied on internal capital, around 87 percent during 1960 through 1964 according to a study by the Chase Manhattan Bank. But in recent years that figure has dropped to 72 percent for 1970–74. With the loss of the cash generated by the depletion allowance, about $1.7 billion for 1975 according to the Joint Committee on Internal Revenue Taxation staff estimates, and the implementation of the 40-month Energy Policy and Conservation Act price controls, the necessary increase cannot be borne alone by capital from within the oil and gas industry. Yet outside capital sources are reluctant to pour large amounts of money into the industry because of their uncertainty about Government policy. With the elimination of the depletion deduction, proposals restricting the use of intangibles, the current divestiture discussion, and the confusion over natural gas deregulation legislation, the Government attitude toward the oil and gas industry is not conducive to raising outside capital.

An investment credit for exploration costs would serve two functions here. It would allow more internal capital to be used for exploration, and it would signal to the outside investors and to the American public that the Federal Government is committed to the search for new oil.

The investment credit, already a part of the tax law, is a logical way to encourage exploration. Restricting its application to exploration in the United States targets it where we need it the most, at home. By establishing the credit at 12 percent and extending it to intangible drilling and development costs and geological and geophysical costs for oil and gas exploration, those companies involved in the search for new oil and gas will be able to expand their efforts. The intangible costs, such as labor, fuel, repairs, supplies, surveying, hauling, et cetera, and those geological and geophysical costs involved in finding new sources of oil, are not currently eligible for the investment credit. It might also be noted that the House, in its version of tax reform, extends the investment credit to certain intangible costs of the movie industry for the purpose of creating jobs. Extending this same type of credit for energy exploration, while no doubt creating jobs, adds to our domestic oil reserves and our national security, purposes vital to the United States.

The scope of the definition of exploration, for the purposes of investment credit, should be broad enough to encompass not only the first well in a field, but also those others needed to define the limits of the reservoir. Similarly, a well close by a producing well, but tapping another reservoir, should still be considered exploratory. The credit

should be structured to encompass all those costs related to finding new oil and gas, including lease acquisition costs and bonuses.

Making use of the investment credit is an administratively simple way to encourage exploration. Unlike the frequently discussed plowback feature tied to other tax proposals, the credit is a part of the tax system that requires no new interpretation and is self-monitoring. An investment in exploration generates a credit and the money is spent for the desired goal before the credit applies. Additionally, it attracts investors who have capital because they know that if their money is used for this purpose they will obtain a credit.

The investment credit will benefit those companies doing the exploring. It is not going to reward a company for its size or its market share. It is going to help the segment of the industry doing the most to find new oil and gas: the independents and the wildcatters, companies like those belonging to the Domestic Petroleum Council.

In testimony before this committee 2 years ago, John Miller, president of the Independent Petroleum Association of America, indicated that over 85 percent of the exploratory drilling in this country was done by independents. An investment credit for intangibles and geological and geophysical costs will provide additional financial incentives which will enable a company to take more risks in attempting to discover reserves, which in the final analysis will lead to the production of more oil and gas in the United States.

The investment credit should also apply to costs for enhanced recovery methods since new ways to recover oil from old wells will also add substantially to our domestic production.

Using my company, Santa Fe Natural Resources, Inc., as an example, the loss of percentage depletion in 1975 resulted in a reduction of cash flow of approximately $12 million which would have been used for exploratory purposes in 1975. In addition, we are presently estimating that for 1976 our cash flow will be reduced by an additional $4 million because of the implementation, effective February 1, of the Energy Policy and Conservation Act, again resulting in $4 million not being available for exploration. The proposed investment credit will not offset the above cash flow losses, but it is at least a turn in the right direction as it will for a change provide us with a positive means of increasing our cash flow which in turn will be used for exploratory purposes.

In this connection our 1976 budget for exploration is $48 million, which is an increase of $19 million over 1974.

Considering a 12 percent credit for intangible costs and geological and geophysical exploration costs, we will be able to generate approximately an additional $4.3 million for more drilling. This kind of expanded exploration throughout the industry will help toward increasing our domestic oil and gas reserves.

A Finance Committee staff analysis of a 10 percent credit, similar to that which I have just discussed, estimates a revenue cost of $210 million for 1976 growing to $370 million by 1980. We have recommended a 12 percent credit. This will, of course, increase the revenue loss, yet the other side of revenue loss is additional cash flow for exploration. The search for domestic oil and gas costs money. If we want more sources of petroleum in the United States, we have to spend more

money. We have described one method we believe will successfully produce more oil and gas in this country.

I thank you, Mr. Chairman, and members of the committee for the opportunity to present these comments and for your courtesy to the Domestic Petroleum Council today.

Senator BENTSEN. Thank you, Mr. Rodgers. We are very appreciative of having your testimony.

We are facing a paradox, it seems to me, in this Congress. In 1970, we were importing approximately 23 percent of the oil used in this country. Today we are importing about 45 percent of it. We are going absolutely in the wrong direction. The oil bill that passed through this Congress was supposed to reduce gasoline by 1½ cents a gallon. I do not think that this has helped; it has made us more dependent, rather than less dependent on the Middle East.

We have a proposal over in the Ways and Means Committee that would put severe limitations on the intangible drilling costs. With their proposal, the members of the IRS Agency would have to be geologists to make the determination about whether you really have an exploratory well, which it might well be. Almost every piece of legislation that has been passed has been one that has made us more dependent rather than less dependent.

As I understand it, your 12 percent proposal is one not in lieu of, but in addition to, the intangible drilling costs. Now, we have had testimony calling for a 12 percent investment tax credit for exploratory wells, but they had also proposed it as an alternative to the use of the intangible drilling cost. I am sure that is not what you are proposing at all.

Mr. RODGERS. No, sir.

Senator BENTSEN. Senator Packwood, I think you are next in the order of appearances.

Senator PACKWOOD. Mr. Rodgers, I want to make sure that I understand what you are advocating.

Let's presume that an oil drilling business of $2,000 gross income for a year, where you have got $500 in the laboratory, a full $500 in supplies, surveying and other miscellaneous, so that you have $1,000 apparently of intangible drilling costs. As I read your statement, you are suggesting that those intangible drilling costs be taken as current business deductions, subtracting from the gross, leaving with you the net income upon which, just to say for simplicity, you would pay 50 percent tax, or $500.

Now, in addition to that, you would like a 12 percent tax credit on the thousand dollars, one hundred and twenty would be subtracted from the $500, leaving $380.

Mr. RODGERS. Yes. As you are aware, Senator, when the investment tax credit is available for the purchase of equipment, the Congress has provided that the depreciable basis of that equipment is not reduced by the amount of the credit. We are requesting parallel treatment if our proposed credit is adopted by Congress. The whole problem is one of aggregate cash flow. There is the need for more capital coming into the drilling business, but if we are granted some money in one category and have it taken away in another, it is really a wash out and does no good.

In the case of my own company, as I mentioned, the legislative impact of recent congressional action has been to reduce our exploration budget by $16 million.

Senator PACKWOOD. Let me stop you there. I want to understand how this works. It is an additional $120 tax credit. I may even be sympathetic to it.

Now, we come to these intangible drilling costs. I never have understood exactly what they are. Is there anything that is not an intangible cost short of a hard investment? What counts and what does not count in intangible drilling?

Mr. RODGERS. I am not a tax expert, but my general understanding is in our experiences that out of $100,000 spent on a well, about 60 percent of the expenditures can be lumped into the intangible category. That would be labor and all of those things which are not fixed assets.

Senator PACKWOOD. Is there a difference between intangible costs, intangible drilling costs and geological and geophysical costs? Are those costs in addition to the intangible drilling costs?

Mr. RODGERS. Yes they are, geological and geophysical costs are computed separately from intangible drilling costs, but of course they are just as necessary for the well.

Senator PACKWOOD. So when you talk on an average of $60,000, $100,000 that would not include your geophysical?

Mr. RODGERS. That is correct, it would not.

Senator PACKWOOD. So that would make your costs even higher?

Mr. RODGERS. That is correct.

Senator PACKWOOD. Then, about the only thing that is left out of this $100,000 seems to be the hard fixed investment; almost everything else fits into the intangible category?

Mr. RODGERS. That is true, intangibles or geological and geophysical costs.

Senator PACKWOOD. Your figures for 1974 talk about investment costs having gone up. You indicate that more of the cost is now coming from borrowing rather than internally generated capital. When we eliminated the oil depletion allowance and when we passed the energy bill last year with the oil ceiling on it the argument made was that it was going to force the amount of money to be invested to go down.

In terms of constant dollars, has that happened in 1975? Has the amount of money going into the investment, into the exploration and development been going down?

Mr. RODGERS. I cannot answer for the industry; I can only answer for my company. In our case, our investment is going up.

Senator PACKWOOD. Up even in constant dollars?

Mr. RODGERS. Yes, we are investing more money in exploration. There are several reasons for this. We have been successful in generating cash because of important discoveries and development. These generate cash. Although exploration expenditures for the industry as a whole are not available yet for 1975, several other members of the Domestic Petroleum Council have indicated increases in exploration expenditures as well as Santa Fe. But, so far this year, drilling activity is down, the number of active rigs for the 4 weeks ending March 8, reaching a new low for the year, are well below 1975 levels, according to a recent

Oil and Gas Journal. But, even if the figures for exploration by the entire industry were up, the critical fact remains, known reserves have continued to drop, our dependence on foreign oil has increased. The fact that there may be some increase in exploration becomes significant when our domestic production continues to lose ground against imports.

Senator PACKWOOD. With the elimination of the oil depletion allowance and with the passage of that energy bill putting the cap on oil, indeed, there is more capital that goes into the exploration.

I have looked at your statement and I have noticed your increase of $19 million, and I was wondering how, under those circumstances you generate that much additional capital.

Mr. RODGERS. Well, Senator, as I say, we have been extremely fortunate in development of oil resources. On the west coast, our present well production is at 17 million barrels a year. It is up from only 5 million barrels a year in 1964. So there we have had a substantial increase, and with the effect of the inventory profits from 1974, there has been cash available to put into exploration.

Senator PACKWOOD. Thank you very much.

Senator BENTSEN. Let me intrude here.

Intangible drilling costs, those are all costs, I understand it, for preparation of the well other than G. & G., and except those things that are solvent.

Senator PACKWOOD. I beg your pardon?

Senator BENTSEN. All the costs that you have and pay for labor, if you will, repairs, anything in preparation for drilling that is not a solvent thing, such as a pump——

Senator PACKWOOD. Everything else is intangible drilling cost which you would have in as part of the tax credit.

Senator BENTSEN. Yes.

Senator Fannin?

Senator FANNIN. Is that a fair statement of the intangible drilling costs?

Mr. RODGERS. Yes.

Senator FANNIN. Just following up on the question of the Senator from Oregon about the investment and capital structure and capital formation that you speak about, has there been a change in the source of capital? In other words, when we had the depletion allowance, we had a great incentive for professional people to invest and for many dollars to come from sources that had been available over the years.

As I understand that, some of that source of funding has dried up. Is that your understanding?

Mr. RODGERS. Yes, I think that is correct, for the industry as a whole Senator, although we have never used that type of financing. We have always internally generated our own cash for exploration and have not borrowed on the outside, which has increased the impact of the loss of the depletion allowance and the energy bill on us.

Senator FANNIN. Does your Council have a position on LAL, a provision in the House bill applicable to oil and gas development? This is beyond the development of wells.

Mr. RODGERS. Yes, Senator, we do. The Domestic Petroleum Council is opposed to the LAL provisions of the House bill. By removing the incentives for investment in drilling, the Congress would be forcing all of the industry to rely even more intensely on internal capital and

would be discouraging, instead of encouraging, this country's efforts to expand its domestic oil and gas production.

Senator FANNIN. Eighty-five percent of the exploration drilling in this country was done by independents. Has that changed? Two years ago we were very concerned about that, that it changed, and this Congress passed a bill.

Mr. RODGERS. The independents still do the greatest share of the exploration, but there are drilling rigs available and drilling crews available, and I would have to assume that there is less of a demand for them.

Senator FANNIN. I think that both the public and the Congress do not understand the risks involved in your industry and do not differentiate between the oil industry, especially on exploration, and also in development and how these kinds of factors affect the investors as compared to the investors of real estate, film makers, farming, and the sportsmen's businesses.

I think if we could differentiate the risks involved in the different businesses involved it would be a good thing.

Mr. RODGERS. There are high risks involved in the oil and gas industry, with a great chance of failure. I suppose there are risks in these other industries, but the success ratio is much smaller for us than those other categories which you mention. But by the same token, we are seeking something regarded as generally greater in value to America, that is, energy to run our Nation. So the risks we have to take are going to be greater.

In our business, enormous sums of capital are required, and the requirements are getting larger all the time. We go offshore, and Santa Fe participates in 25 offshore projects, where it is not uncommon to pay $30,000 a day for a drilling barge and production platform. It may cost you $10 to $20 million to be successful in finding something. So capital requirements have grown dramatically over the years but the success ratio of finding new oil has not changed much.

Senator FANNIN. The amount in the continent where we have been drilling for years and, of course, the areas that were considered to be very productive and would be productive, have been drilled. You now have to go out into new areas and you drill a new number of wells.

Do you know the number of wells that are productive as well as those that are dry wells?

Mr. RODGERS. The onshore success ratio historically has been about 11 percent and offshore, we are experiencing somewhere around a 33-percent success ratio. These figures should not be emphasized too strongly, however, because you are better to have a 1-percent success ratio, if you have an enormous find. You are quite correct that the activities offshore are getting more expensive. We are going into deeper waters and we are going back over areas that have been drilled again and again. The big strikes have already been attained. Although new frontiers in Alaska may somewhat change this, it will be some of the most expensive drilling ever done.

Senator PACKWOOD. May I ask one more question?

Senator BENTSEN. Yes.

Senator PACKWOOD. If we give you the intangible tax credit, that will be an alternative to your present method, or are you talking about having both?

Mr. RODGERS. You mean on the intangibles?

Senator PACKWOOD. In the intangibles.

Mr. RODGERS. Senator, we are requesting this 12-percent investment credit in addition to the current method of treating intangibles. We are suggesting that if the Congress extends this credit to the industry, it will be similar to the credit for investment in equipment, which does not reduce the depreciable basis of that equipment. The deduction for intangibles would similarly not be reduced. What we are saying is that in order to increase exploration in this country, more capital is required. It won't do any good to set up the investment credit as an alternative and knock out the money somewhere else.

Senator PACKWOOD. To keep most of the capital and the cash flow to get both the credit and to continue to extend them over the life of the well. I am not sure if that is what you are asking or not, or rather saying that you would like to have an election between the two and give you the one that gives you the most cash flow.

Mr. RODGERS. We are proposing that both be available, not one or the other.

Senator PACKWOOD. Yes.

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

[The factsheet referred to in Mr. Rodgers' statement follows:]

FACTSHEET

The Domestic Petroleum Council is a group of small to medium-sized companies primarily concerned with domestic production of oil and gas. Some members are strictly producing, some are totally integrated, and some are affiliated with companies outside the industry. Their domestic production ranges from approximately 3,000 to 200,000 barrels of oil per day and up to 400 bcf/yr of gas.

The Council's member companies operate in 47 states and offshore. Despite its dissimilarities, the Council agrees on certain broad solutions to the current energy and tax problems.

There has not been an overall understanding in Congress of the problems which besiege small to medium-sized oil and gas companies, and the Council was formed to help promote the business conditions of these companies. Many chief executive officers have noted an absence of effective representation for their segment of the industry. The Council fills that void.

The Council provides its members with current information on Federal legislation and regulations on major issues affecting the domestic oil and gas industry. However, it does not duplicate the work of the existing industry associations. It serves as a medium between the chief executive officers of the member companies and the Legislative and Executive Branches of Government. Personal contact by the chief executive officers has proven to be most effective in the Council's efforts to foster more universal understanding of the plights of these companies.

An Operating Committee—consisting of representatives of member companies in Washington, D.C.—meets regularly to discuss legislative developments and make operating decisions. The Operating Committee provides the directives for the Council's Washington Office functions.

Information which is compiled is analyzed by the Council. Position papers and legislative proposals are drafted and disseminated to government officials and members of Congress on behalf of the Council. Testimony concerning legislation affecting the Council is presented to Congressional Committees. Recent experience has demonstrated that many members of Congress are willing to listen to what the middle-sized companies have to say. The Council is presently concentrating on regaining capital formation incentives which were lost by repeal of the percentage depletion allowance, and statements to that effect are being prepared.

The Domestic Petroleum Council engages in no fund raising, and undertakes no business activities. Expenses are met by assessments of member companies (based on production).

DOMESTIC PETROLEUM COUNCIL

MEMBER COMPANIES

Adobe Oil Co., Midland, Tex.
American Quasar Petroleum Co., Fort Worth, Tex.
Argo Petroleum Corp., Los Angeles, Calif.
Burmah Oil & Gas Co., Houston, Tex.
Champlin Petroleum Co., Fort Worth, Tex.
Clinton Oil Co., Wichita, Kans.
Coastal States Gas Corp., Houston, Tex.
Equity Oil Co., Salt Lake City, Utah
Felmont Oil Co., New York, N.Y.
General Crude Oil Co., Houston, Tex.
Husky Oil, Washington, D.C.
Louisiana Land & Exploration Co., New Orleans, La.
Mountain Fuel Supply Co., Salt Lake City, Utah
Quaker State Oil Refining Corp., Oil City, Pa.
Santa Fe Natural Resources, Inc., Chicago, Ill.
Southland Royalty Co., Fort Worth, Tex.
Tenneco Oil Co., Houston, Tex.
Terra Resources, Inc., Tulsa, Okla.

Senator BENTSEN. Our next witness is Mr. John Chapoton, Domestic Wildcatters Association, accompanied by Allan King and Robert Beren.

STATEMENT OF JOHN E. CHAPOTON, ON BEHALF OF THE DOMESTIC WILDCATTERS ASSOCIATION; ACCOMPANIED BY ALLAN C. KING, INDEPENDENT EXPLORER, HOUSTON, TEX.; AND ROBERT M. BEREN, INDEPENDENT PRODUCER, WICHITA, KANS., AND COCHAIRMAN, SMALL PRODUCERS FOR ENERGY INDEPENDENCE

Mr. CHAPOTON. My name is John E. Chapoton. I am an attorney in Houston, Tex. I am appearing on behalf of the Domestic Wildcatters Association, an association composed of more than 30 independent explorers and producers of oil and natural gas in Texas and Louisiana.

I am accompanied by Mr. Allan C. King, an independent explorer and producer of oil and gas with offices in Houston, and whose exploration and production activities extend throughout south Texas and southern Louisiana. Mr. King is president of the Domestic Wildcatters Association.

Appearing with us today is Mr. Robert M. Beren, an independent producer with offices in Wichita, Kans. Mr. Beren is active in exploration and production of oil and gas throughout the midcontinent of the United States. Mr. Beren is cochairman of the Small Producers for Energy Independence.

We are here today to testify with respect to the provisions of the Tax Reform Act now being considered by this committee which would affect producers of oil and natural gas.

I want to emphasize that we are here today to discuss only the impact of the legislation on what we know, that is, the segment of the industry composed of the independent producers.

Our point here today is to describe for you the fact of the proposed legislation on the independent producers such as Mr. Beren and Mr. King. It must be considered in connection with the recent 1975 tax change as affecting the oil and gas ceiling imposed regulated by the Federal Government.

Article V of the Tax Reduction Act of 1975 repealed the 22-percent depletion allowance with respect to income from oil and natural gas production. The legislation contained a partial exemption from the repeal for independent producers and royalty owners. Independent producers and royalty owners will be allowed to claim a percentage of depletion deduction on a limited quantity of domestic oil or domestic natural gas at a reduced rate.

The quantity of production qualifying for percentage depletion under this exemption begins at 2,000 barrels of oil, or 12 million cubic feet of natural gas per day—based on the taxpayer's average daily production for the year—and phases down at the rate of 200 barrels per day per year until a permanent level of 1,000 barrels of domestic crude oil, or 6 million cubic feet of domestic natural gas per day, is reached in the year 1980.

Beginning in 1981, the rate of depletion on this quantity of production begins to phase down from 22 percent to a permanent depletion rate of 15 percent in 1984 and subsequent years.

Thus, the exemption will eventually allow 15 percent depletion on up to 1,000 barrels average daily production of oil, or 6 million cubic feet average daily production of natural gas—or any combination of oil and natural gas, if elected by the taxpayer.

These changes in the tax laws took place at a time when the country was facing an energy crisis and the President had declared a national goal of energy independence through encouragement of exploration for and development of domestic energy resources. Moreover, these changes were adopted even though the price of most crude oil and domestic natural gas was subject to Federal price controls, preventing the replacement of the capital lost because of higher Federal income tax liabilities through an increase in the sales price of the product.

Perhaps most startling in light of our domestic energy situation is the fact that oil and natural gas were singled out—virtually all domestic minerals are granted a percentage depletion allowance for Federal income tax purposes—20 of which have a 22-percent rate—none of these representing an energy source for the Nation, but no change in the treatment of percentage depletion for minerals other than oil or gas was proposed by the tax-writing committees or adopted by the Congress in 1975.

By the same token, none of the tax reform provisions passed by the House as part of the Tax Reform Act of 1975, including the changes in the minimum tax provisions which would greatly increase its impact on oil and gas producers, would affect these other minerals.

In addition to the direct reduction of the tax incentive provided independent oil and gas producers through the pecentage depletion

allowance, the legislation passed last year imposed a new 65 percent of taxable income limitation on the total percentage depletion allowance which will be allowed any taxpayer with respect to oil or natural gas under the independent producers and royalty owners exemption.

At first glance, this does not seem to be an unreasonable limitation. On analysis, however, it is clear that the 65 percent limit will curtail exploration and development activities of many independent producers. An active "wildcatter" budgets his exploration program to utilize virtually all of his available cash flow in the search for additional reserves of oil or gas.

If his exploration ventures are unsuccessful, his overall taxable income will be reduced, thus lowering the 65 percent ceiling on the percentage depletion allowance. The result will be that such a wildcatter would find that his wildcat program not only was unsuccessful in terms of locating new reserves of oil or natural gas, but also had the impact of reducing his percentage depletion allowance on production found in previous years.

As I said earlier, you are going to have a lot of statistical information, and I think it would be interesting for you to understand the impact of these changes and the changes on the typical budget, and we have the actual figures here. Mr. King has his 1975 budget, which I would like him to review and discuss generally, and the other impacts of these provisions on him.

Mr. KING. Thank you very much.

I wish to supplement Mr. Chapoton's statement by describing to you what I believe to be a fairly typical independent oil and gas exploration and production business in Texas and Louisiana, and by showing you the impact the recent and proposed tax changes Mr. Chapoton described would have on my 1975 oil and gas exploration and development budget.

I am 43 years old. There are only six men younger than I am in my business. That is a sad commentary on our business.

I would say that my partner, Mr. J. N. Warren, and I tried to determine how we would stay in if we were successful. We determined that the demise of so many independent oil men over the past 20 years had been probably the lack of financial prudence, not looking at what their cash flow needs were and getting overenthusiastic about their prospects for finding new oil and gas.

So we set up in our company a very strong financial department. We first started our budget by looking at the bottom line cash flow requirement, and then we worked back up from that to find what we can and should spend.

Mr. CHAPOTON. I know that the bell has rung. Can we take a couple more minutes?

The CHAIRMAN. Go ahead. I would like to hear what you want to say.

Mr. KING. Thank you, sir.

We decided the best thing to do is take the numbers actually off our books, and the numbers that we have are shown on the last page of

our testimony. If I could very briefly go over that, we would like to show you the impact.

[The figures referred to follow:]

1975-EXPLORATION BUDGET

	Original budget	Adjusted for— 65-percent limit on depletion	Deferral of IDC on 50 percent of development wells	14-percent minimum tax without offset	Cessation of exploratory drilling
	(1)	(2)	(3)	(4)	(5)
Income:					
Oil and gas receipts (net of production taxes)	2,749.9	(1)	(1)	(1)	(1)
Other income	200.0	(1)	(1)	(1)	(1)
Total	2,949.9	(1)	(1)	(1)	(1)
Costs:					
Operating	347.7	(1)	(1)	(1)	(1)
Development wells:					
Intangible costs	444.6	(1)	(1)	(1)	(1)
Tangible costs	303.2	(1)	(1)	(1)	(1)
Wildcat wells:					
Intangible costs	1,278.1	1,159.1	1,053.6	871.4	0
Tangible costs	319.5	289.9	263.3	217.8	0
Total costs	2,693.1	2,545.0	2,414.4	2,184.7	1,095.5
Federal taxes:					
Income tax	111.0	193.9	423.7	551.3	1,005
Minimum tax:					
Present law, 10 percent	45.1	36.8	13.8	0	0
Proposed 14 percent				113.9	0
Total Federal taxes	156.1	230.7	437.5	665.2	1,005
Net cash flow	100.7	174.2	98.0	100.0	849.4

[1] Same.

Mr. KING. This budget was made up in early 1975 based upon our projected income expenses, what we now have, and then at the bottom line it would come up to $100,000 cash flow. We then, as the new bill came in last year, you can see from this, what we call wildcat wells intangible costs. We then budgeted back in what we could spend, $1,-278,000 for our IDC, and the tangible cost is shown right below that. That is the amount of money we would anticipate the needs in the case would be as a result of the successful wells in the wildcat program.

Senator PACKWOOD. IDC—intangible drilling cost and dry hole?

The CHAIRMAN. If I might, let me go through this chart at the end of your statement with you. You based this on your original budget, and you started out with $2,949,900, shown on the chart as total income?

Mr. KING. Right.

The CHAIRMAN. Your total costs were $2,693,100, and then you have a Federal income tax of $110,000?

Mr. KING. $111,000.

The CHAIRMAN. I see, $111,000 in Federal income tax, plus a 10-percent minimum tax, $45,100, for a total Federal tax of $156,100, leaving a cash flow of $100,700?

Mr. KING. Yes, sir.

You see, Senator, we started really with the income figure and then went down to what our cash flow requirement, direct debt service amortization.

The CHAIRMAN. If I am with you, you started out with almost $3 million of income, and down at the bottom you wind up with about $100,000?

Mr. KING. Yes, sir.

The CHAIRMAN. So you wind up with $1 for every $30 that you start out with.

Mr. KING. Yes, sir.

Now, going back real quickly, we have our operating costs that are ongoing costs of the pumpers and the employees, and so forth. We then have certain developmental wells to be drilled as a result of earlier discoveries. We then adjust our budget in the wildcat drilling segment in order to come up with a cash flow requirement down at the bottom.

The CHAIRMAN. When you adjust for the 65-percent limit on depletion, it looks like you come up with a cash flow of $174,200.

Mr. KING. In order not to invade into the 65-percent limitation, we reduced our drilling by about 10 percent in 1975. We readjusted our budget, of course, and that meant that we had more cash—not more cash flow—and more taxes.

The CHAIRMAN. So you did less drilling, paid more taxes and wound up with a larger cash flow for the reason that you did less drilling.

Mr. KING. Yes, sir; that is exactly right.

The CHAIRMAN. Go ahead.

Mr. KING. Go to columns 3 and 4. With the proposed House rule, once again we were at the same 1975 income. We have $98,000 instead of $100,000 cash flow at the bottom. We would develop our dollars spent, our machinery on developmental wells initially because those are far less risky, although you can find that there will be dry holes there.

Then, we have to adjust somewhere on the column and come up with the cash required to come up to the end with $198,000, at the bottom, so we would alter our wildcat drilling program here down $1,053,000. That is another 17-percent drop in wildcat exploration. You understand that in our wildcat exploration we are producing, over here at the top of the page, if the minimum tax rule as proposed—once again, we had to come up with $100,000 at the bottom, because we were already having those established costs that we have to meet—I mean, there are firm obligations.

So you are to take away somewhere else. We made a business decision to take away from the wildcat drilling and we would therefore reduce our wildcat budget once again to this $800,000 figure, which is from column 1 to 4 with about 33 percent drop in exploration.

Column 5, very quickly, we say what our alternatives are that we have in our business. One of the things we could do is sell the groceries off our shelves, which would reduce our reserve, and go out of business because we would not replace them.

In other words, you end up with a whole lot of cash flow down at the bottom and you end up going out of business. You have lost a wildcatter, and I do not know if that is good or worse.

The CHAIRMAN. I do not know whether it is better or worse. What you are saying happens is just what I did a long time ago. We are just not drilling any more; we quit a long time ago. We did not do it quite the same way that you did. I persuaded my family to take a look at how we had been making out by drilling these little wells around north Louisiana, just going back for the previous 5 years to see how we made

out. As you say, when you bring in a new well, everybody gets all excited and calls it black gold. They want to dip their face in it. But after the initial production tapers off, you have to rework the well. When you get through with all of that, you find after 3 years that you lose money on the well.

So I said that we should look at how we were doing for the previous 5 years. We had just lost money hand over fist, notwithstanding the good it did our mood every time we saw one of these little pumpers come in. The result of our close look was that we just wanted to get out before we lost any more money.

What you are showing here is what the sum total effect of this proposal is. I can only conclude that the people who are trying to push this kind of tax proposal must know that this is the kind of thing that would result from their proposal, and I cannot believe that they are pushing this for the purpose of raising government revenue. It seems to me that it is just like the situation when you sue a person who is doing something—he is presumed to know and be cognizant of his act. You have the right to assume that if people are proposing this kind of effect, their purpose must be to nationalize the industry. Perhaps their purpose is to set the stage for eternal world peace or something like that. But I cannot for the life of me believe that the proponents of this had revenue purposes in mind.

What you are talking about in this chart is all in the bill the House passed, is it not?

Mr. KING. The House proposed bill would result in columns 3 and 4 being added, our financial people would add this into the estimate of our budget.

The CHAIRMAN. What you show in column 5 is not in the House bill. That is in Senator Kennedy's amendment, I think.

Mr. KING. Five is not meant as a threat, just a viable alternative, something you have to figure out, what you ought to do.

Mr. CHAPOTON. If we could beg the committee's indulgence for Mr. Beren to make a brief statement.

The CHAIRMAN. If the committee will permit, I would like to have him go ahead with his statement.

Mr. BEREN. I am Robert M. Beren from Wichita, Kans. I am also cochairman of the Small Producers for Energy Independence, which is a group of more than 60 independent producers and operators in the States of Kansas, Oklahoma, Colorado, Texas, and California.

Under the 1975 act, the Congress effectively imposed a minimum tax exclusively on independent oil and gas producers by limiting the availability of percentage depletion to 65 percent of taxable income. The computation of percentage depletion had already been limited prior to the 1975 act to 50 percent of taxable income from each given property. Notwithstanding the existence of these disincentives, the House bill which you are now considering would place an added tax burden upon the independent producer which would severely restrict his ability to generate the large sums of capital necessary for significant exploration and drilling activity. Let me demonstrate how this works.

Let us take a man who, after accounting for all tax deductible charges such as severence taxes, operating costs, and that part of drilling expenditures which do not have to be capitalized, has a $1 million subject to tax before depletion. Assume the producer has enough oil

and gas income on a property-by-property basis to provide $650,000 or more of percentage depletion. He would be allowed a maximum of 65 percent or $650,000 percentage depletion which would then cause taxable income of $350,000. Normal income tax rates are then applied on $350,000 because that is the way the rule works.

To the normal income taxes on the $350,000, add the minimum preference tax on the $650,000 of percentage depletion, and then those two tax numbers will total 70 percent of taxable income. This does not include State income taxes. Then if you apply only two of the added taxes under the suggested H.R. 10612, the first to increase minimum preference tax from 10 to 14 percent and the second not to allow in the computation of minimum tax the deduction of the normal tax, you will find the total Federal tax will be at 80 percent of taxable income. As another example, a producer with properties generating $850,000 depletion would pay 90 percent Federal income tax and about 96 percent including State income tax. The individual oil producer could have most of his total taxable income eroded by the tax laws of this country.

The CHAIRMAN. There are those who do not agree with you and who take the view that any depletion other than cost depletion is an error. I don't agree with that, but if you stayed in business, you would have to exist on such portion of the depletion allowance that was permitted to remain.

Incidentally, there ought to be another amendment offered to take care of that.

Let me ask you this: Can you put that on a chart like the one shown to us by Mr. King?

Mr. BEREN. I would be happy to.

The CHAIRMAN. I would like Mr. King's chart to appear in the record in connection with his testimony.[1]

If you can put this on a chart and show what is being advocated, especially if that is economic income rather than taxable income, but this is something that results in taxing away from you 100 percent of your income for producing oil and gas. One can only assume that those who advocate this, just do not want you people to produce oil and gas. I guess that is what one could ordinarily conclude when Congress puts 100 percent tax on somebody for doing something.

[The material referred to follows:]

ARTHUR YOUNG & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
Wichita, Kans., April 5, 1976.

SMALL PRODUCERS FOR ENERGY INDEPENDENCE,
970 Fourth Financial Center,
Wichita, Kans.

GENTLEMEN: You have requested that we illustrate and comment upon the impact to an independent oil operator of the limitation of percentage depletion to 65 percent of taxable income before depletion contained as one of the provisions of the 1975 Tax Reduction Act, and upon that part of proposed tax legislation in H.R. 10612 which affects the minimum tax on percentage depletion in excess of basis. Based on our general understanding of the operations of a typical independent producer we have prepared the enclosed analysis. Discussion and explanation of the analysis follows:

Column (1) illustrates the results for 1974 of an active independent oil and gas operator who followed the practice of maximizing his drilling to the point

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[1] See p. 772.

of reducing his taxable income to a negligible amount. He therefore paid only a minimum tax on the preference items of percentage depletion and capital gains. (This is not to imply that all independent producers historically followed the practice of reducing taxable income to a minimal amount.)

Column (2) illustrates in 1975, the effect on the same taxpayer of the provision in the Tax Reduction Act of 1975 which limits percentage depletion to 65 percent of taxable income before percentage depletion. This taxpayer is not yet affected by another provision of the Act which progressively will reduce allowable depletion to a maximum 1,000 barrels a day at 15 percent by 1985. So that the independent producer can retain his full depletion as a source of capital funds he must reduce drilling by $457,692. (Consideration of the consequences to the economy and to energy independence of this reduced drilling multiplied by all the independents is beyond the scope of our work.)

The 65 percent limitation on percentage depletion effectively has forced a tax of $291,364 on taxable income of $457,692. When the 10 percent minimum tax is added, the effective rate on taxable income becomes 75.6 percent. The 65 percent-of-taxable-income limitation on percentage depletion alone has created a current tax burden to the oil operator that would seem to eliminate the necessity for an added minimum tax.

Column (3) illustrates for 1976 the consequences of the H.R. 10612 increase in the minimum tax rate, the disallowance of the deduction for federal income tax and the change in the minimum tax exemption in computing the minimum tax as it applies to percentage depletion. The immediate consequence to the independent producer is to increase the tax rate on his taxable income to 90.3 percent at the federal level and to a total 95.8 percent when state income taxes are considered. At your request, other legislation, particularly changes in the treatment of intangible drilling costs and the minimum tax applicable thereto, has not been considered in this analysis.

Very truly yours,

R. R. CRAWFORD, *Partner*.

Enclosure.

	1974	1975	Rate (percent)	1976	Rate (percent)
Oil and gas sales less severance and ad valorem taxes, operating costs, depreciation, intangible drilling costs, delay rentals, overhead, etc.[1]	$1,500,000	$1,500,000		$1,500,000	
Depletion (22 percent of gross income limited to 50 percent of net—effective rate 18 percent	(850,000)	(850,000)		(850,000)	
Adjusted gross income before additional drilling	650,000	650,000		650,000	
Additional drilling to reduce taxable income to zero	(617,000)				
Maximum additional drilling possible to maintain full depletion allowed by the Tax Reduction Act of 1975		(159,308)		(159,308)	
Adjusted gross income	33,000	490,692		490,692	
Itemized deductions	(30,000)	(30,000)		(30,000)	
Personal exemptions	(3,000)	(3,000)		(3,000)	
Taxable income	0	457,692		457,692	
Federal income tax (from tax rate schedules)	0	291,364		291,364	
Minimum tax (see computation below)	84,000	54,864		121,800	
Total Fedetal tax	84,000	346,228	75.6	413,164	90.3
State income tax (assumed 5.5 percent effective rate)	0	25,173		25,173	
Total income taxes	84,000	371,401	81.1	438,337	95.8
Minimum tax on preference items:					
Depletion	850,000	850,000		850,000	
Capital gain on oil equipment	20,000	20,000		20,000	
Tax preference exemption	(30,000)	(30,000)			
Federal income tax deduction	0	(291,364)			
Total	840,000	548,636		870,000	
Rate—Times 10 percent	84,000	54,864		121,800	

[1] In arriving at this amount the mix of operating costs and intangible drilling costs will vary depending upon the percentage of stripper wells that a producer operates. With an assumed 7 percent effective rate for severance and ad valorem taxes, $330,000 in this example is included as an expense of production.

See accompanying discussion.

Mr. BEREN. If I could make just this added explanation. Capital funds—as distinguished from funds which are deductible for tax purposes—are needed for: (1) The purchase of equipment to put oil and gas wells on production; (2) to purchase undeveloped acreage and to pay geophysical costs to see if there is something worth drilling; (3) to repay loans contracted in earlier years because prior income was insufficient to provide capital funds; and (4) for payment of Federal, State, and local taxes at tax rates that I mentioned earlier.

Where does the money come from to provide these capital funds? The sources are extremely limited. The principal source is noncash deductions, the most important being percentage depletion; and that will be disappearing year by year under the terms of the 1975 tax law. Additional sources are: (2) that portion of depreciation which is not needed to replace and repair equipment in use; (3) bank borrowing to the extent you can go back for more money; and (4) after-tax earnings, which as I have already indicated is a disappearing phenomenon for the individual independent oil and gas producer by virtue of combined tax rates; and (5) from the sale of properties, which as Mr. King has already suggested, is critical. It may be the only way to get enough capital to stay in the business—find some oil, then try to sell the property. But we have two problems. Values of property have been diminished by the 1975 Act preventing the passing on of percentage depletion to a purchased, and the value would deteriorate further under the new House bill which has a provision to recapture intangibles in the event of a sale.

Based on a study performed at S.P.E.I.'s request by one of the major national accounting firms, drilling and exploration by independents will necessarily be cut by as much as 25 to 30 percent if H.R. 10612 is enacted. This would be a terrible blow to our Nation's efforts to achieve energy self-sufficiency.

I urge you to eliminate disincentives such as the minimum tax on percentage depletion since the 65 percent limitation serves effectively to cause a minimum tax. Exploration by independents will grow if Congress will replace disincentives with capital-generating incentives to promote maximum discovery of new reserves.

The CHAIRMAN. Senator Bentsen?

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

I am pleased to have this very distinguished friend who is a very distinguished citizen of Houston.

Mr. King, despite his tender years, and Mr. Beren comes from a very fine family of entrepreneurs in Kansas. One of the things which concerns me very much is in the operation of our people's money ventures there is a provision which would limit the intended deduction attributable to a property to an amount which taxpayers have as a risk on the property.

Now, what effect would that have on the independents?

Mr. CHAPOTON. Senator, it is well to say that it will have a definite impact. Some, it will not bother at all because they do not use recourse debt or financing property. But many independents and many people in the oil business, after the field has been established sufficiently, where it will support nonrecourse debt, they do borrow more money on a nonrecourse basis, giving in effect a production payment for the repayment of a loan.

No individual is personally liable on that debt and it is a common method of financing. That would be income produced to pay back a loan, so it would have the same effect on that type of operation as the LAL proposal, because it would hit it twice. I think that most tax practitioners agree that to apply that type of rule to the oil and gas makes no sense whatsoever.

Senator BENTSEN. Mr. King, there is also a provision in here on the House bill, a recapture bill, and that is the question of the transfer of property, that to expend the excess of the intangible drilling cost, taking off the deductions that would have been allowed had those expenses been capitalized, that has come back as ordinary income.

Now, as I understand the interest procedure, time and time again when you were giving up your excess cash flow, the thing that happens with the independent, he is the fellow who goes out and does the wildcatting, the digging, exploring the wells, and one way is to sell off that production to other companies who do not like to take those kinds of risks.

Now, isn't that going to give the independent some real problems in selling off property to do more exploratory drilling?

Mr. KING. I think, Senator, the net effect is the value of your property, which maybe we should have done what Senator Long had done earlier. I mean, our value of our property is definitely down, because after the tax dollar that comes into the pocket, after we sell it, I frankly had hoped that our company would be one that could retain their oil and gas production and not be a finder and seller.

Senator BENTSEN. A lot of them have to be, and that is their objective, to expand and do more exploratory work.

Mr. KING. That is the way you reduce your loans.

Senator BENTSEN. That would be an incentive for them to keep their property rather than sell it.

Mr. KING. Definitely.

Senator BENTSEN. Now, the other point that was made, and the chairman here talks about going into other businesses, one thing that is not understood enough by these people who are proposing this legislation, you cannot force people to stay in oil and gas, and particularly at the exploratory end of it, if they cannot get a reasonable return for their investment, as related to the risk taken.

They are going to pull up their chips and go into another line of business. That is what happens and we are going to see a lot of that if we continue in this vein.

One of the problems that I see is the definition of exploratory wells as apart from development wells. For it to be an exploratory well, there has to be a difference in the bottom pressure—this seems to give you another serious problem.

Mr. KING. Yes, sir. I was just about thinking of switching into some other business. To be a wildcatter, you have to have somewhat the heart of a river gambler, somebody must be born with it. It is a very high-risk business. Not only is it a catastrophical environmental risk, you do have these choices to make, and they will mean whether you will eventually stay in or go out of business.

Now, as far as the definition of an exploratory well, we have, quite frankly, worked very hard to try to come up with a presentation to

Congress of an exploratory well. From what came out of the House, we do not know whether we have an exploratory well or a development well until after you get down and test the pressure.

Senator BENTSEN. It makes it a little rough financing, doesn't it?

Mr. KING. It wrecks my bottom line down here real bad because it turns out to be a year or two later that somebody says that it is really a development well and it was not really an exploratory well.

Senator BENTSEN. My time has run out, but I would like to submit a lot of questions to the gentlemen in writing for the record. I think that the witnesses are very knowledgeable in the field.

The CHAIRMAN. You can provide for information to be added to the record at the end of the hearings.

Senator Packwood?

Senator PACKWOOD. In your statement, Mr. Chapoton, you made reference to the fact that it is difficult to borrow money, and this cannot be analyzed building to building because there is no real capital asset left over at the end of the period.

Do I understand that you are saying almost any loans which you can get at all in this business are not based on your past record, or on the likelihood of what you are going to hit in oil or gas?

Mr. CHAPOTON. No established company has an oil business like any other business—my point is drawing the distinction between a normal capital investment such as a capital investment in other buildings or physical assets, as opposed to the investment of the intangible drilling cost or drilling wells, part of which will be the intangible drilling cost.

In the building case, you have the capital asset. You can borrow money on the projected value of that asset. Most companies operate to the full hilt of the cash flow borrowing to the extent they can on credit and the new assets to the extent that they think prudent in their business. The oil business is denied the right to borrow on projected wells to be drilled, even a development well, because it simply is not predictable what their value will be even after the well is drilled and the reserve established.

Normally, there is a substantial period of time before the value is known.

Senator PACKWOOD. Your borrowing is similar to the contractor with the construction loan?

Mr. CHAPOTON. No; I think—in that case, a building is something that he takes his plans and knows where it is going to be built. They project the value before he goes into it.

Senator PACKWOOD. He is not doing it for him. He is going to hope that the people he is building it for are going to pay him.

Mr. CHAPOTON. That is correct, but the contractor who will build a building through construction financing, the bank will contract a loan on the basis of the projected value of that building, which is taken off his hands when he sells that building.

Senator PACKWOOD. He does not own the building; he is building it for somebody else. The contractor's cost is the labor cost. He does not have any assets at all. What he is borrowing on is to pay his laborers and he hopes that the person he is building the building for will pay him.

Mr. CHAPOTON. He takes that contract to the bank and that is what supports the construction loan. The bank hopes very much that the person will pay it off.

Senator PACKWOOD. Mr. Beren said that under the House bill that we have to recover intangibles in case of a sale.

Mr. CHAPOTON. It is simply the recapture of intangible expenses to the extent that they would not have been recovered through normal depletion to the extent they were deducted when the well was drilled.

When you sell property to that extent, income is treated as ordinary income rather than capital gains on selling the property. It creates recapture. It is ordinary income of what would otherwise be capital gains.

Senator PACKWOOD. I do not understand your answer.

The CHAIRMAN. I think it would be the intangible expenses which you are talking about.

Mr. CHAPOTON. We did go through what the intangibles were, such as wages, which are deducted in drilling the well and would not enter into the base of the assets because they would not be deducted immediately.

Senator PACKWOOD. This is if you can deduct immediately.

Mr. CHAPOTON. Wait. So, let us say $100,000 to drill and $60,000 of that is intangible. It is deducted; $40,000 is not; it is capitalized, and the well cost $100,000. Let us say that the property is successful and has a value of $200,000 after the drilling is completed. You will immediately sell it for $200,000. Your gain would be $160,000. So you have $100,000 again and plus the $60,000 in the intangibles, and the present law, the $160,000 would be the capital gains.

Under the House bill, $100,000 would be the capital gains, and the 60 would be picked up as ordinary income.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Might I say to you gentlemen that in wrestling with these tax problems, this committee is not the final authority, and a great deal of the tax legislation has been written on the Senate floor in the last few years, and the current discussion about the tax reform, where the distinguished Senator from Massachusetts, Mr. Kennedy, appears to be the leader in advocating for the so-called tax reforms. He appeared before this committee earlier in our hearings. As I understand it, he endorses LAL and a modification and the minimum tax and other provisions in the House bill which would affect oil.

Then he has this to say in his presentation:

> Tax shelters have become a new American way of life for wealthy individuals in this country in the tax bracket of 50 percent or higher. There is hardly an area of economic life that the tax shelter has not infected in recent years. They are using it from farms, from cattle to azalea bushes. They are using it in drilling for oil and gas.

Then he goes on to say this:

> With the price of oil continuing at astronomical levels, the time has come to end the major Federal tax subsidies for oil and gas. The Congress should take the following steps and require the capitalization of intangible drilling and the development cost required, recapture of the tax benefits in cases where property subject to intangible deductions is subsequently sold at a gain. Phase out the 2,000-bbls.-per-day exemption from the repeal of the depletion allowance and reduce the tax credit for foreign oil income.

Do any of you have any comments on this proposal, which I am sure we will be confronted with on the floor of the Senate.

Mr. BEREN. If those things which the Senator from Massachusetts advocates were to become a realism, then the realism would be that the drilling rate in this country, any chance of maintaining or improving our energy self-independence, would be utterly destroyed and that Mr. King and I would have to perhaps use the No. 5 alternative, because you simply could not stay in business under those kinds of concepts, because you could not generate the capital.

You could not generate the capital to run your business. It would just be impossible.

Senator CURTIS. I regret to say that I do not agree with it. I have not voted for any of the tax bills in a long, long time, but I regret to say that the philosophy has become a policy of the U.S. Congress. In the last two congressional sessions, at a very time when we were facing an energy crisis in the country, the Congress took steps to further discourage the development of oil in this country. It is the exact opposite direction that we should go in.

Of course, to say that they are doing this in the interest of the consumer is certainly in error.

Mr. CHAPOTON. Senator, there certainly has been a significant increase in the price of oil over the last several years. There wasn't really an increase in the price of oil and gas for 30 years. This increase breathed new life in the independent segment of the industry, particularly before the current round of adverse legislation.

The recapture was going up possibly at a significant increase. Reserves were real possibilities. Now, we have legislation——

The CHAIRMAN. Well, so far the Congress has made massive contributions to the energy crisis. It has rolled back the price of domestically produced oil. It has doubled the tax on everybody in the business, and it has passed laws to force automobile companies to build small cars that they cannot sell. The simple reason is that if you are going to force the companies to sell gasoline at 51 cents a gallon, there is no point in anybody foregoing all the comfort of big automobiles, airconditioning, power seats, power brakes, power door locks, and power ashtrays.

You are making them sell the energy for one-third of what people pay for it in other nations, and at a price below that in which producers on an economic basis can afford to invest in it with any hope of a fair profit—that is what has been achieved so far.

I would hope that some of the people here who are concerned about the problem of the oil and the gas industry would try to compute for us how many jobs we have lost by these tax increases on the petroleum industry, what the tax gains from those jobs would have been, and how many additional jobs one could expect they would lose if we go beyond those tax increases.

Now, I am trying to make the Treasury and our own Joint Tax Committee staff compute the ultimate mischief of some of these suggestions. It is not quite proper to say that if you raise the tax on a man up to 100 percent, you thereby gain a large amount of additional income. All you do when you do that is to persuade the man to quit

working, and you lose the tax revenues that you were getting from him while he was working and paying the lesser tax rate.

When you cause that man to quit working, that causes a ripple effect beyond that. There is someone who is working for him, and the second fellow loses his job because the first man quit being productive. Now neither of them are trading down at the grocery store. Perhaps they are going into the backyard to provide their vegetables. So the grocery man can no longer afford to have help to stack the shelves. When you compute it all the way down, I believe we will find that these new taxes have been counterproductive. I am confident that any fair calculation of the additional $1.7 billion of new taxes for the oil and gas industry would be likewise counterproductive.

Mr. Chapoton started out by saying that where his company had hoped to succeed where others had failed, they would look on down the road far enough to see what would happen after that great burst of sunshine that occurs when one discovers the "black gold"—only to find out, by the time they got through with all the cost incidentals and the taxes, they wouldn't wind up with enough to justify the investment to begin with.

Now, those are things that we need to understand and that the Senate ought to try to understand before we conclude action on a bill of this sort. Either your group or some of these other organizations perhaps can help us learn what is the real ultimate result of these tax proposals, rather than what happens when you assume that you can go ahead and impose these taxes and just raise more money.

Thank you very much.

I would suggest that we recess now and come back in here at 2:30.

[Material supplied in response to the Chairman's preceding statement and the prepared statements of Messrs. Chapoton, King, and Beren follow. Oral testimony continues on p. 794.]

ALLAN C. KING,
Houston, Tex., April 23, 1976.

Hon. RUSSELL LONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: On March 25, 1976, I testified before your Senate Committee on Finance regarding HR 10612 and its effect on the oil and gas industry. You asked me if I could obtain a comparison of the Treasury Department revenue gained by the bill as opposed to revenue lost due to job losses in the oil and gas industry. This, of course, is a huge undertaking; but we are taking steps toward fulfilling your request.

Attached is a letter from Drilco, an oil and gas service and manufacturing company which has sales of 120 million dollars. As the letter indicates, Drilco anticipates a 30 percent reduction in work force in 1976 because of a downturn in oil and gas exploration. A recent survey showed that the twelve largest companies in the oil and gas service and manufacturing industry had sales of 12 billion dollars; therefore, Drilco represented 1 percent of these sales. Assuming that the twelve largest companies have similar plans to Drilco's, you can see that by expanding the Drilco numbers by 100, the twelve largest companies in this industry would have job losses of 45,000 employees, resulting in a loss to the Treasury of payroll taxes of 94.5 million dollars and corporate taxes of 280 million dollars. Applying the ripple effect of 9 to 1 only on these twelve largest companies, the Treasury Department would have a loss of revenue of 3.4 billion dollars.

We feel that a major factor in this reduction in the sales of Drilco and other manufacturing and service companies is the Tax Reduction Act of 1975, mainly as it applies to depletion and its 65 percent limitation that affects not only dry holes but also exploratory wells. In my particular case, even though I am still allowed statutory depletion as a small producer, the 65 percent limitation

restricted my 1975 drilling by approximately 30 percent, which is now being felt in 1976 by companies such as Drilco. The proposed HR 10,612 would further reduce my drilling by another 25 percent, which would, of course, adversely affect the sales of Drilco and similar companies in 1977. An assumption could, therefore, be made that the House proposal would have approximately the same effect as the 1975 bill as far as job losses and revenues are concerned.

Our understanding of HR 10,612 is that there would be an anticipated revenue gained from this bill as it applies to the oil and gas industry of approximately 250 million dollars. There would, therefore, be a net loss to the Treasury Department of approximately 3.15 billion dollars. Again, we wish to point out that this statistic applies only to the twelve largest companies in this segment of the oil and gas industry. If HR 10,612 would have approximately the same emphasis on the service and manufacturing industry as the 1975 legislation, then, as demonstrated above, the revenue loss to the Treasury Department would approximate 3.4 billion dollars.

We realize that this presentation is a very unsophisticated approach to your question about "net Treasury revenue losses", because we have not taken into account many other considerations, such as the fact that some of the unemployed from this industry might find other employment (although until full employment is attained, I assume that someone else might become unemployed as a result of being bumped by oil and gas industry unemployed). Also, we are not sure if the twelve major companies anticipate the same sales reduction as Drilco. It must be kept in mind, also, that the 12 billion dollar sales figures used in this simplified presentation represent only a very small segment of the oil and gas industry and, of course, do not cover other related industries such as the exploration companies, producing companies, gas transmission and distribution companies, steel suppliers, and many other segments of the oil and gas industry. Also, we have made no attempt to take into account at this time the effects of not finding new oil and gas reserves, such as adverse balance of payments consequences or adverse effects on the petrochemical industry and many other manufacturing businesses.

As we establish additional information concerning your inquiry, we will, of course, pass this on to you and your staff.

Sincerely,

ALLAN C. KING.

Enclosure.

DRILCO, DIVISION OF SMITH INTERNATIONAL, INC.,
Houston, Tex., April 22, 1976.

Mr. ALLAN C. KING,
Goldking Production Co., First City National Bank Building,
Houston, Tex.

DEAR ALLAN: With reference to Senator Russell Long's request to you, we are submitting the following information on the pending impact on our employment level if the present drilling activity remains the same.

At the present time Drilco has approximately 1500 employees (80% in the Houston Area) and if the present trend of oil exploration and drilling activity remains the same we will be looking at a 30% reduction in our work force by the end of the year. The average wage of our employees is $14,000 per year, therefore, a lay-off of 450 employees would result in a payroll reduction of approximately $6,300,000. Assuming that our average employee wth a family of four has a tax rate of 15% (which we have checked with our Accounting Department and find this to be reasonable) this would generate a $945,000 loss in taxes to the United States Treasury. This 30% reduction in business would amount to approximately $36,000,000 so this would generate a loss of $2,800,000 in taxes to the United States Treasury.

Chambers of Commerce in metropolitan areas generally agree that the ripple effect of this loss in jobs has a 9 multiple so you would have a $34,00,000 loss in tax revenue to the United States Treasury.

I feel this is a justifiable number because we have already eliminated steel purchases for the 3rd and 4th quarters of this year due to a decrease in demand because of the "wait and see" attitude of our customers. During the first 4 months of this year we have received cancellations of orders amounting to $6,038,100. We have also reduced our capital equipment expenditures from the planned $10,000,000 to somewhat less than $2,000,000 due to the lack of demand. Unless something changes by the first quarter of 1977 we will be faced with even further reductions.

Hoping that this clarifies our position to you, I remain

Very truly yours,

DONALD S. MORRIS, *President.*

STATEMENT OF JOHN E. CHAPOTON ON BEHALF OF THE DOMESTIC WILDCATTERS ASSOCIATION

Mr. Chairman and members of the committee, my name is John E. Chapoton, I am an attorney in Houston, Texas. I am appearing on behalf of the Domestic Wildcatters Association, an association composed of more than 30 independent explorers and producers of oil and natural gas in Texas and Louisiana. I am accompanied by Mr. Allan C. King, an independent explorer and producer of oil and gas with offices in Houston, and whose exploration and production activities extend throughout South Texas and Southern Louisiana. Mr. King is president of the Domestic Wildcatters Association.

Appearing with us today is Mr. Robert M. Beren, an independent producer with offices in Wichita, Kansas. Mr. Beren is active in exploration and production of oil and gas throughout the midcontinent of the United States. Mr. Beren is co-chairman of the Small Producers for Energy Independence.

We are here today to testify with respect to the provisions of the Tax Reform Act now being considered by this Committee which would affect producers of oil and natural gas. We are particularly concerned about the legislation adopted by the House, coming as its does on the heels of the Tax Reduction Act of 1975 which very drastically reduced the tax incentives for independent producers to engage in the high risk business of exploring for and developing new domestic sources of oil and natural gas.

Our purpose today is to demonstrate to the Committee the full ramifications of the provisions of the House-passed bill which affect independent oil and natural gas producers. However, as background for our testimony, we think it is important that the Committee fully understand and appreciate the impact of the provisions of the Tax Reduction Act of 1975 affecting oil and gas producers, particulraly in light of the Treasury Department's restrictive interpretation of the partial exemption for independent producers contained in that legislation.

It should be emphasized that we are addressing our remarks only to the impact of the pending tax legislation on the segment of the oil and gas industry with which we are familiar: the exploration and development of domestic oil and gas reserves by independent producers. Our information is, for the most part, not statistical. It is, instead a description of the consequences to independent producers, such as Mr. King and Mr Beren, we foresee from changes in the tax laws.

Article V of the Tax Reduction Act of 1975 repealed the 22 percent depletion allowance with respect to income from oil and natural gas production. The legislation contained a partial exemption from the repeal for independent producers and royalty owners. Independent producers and royalty owners will be allowed to claim a percentage depletion deduction on a limited quantity of domestic oil or domestic natural gas at a reduced rate. The quantity of production qualifying for precentage depletion under this exemption begins at 2,000 barrels of oil, or 12 million cubic feet of natural gas, per day (based on the taxpayer's average daily production for the year) and phases down at the rate of 200 barrels per-day per-year until a permanent level of 1,000 barrels of domestic crude oil or 6 million cubic feet of domestic natural gas per day is reached in the year 1980. Beginning in 1981 the rate of depletion on this quantity of production begins to phase down from 22 percent to a permanent depletion rate of 15 percent in 1984 and subsequent years.

Thus the exemption will eventually allow 15 percent percentage depletion on up to 1,000 barrels average daily production of oil or 6 million cubic feet average daily production of natural gas (or any combination of oil and natural gas, if elected by the Taxpayer).

These changes in the tax laws took place at a time when the country was facing an energy crisis and the President had declared a national goal of energy independence through encouragement of exploration for and development of domestic energy resources. Moreover, these changes were adopted even though the price of most crude oil and domestic natural gas was subject to federal price controls, preventing the replacement of the capital lost because of higher federal income tax liabilities through an increase in the sales price of the product.

Perhaps most startling in light of our domestic energy situation is the fact that oil and natural gas were singled out—virtually all domestic minerals are granted a percentage depletion allowance for federal income tax purposes (20

of which have a 22 percent rate), none of these representing an energy source for the Nation, but no change in the treatment of percentage depletion for minerals other than oil or gas was proposed by the tax-writing committees or adopted by the Congress in 1975. By the same token, none of the tax reform provisions passed by the House as part of the Tax Reform Act of 1975, including the changes in the minimum tax provisions which would greatly increase its impact on oil and gas producers, would affect these other minerals.

In addition to the direct reduction of the tax incentive provided independent oil and gas producers through the percentage depletion allowance, the legislation passed last year imposed a new 65 percent of taxable income limitation on the total percentage depletion allowance which will be allowed any taxpayer with respect to oil or natural gas under the independent producers and royalty owners exemption. At first glance this does not seems to be an unreasonable limitation. On analysis, however, it is clear that the 65 percent limit will curtail exploration and development activities of many independent producers. An active "wildcatter" budgets his exploration program to utilize virtually all of his available cash flow in the search for additional reserves of oil or gas. If his exploration ventures are unsuccessful, his overall taxable income will be reduced, thus lowering the 65 percent ceiling on the percentage depletion allowance. The result will be that such a wildcatter would find that his wildcat program not only was unsuccessful in terms of locating new reserves of oil or natural gas, but also had the impact of reducing his percentage depletion allowance on production found in previous years.

To allow dry holes to have this impact on the depletion allowance makes no sense, we submit. This result should be corrected by this Committee at the earliest possible date. This can be done quite easily by simply removing dry hole costs from the base in computing the 65 percent limit on the depletion allowance. Thus the "penalty" now imposed on dry holes under the 65 percent limit would be removed, while still leaving the basic concept behind the limitation intact—a taxpayer could not utilize the percentage depletion allowance to reduce by more than 65 percent his taxable income as otherwise computed (before dry hole costs). If a larger reduction in taxable income resulted after this change it would be due to dry hole costs, not the depletion allowance.

It should be pointed out that the new 65 percent limit with respect to percentage depletion on oil and gas is in fact a separate minimum tax applied to this one preference. That is, it requires that a minimum amount of income be subject to tax at the taxpayer's normal rates.

Finally, the exemption for independent producers under the Tax Reduction Act of 1975 is subject to restrictive and very complicated conditions. One of these new rules would deny percentage depletion under the independent producers exemption in the case of an oil or gas property, or an interest therein, which was transferred after the property was a "proven" oil or gas property. Another of these rules would deny the independent producers exemption altogether to a producer who is considered to operate a retail outlet for the sale of oil or natural gas (or any product derived therefrom).

These special rules would be burdensome, at best, but in many instances they have been interpreted in proposed regulations issued by the Treasury Department in an extremely restrictive and technical manner. It is the opinion of many in the industry that the intention of the Treasury Department is to deny independent producers the percentage depletion allowance to every extent possible, rather than retain it in an effort to keep this group of businessmen as a viable and competitive segment of the oil and gas industry, as was the stated Congressional intent.

As one example, the Treasury Department's proposed regulations would label many independent producers who engage in no marketing activities, and have no direct or indirect interest in service stations, as "retailers." Under these regulations a producer who makes bulk sales of his natural gas production to a single industrial consumer of the gas would be considered to operate a "retail outlet" at the place where such bulk sales are made if his income from the sales to that consumer constitutes more than 25 percent of his gross receipts from production of oil or natural gas. As long as this "retail outlet" exists, such producer would be denied percentage depletion on all of his production, including production sold to others.

These controversies should be resolved by this Committee. The retail outlet problem could be easily cured by a brief amendment to new section 613A of the

Internal Revenue Code, stating more precisely that the taxpayers to be denied the partial exemption for independent producers and royalty owners are those operating establishments which make small quantity sales of oil or natural gas products to numerous members of the general public. A de minimis exclusion should also be added to prevent ridiculous situations, such as the retail sale of a few cans of machine oil by a store in which a producer owns an interest resulting in the complete denial of his percentage depletion allowance.

The problems created by the new "transfer rule" in section 613C(a)(9) of the Internal Revenue Code are more difficult to solve, but they are soluble nevertheless. A rule can be fashioned to prevent unwarranted proliferation of the exemption for independent producers and royalty owners that will not upset normal business and estate planning arrangements of producers.

In spite of the confusion the 1975 legislation has caused, no final administrative interpretations have been issued to date even though almost a year has lapsed since the legislation was passed. The resulting uncertainty has inhibited bold exploratory and development activity by the independent segment of the industry.

All of these consequences of the 1975 legislation—the direct reduction of the depletion allowance and the indirect effects of the legislation described above—increase the costs of independent producers which must be recovered from some source if their exploratory and development activities are not to be curtailed.

On the heels of this disasterous action by the Congress insofar as independent oil and gas producers are concerned, came the Tax Reform Act of 1975 passed by the House of Representatives in December of last year. This legislation was aimed not at the oil and gas industry, but instead was originally designed to restrict certain tax shelter opportunities often used by high bracket individual investors. In attempting to limit the attractiveness of tax shelters to such investors, however, the bill as finally passed by the House would deal a second body blow to the independent oil and gas producing industry. The principal provisions of the House bill with which we are concerned would not apply to corporations at all (other than Subchapter S corporations), only individuals, trusts and estates would be affected.

The principal way the Tax Reform Act would affect independent oil and gas producers would be to reduce significantly the benefits under the option to deduct intangible drilling and development expenses. The deduction for intangible drilling expenses on many wells would be deferred from the year in which incurred to a later year or years, and virtually all intangible expenses would become a tax preference item for purposes of the minimum tax on preferences.

The impact of these changes on exploration and development activities of independent producers must be fully understood by the Committee. The best starting point is a more complete understanding of the nature of intangible drilling expenses and the logic and equity in granting an immediate deduction for these expenses.

Perhaps the best description of intangible drilling expenses is found in the Treasury Department's regulations, which read as follows:

"This option [to deduct intangible drilling and development expenses] applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. * * * Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used: (1) In the drilling, shooting, and cleaning of wells; (2) in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

"In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. * * *"

These expenditures are referred to as "intangible" to contrast them with "tangible" expenditures made in the acquisition of physical assets such as derricks, tanks and other structures, the cost of which must be capitalized and recovered through depreciation over the life of the physical asset.

Intangible drilling expenses have been allowed as a deduction since 1917. They may not, as some assert, be properly equated to the costs of a building or other capital assets. First and foremost, they are normally cash expendi-

tures—payments for fuel, labor and similar items—as opposed to the cost of a building (which of course may include labor and related expenses) which can easily be financed through debt capital because a physical asset with a reasonably predictable value results from the expenditure. Oil and gas reserves may be located as the result of drilling an oil or gas well, but in the usual case the value of the asset thus located is not determinable for a considerable period of time.[1] Moreover, in the case of natural gas the reserves cannot be produced unless and until sufficient production is obtained to warrant the construction of a pipeline to the area. Usually this will require the drilling of several successful wells.

Intangible drilling expenses are, in short, a cash outlay which is not analogous to normal expenditures made in the acquisition of a capital asset, and for that reason they have not been treated in the same manner for economic purposes (i.e., debt capital is normally available to finance intangible drilling costs) or for federal income tax purposes.

From the standpoint of the independent producer the distinction is even more important. The activities of an independent wildcat explorer are totally cash flow oriented. His exploratory program will be sized according to his projected cash flow. A denial or deferral of the deduction for intangible drilling expenses, or a penalty on the deduction through the minimum tax, will quite obviously reduce his cash flow, and thus will remove dollars from the area where they are most needed—the actual drilling of oil and gas wells to increase domestic productive capacity.

Unquestionably the drilling of oil and gas wells is a very high risk financial venture. Even development wells within the industry meaning of that term have a success rate of only about 80%. It would not be possible for this industry to compete successfully for funds with which to drill exploration and development wells if the provisions of current law allowing a deduction for the portion of such expenditures which are made for intangible drilling expenses were significantly curtailed. Other investment opportunities are available which will produce an asset having a reasonably predictable fair market value. By contrast, the expenses of drilling oil or gas wells may produce an asset having no value, or even if an asset having value is located, its value is certainly not predictable in advance and is normally not ascertainable for a substantial period of time. In the meantime, of course, if the deduction under current law were not allowed, the taxpayer making such expenditure would be required to locate other funds for payment of taxes.

It should also be kept in mind that not all expenses incurred in drilling oil and gas wells are deductible under the intangible drilling expense allowance. Quite the contrary. A significant portion, usually estimated to be from 25 percent to 50 percent of the total costs of drilling onshore oil and gas wells (including leasehold costs and tangible completion costs), are not classified as intangible costs and must be capitalized and recovered through depreciation or depletion. Offshore the nondeductible portion is much higher, approximating 75 percent of the total costs.

In sum, it is submitted that the rules of present law with respect to intangible drilling and development costs were reached on a logical and economically sound basis. The portion of the expenses of drilling oil and gas wells which do not produce an asset of predictable value and represent high risk cash outlays should be treated as a current expense rather than a capital cost to be recovered over some unpredictable period of time. Other costs incurred in the venture (leasehold costs and expenditures for tangible equipment) should be capitalized.

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[1] It is difficult to accurately estimate the quantity of recoverable reserves discovered. There are several geological and physical parameters which must be obtained to make a rserves estimate, and yet cannot be obtained without extensive drilling and production history. Also, the timing of production and the location of reserves affect asset value. Obviously, reserves that can be rapidly developed and produced are more valuable than reserves which are either far from markets or must be produced slowly to prevent reservoir damage. Finally, the risk inherent in producing reserves can affect asset value. There is always the risk of mechanical well failure, blowouts, peculiar reservoir behavior, water coning, inefficient reservoir drive, etc., which may cause the reserves to either become more expensive than anticipated to produce or unproducible. It is normal industry practice when buying reserves in the ground, to apply estimated product prices and future expenses and taxes to the reserves, than to discount them to present value. This value is then reduced by 20 to 50 percent to take risk into account.

The basic approach utilized by the Ways and Means Committee in curbing tax shelters is the "Limit on Artificial Accounting Losses" (LAL), a concept initially proposed by the Treasury Department in 1973. (However, Treasury now opposes application of the LAL to oil and gas activities, as explained by Secretary Simon to the Committee last week, because of the significant legislative activity adversely affecting domestic oil and gas producers since 1973.) The concept of LAL is that certain types of deductions, labeled "accelerated deductions," attributable to specific classes of property will be allowed only to the extent that they do not exceed the "net related income" for the year from such class of property.

In this manner such deductions would not be available to offset other income, such as salary or dividends, in the current taxable year or in any future taxable year. The accelerated deductions not allowed in the current taxable year would be placed in a "deferred deduction account" for the class of property to which they relate, and the balance in this account would be allowed as a deduction in any future year to the extent of net related income from such class of property in such future year.

There are six separate classes of LAL property under the House bill. In the case of oil and gas the LAL applies to any interest in an oil or gas well which is not an "exploratory well," as defined in the bill. The accelerated deduction with respect to oil and gas properties is the excess of intangible drilling and development costs allowed under section 263(c) of the Internal Revenue Code over the amount that would have been allowable as a deduction in the taxable year if the intangible costs had been capitalized and recovered ratably over a 10-year period, or if the taxpayer elects, over the amount that would have been allowed as a deduction in the current taxable year if the costs had been capitalized and recovered under normal cost depletion.

Each oil and gas property would be treated as a separate class of LAL property under the House bill. Thus the intangible drilling expenses with respect to one oil or gas propety could not be utilized to offset the income from another property regardless of the proximity of the properties, geographically or geologically, or any other factors. This is the harshest possible treatment of intangible drilling expenses under the LAL concept. In other cases, notably real estate, all properties would be aggregated so that the accelerated deductions with respect to real estate, for example, would not be deferred under LAL unless such expenses exceeded a taxpayer's income from all of his real estate ventures, wherever located.

The mechanics of LAL as applied to the oil and gas industry would be relatively simple. The deduction for intangible drilling expenses with respect to wells which are not exploratory wells (as defined in the bill) would be denied until the oil or gas property on which the well is drilled produces sufficient income to offset the expenses. When the deduction is allowed to offset the income from that property in a later year, it will have the effect of reducing net income from the property and therefore may reduce the percentage depletion deduction allowable in that later year because of the limitation that percentage depletion cannot exceed 50 percent of a taxpayer's net income from the oil or gas property. (This limitation has been in the law for many years and was not superseded by the new 65 percent of overall taxable income limitation discussed earlier which was added by the 1975 legislation.)

If the taxpayer disposed of an interest in an oil or gas property while there is a balance in the deferred deduction account with respect to that property, the balance in the account at the end of that taxable year would be allowed as a deduction. If the a well is a dry hole, then upon a final determination that it is a nonproductive well the intangible expenses would be allowed with respect to that well. (Technically this is accomplished by treating the nonproductive well as a "disposition" of a separate class of LAL property so that the balance in the deferred deduction account with respect to that property would be allowed as a deduction upon the deemed disposition.)

Because the LAL would apply only to intangible drilling expenses on wells which are not exploratory wells, a definition of an exploratory oil or gas well would be contained in the law for the first time. The legislative drafters had a great deal of difficulty in developing such a definition and the final product is very poor indeed.

Under the House bill any well would automatically be an exploratory well if it is more than two mies from the nearest producing well at the time the well

in question is completed. (The two miles are measured from the nearest point on the nearest producing well to any point on the new well in question.)

If the well fails the two-mile test, then it may nevertheless be an exploratory well but only if it is completed two years or more after the completion of the last producing well which is within two miles, and even then only if the taxpayer is able to establish "by maps and other evidence" that the well will not tap any reservoir from which there has been significant oil or gas production. Finally, the legislative language adds a further stumbling block for the taxpayer by providing that he will not be able to show he has tapped a new reservoir if on completion of the well the bottom hole pressure indicates that there has been significant oil or gas production from any reservoir tapped by such well.

This definition is counterproductive. It is inconsistent with the industry concept of an exploratory well, the industry concept being based on the available geological and engineering information. Exploratory wells are wells other than those drilled to develop a known reservoir and therefore exploratory wells are many times more risky than development wells. The definition in the House bill does not accurately describe exploratory wells and thus does not encompass those wells which are considered to be the greatest economic risk, even though the obvious purpose of a special rule for exploratory wells would be to encourage this high risk investment; moreover, the House bill definition would usually leave uncertain the status of a well before it is drilled, thus making accurate cash flow projections impossibe.

The House Tax Reform Act would change the present minimum tax insofar as it affects individuals, trusts and estates, by (i) increasing the 10 percent minimum tax rate to 14 percent, (ii) reducing the $30,000 exemption to $20,000 and phasing out this $20,000 exemption on a dollar-for-dollar basis as preference income rises above $20,000 (so that when total preferences reach $40,000 there would be no exemption), and (iii) eliminating the deduction for normal tax liability or tax carryovers from previous years.

The effect of these changes would be to alter insofar as non-corporate taxpayers are concerned, the concept of the minimum tax as an additional tax on taxpayers who do not pay sufficient normal income tax in relation to the total amount of their tax preferences. Instead the minimum tax would become a straight 14 percent tax on preferences, except to the extent the $20,000 exemption is available, without regard to the amount of normal taxes paid.

The drastic change in the minimum tax insofar as independent oil and gas producers are concerned would be the addition of the deduction for intangible drilling expenses on productive wells to the list of tax preferences. The amount of the preference would be equal to the amount of the intangible drilling expense deduction, reduced by the amount which would have been allowed if the intangible expenses had been capitalized and recovered over a 10-year period (or at the election of the taxpayer) reduced by the amount which would have been allowable if the intangibles had been capitalized and recovered through normal cost depletion).[3] Intangible drilling expenses which are deferred under LAL would not be a tax preference item under the House bill, nor would intangible drilling expenses with respect to nonproductive wells.

As changes in the treatment of independent oil and gas producers are considered it should be kept in mind that this industry is subject to very stringent price controls at the present time. All domestic crude oil and most domestic natural gas are subject to restrictive price ceilings administered by agencies of the federal government. Therefore, an increased tax burden on producers cannot be explained away on the basis that tax incentives, or "tax expenditures" as they are now often called, have no place in a free economic system. There is not a free economic system insofar as this industry is concerned, and any increased tax burden must necessarily reduce the ability of the industry to generate internal funds for further replacement of exhausted reserves, as well as have the obvious impact of making it more difficult to attract outside capital.

There has, of course, been a significant increase in the price of crude oil over the last few years. However this is the first real increase in price which had occurred over the past 30 years, so a large portion of recent increases simply

[3] The Ways and Means Committee added to the list of tax preferences intangible drilling expenses only on wells other than exploratory wells (using the definition of exploratory well discussed above), but the House, by floor amendment, included both development well and exploratory well intangibles in the list of tax preferences.

makes up for past erosion of the price through inflation. Also, there has been a tremendous increase in all costs associated with the exploration and development of oil and natural gas. More realistic prices have revitalized the independent segment of the industry over the last few years and it can, and must, play a major role if this Nation is to become less dependent on oil and gas produced abroad. It cannot do so, however, if the capital presently available to it is decreased at a time when no alternative sources of capital are available.

Perhaps the most graphic way to illustrate the impact of the 1975 tax changes affecting independent oil and gas producers and the proposed changes in the House-passed bill is to show the impact they would have on the actual 1975 budget of Mr. King, who as I mentioned is an independent oil and gas producer in Houston. Mr. King will present these figures, showing his original budget, changes in that budget required by the Tax Reduction Act of 1975, and the further changes which would have been required if the House bill had become law during 1975.

(A copy of Mr. King's statement is attached.)

CONCLUSION

The inescapable conclusion is, we think, that now is not an appropriate time to increase the tax burden on independent oil and gas producers. This segment of the industry has suffered a very significant increase in tax burden as a result of tax legislation passed in 1975. We are for the most part subject to price controls and therefore cannot offset diminution of tax incentives by increasing the price of our product. Independent producers play a major role in the discovey of new oil and natural gas deposits in the United States and the viability of this industry should not be curtailed.

Statement of Allan C. King, on Behalf of the Domestic Wildcatters Association

Mr. Chairman and members of the committee, I wish to supplement Mr. Chapoton's statement by describing for you what I believe to be a fairly typical independent oil and gas exploration and production business in Texas and Louisiana and by showing you the impact the recent and proposed tax changes Mr. Chapoton described would have on my 1975 oil and gas exploration and development budget.

By way of background, I am independent producer with offices in Houston, Texas. I operate with a partner, Mr. J. N. Warren. We are active in exploration, drilling and development of oil and gas properties onshore throughout Texas and Southern Louisiana, employing more than 300 people. Like most independent oil men, we usually participate in exploratory ventures with other oil men, the size of our participation in each venture being dependent upon the initial cost of the oil or gas property and the anticipated expenses in drilling the exploratory and development wells required to determine its value.

In our exploratory and development programs we utilize our own internally-generated funds, attempting to hold back sufficient amounts to service debt which inevitably mounts in our business, and we utilize the funds of a limited number of investors who have participated with us in our ventures for several years. We do not operate a drilling fund and do not actively seek investors for our ventures.

Mr. Warren and I have a financial advisor in our office who projects our cash needs and develops our budgets, such as the 1975 budget I am about to describe. We, and other independents who have survived, have found that good cash flow projections are essential. An important aspect of this—and sometimes the most difficult aspect—is being certain that our projected exploration and development expenditures are within our means so that we will be left with sufficient cash flow to meet the debt service on loans previously incurred to develop reserves located in earlier years. Once an exploratory program has established the likelihood of oil and gas reserves in paying quantities in a particular area, we of course undertake to develop the reserves and produce them, selling the oil and natural gas in the normal course of business.

Traditionally we have had to borrow funds by pledging other assets for the purposes of drilling development wells. They, like exploratory wells, can be

extremely expensive. Normal bank financing is not available for development of oil and gas reserves until the extent of the reserves is well established by a production history. Newly-found reservoirs are not considered adequate collateral for debt. Thus loans for development activities can be difficult to obtain under any circumstances, particularly for producers who are not yet well established in the industry.

Once some production is obtained we must continue to explore for and locate new reserves; otherwise, the production of reserves located in earlier years will quite obviously exhaust those reserves and we will rapidly go out of business. Thus, the income from prior production must serve two functions: it must be sufficient to retire pre-existing debt and it must be sufficient to cover exploration and development expenses to replace reserves which are being exhausted. Hopefully, it will also be sufficient to permit us to locate not only reserves to replace those being exhausted but additional reserves as well and thus our business can grow.

IMPACT OF PRICE INCREASES

It is of course quite true that the price of oil and gas has increased significantly over the last few years. That increase has not only substantially increased the domestic reserves which are commercially recoverable, it has also pumped new life into the exploration efforts of independent oil and gas explorers. The price of oil and gas was far too low before the increases began in the early 1970's. The IPAA has estimated that there were only one-third as many active independent oil and gas producers in business in 1970 as there had been in the middle 1950's. Unquestionably this was due to the inadequate price for oil and gas to the producer during this period.

ROLE OF THE INDEPENDENT PRODUCERS

I am convinced independent producers can play a vital part in increasing our domestic productive capacity of oil and gas if a stable federal energy policy with sufficient economic incentives is established. In spite of pronouncements upholding the ideal of energy independence, the actions of our federal government in my opinion seem to indicate a contrary policy. We have recently seen significant tax changes adversely affecting the oil and gas business; we have seen stringent price controls placed on all oil production, with tremendous uncertainty and confusion in the application of the price controls; we have continued to have stringent controls on interstate natural gas; and we have been the House of Representatives pass additional tax legislation which would take yet another significant swipe at the industry, this time hitting most directly the independent explorers and producers through increase of tax costs by altering the present treatment of intangible drilling expenses.

For example, it would be financially foolhardy for an independent producer to budget an exploratory program for 1976 which does not give full effect to the tremendous reduction in its cash flow which would result from the House bill now before you. Yet, as some of the figures I will describe demonstrate, this would result in a tremendous reduction in my exploratory budget, and presumably a similar reduction in the activities of independents throughout the United States.

IMPORTANCE OF THE INTANGIBLE DRILLING EXPENSE DEDUCTION TO INDEPENDENTS

My particular concern today is the intangible drilling expense deduction. Mr. Chapoton has described the nature of the expenses involved and the history and logic of allowing an immediate deduction for the portion of the expenses of drilling and oil or gas well which are labeled "intangibles." If the deduction for intangibles is deferred, as proposed under House Limit on Artificial Losses provision, the additional taxes we will have to pay in the year such costs are expended would be a permanent loss of capital to us. In most cases there is substantial lead time between the location of reserves and their production. For example, in the case of a gas field the sale of production is not possible until a pipeline is built to the area at a cost of $100,000 to $1 million per mile. The pipeline will not be built at such tremendous costs until there are sufficient producing wells in the area to justify the expense.

Thus, intangible drilling expenses, as well as the nondeductible costs of drilling wells, must be incurred in very significant amounts in order to have enough

wells capable of production in commercial quantities to justify the construction of a pipeline. Only then will sale of the gas be possible and recoupment of the costs commence. This may be a matter of several years.

In addition, even where production can be commenced sooner, many wells are simply low-volume producers. The increased costs required by deferral of the deduction for intangible expenses with respect to such low-yield wells will render many of them non-commercial. These are obviously marginal prospects even under present law, but they are prospects which are being developed and would be lost under the proposed change.

All of these time-lag factors are multiplied many times over in the case of drilling activity offshore or in frontier areas far removed from existing production.

1975 PROJECTED EXPLORATION BUDGET—DECREASES WHICH WOULD BE REQUIRED BY TAX LEGISLATION

I have attached a chart showing my original 1975 drilling budget prepared in early 1975 and the change required in that budget due to the 1975 changes in the tax law. We have gone further and projected the additional changes which would have been required if the provisions of the House bill had been in place for 1975.

Column 1 shows the original budget. Gross revenues from oil and gas production plus outside income would amount to $2.9 million. Remaining cash flow after operating expenses, tangible and intangible costs on both development wells and wildcat wells, and federal income taxes, would result in a positive cash flow $.1 million. As described earlier, this net cash flow is destined principally for amortization of debt incurred in prior years.

Column 2 shows the adjustment which our financial people made as a result of the 1975 tax law changes. Since I was not above the 2,000 barrel a day or 12,000,000 cubic feet per day of gas limitations, those limits did not reduce my depletion allowance, although I would be caught by these limits as they phase down toward 1980. In addition the rate of depletion allowed for 1975 remained at 22 percent and therefore no reduction in the rate of depletion is demonstrated by these adjusted figures. The only adjustment required, therefore, was the new 65 percent limitation on the depletion allowance. This is the limitation that provides the depletion deduction cannot exceed 65 percent of the taxpayer's taxable income computed without the depletion deduction (and without certain loss carrybacks to the taxable year.).

As a result of the new 65 percent limit, we projected a curtailment of our wildcat drilling program to prevent a reduction of the depletion allowance on production obtained in prior years as a result of active wildcat operations in 1975. The reduction was from $1.278 million to $1.159, a reduction of approximately 9.3 percent. This resulted in a projected increase in federal income tax liability. However, you will note that it also resulted in an actual increase in cash flow, since I projected a significant cut in my exploratory budget.

I should emphasize that we could have elected not to curtail our exploratory program more than would have been required to meet our originally projected cash flow needs—$.1 million. However, it became obvious that continuing our exploration program to the point it significantly decreased the depletion allowance on production of reserves located in earlier years (by reason of the new 65 percent of taxable income limitation) would increase the costs of such further exploration efforts to the point they would not be economically sound. Therefore, we projected a postponement of exploration of those prospects until 1976.

Column 3 shows the additional adjustment which would have been required had the House bill provision deferring the deduction for intangible drilling expenses on development wells (as defined in the House bill) been in effect for 1975. The deferral shown by these figures is not as great as would be true in the case of many independents because an unusually large portion of our 1975 development program was planned for leases already in production. Nevertheless, to arrive at the same cash flow of approximately $.1 million, it was necessary to reduce my exploratory budget to $1.054 million, a reduction of 17.7 percent from the original 1975 exploratory program. If we had been developing frontier areas, or offshore, where there is little or no production until development is completed, the reduction would be much more dramatic.

Column 4 shows the further adjustment which would be required by the application of the new minimum tax provisions passed by the House to my 1975

budget. Again, attempting to keep the cash flow at approximately $.1 million, my exploratory budget would have been cut to $.871 million, a reduction of 31.8 percent from the original 1975 program.

Finally, Column 5 shows the effect on my cash flow if I ceased all exploratory drilling. The result would have been a projected increase in my cash flow to $0.849 million.

Obviously, I would be going out of business, since there would be no location of new reserves to replace those being exhausted (even though these figures assume continued drilling of development wells for the development of reserves located in previous years). Considering the risks inherent in searching for new reserves, the much less discussed risks of producing reserves once they are located, and most importantly the potential catastrophic risks such as blowouts and environmental suits, this final column would be a viable alternative for me if I became convinced that tax changes similar to those passed by the House are to be adopted, and particularly if continued governmental policies adverse to my business appear possible. If it is not economically feasible to continue to explore my inventory of reserves through continuing an active exploratory program, then I, like any self-employed person, must make a decision whether it is more prudent to liquidate my business.

1975 EXPLORATION BUDGET

		Adjusted for—			
	Original budget	65-percent limit on depletion	Deferral of IDC on 50 percent of development wells	14-percent minimum tax without offset	Cessation of exploratory drilling
	(1)	(2)	(3)	(4)	(5)
Income:					
Oil and gas receipts (net of production taxes)	2,749.9	2,749.9	2,749.9	2,749.9	2,749.9
Other income	200.0	200.0	200.0	200.0	200.0
Total income	2,949.9	2,949.9	2,949.9	2,949.9	2,949.9
Costs:					
Operating	347.7	347.7	347.7	347.7	347.7
Development wells:					
Intangible costs	444.6	444.6	444.6	444.6	444.6
Tangible costs	303.2	303.2	303.2	303.2	303.2
Wildcat wells:					
Intangible costs	1,278.1	1,159.1	1,053.6	871.4	0
Tangible costs	319.5	289.9	263.3	217.8	0
Total, costs	2,693.1	2,545.0	2,414.4	2,184.7	1,095.5
Federal taxes:					
Income tax	111.0	193.9	423.7	551.3	1,005.0
Minimum tax:					
Present law—10 percent	45.1	36.8	13.8	0	0
Proposed 14 percent				113.9	0
Total, Federal taxes	156.1	230.7	437.5	665.2	1,005.0
Net cash flow	100.7	174.2	98.0	100.0	849.4

Statement of Robert M. Beren, on Behalf of the Small Producers for Energy Independence

My name is Robert M. Beren. I am an independent oil and gas producer with offices in Wichita, Kansas. I am also co-chairman of the Small Producers for Energy Independence, which is a group of more than 60 independent producers and operators in the States of Kansas, Oklahoma, Colorado, Texas and California.

I appreciate this opportunity to testify before you today on the matter of tax reform as it relates to the independent oil and gas producer. As others have already explained the mechanics of H.R. 10612 for the record, I shall not further expand on those points; rather, I should like to make some observations as to how this proposed legislation will adversely impair domestic exploration and drilling.

If enacted, the provisions of H.R. 10612, together with the changes in the percentage depletion allowance brought about by the Tax Reduction Act of 1975,

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would seriously impair—and perhaps destroy—the ability of the independent entrepreneur to compete in the field of oil and gas exploration. Under the 1975 Act, the Congress effectively imposed a minimum tax exclusively on independent oil and gas producers by limiting the availability of percentage depletion to 65% of taxable income. The computation of depletion had already been limited prior to the 1975 Act to 50 percent of taxable income form a given property. Notwithstanding the existence of these disincentives, the House bill which you are now considering would place an added tax burden upon the independent producer which would severely restrict his ability to generate the large sums of capital necessary for significant exploration and drilling activity.

This tax burden could run as high as 100 percent of total taxable income in certain circumstances because of the increases in the minimum tax rate from 10 percent to 14 percent and the inclusion, as preference items, of percentage depletion deductions—diminished though they may be—and of intangible drilling expense deductions.

Obviously, this would severely curtail the independent producer's cash flow and leave him at a tremendous competitive disadvantage vis-a-vis large integrated producers with alternate sources of capital.

To illustrate this point, let me discuss briefly the principal role which capital plays in oil and gas exploration and drilling. Capital funds—as distinguished from funds which are deductible for tax purposes—are needed for: (1) the purchase of equipment to put oil and gas wells on production; (2) to purchase undeveloped acreage and to meet geophysical and geological expenses incurred in its development; (3) to repay loans contracted because prior income was insufficient to provide capital funds; and (4) for payment of federal, state and local taxes. Clearly capital expenditures of this type are indispensable.

The sources of capital funds are, however, extremely limited. They must come from (1) non-cash deductions such as depletion; (2) that portion of depreciation which is not needed to replace and repair equipment in use; (3) bank borrowing to the extent it is available; (4) after-tax earnings, which as I have already indicated will be substantially eroded by virtue of unrealistically burdensome tax rates; and (5) from the sale of properties—whose value as a source of funds has already diminished because the 1975 Act prevents the passing on of percentage depletion to a purchaser, and would deteriorate further under a provision of H.R. 10612 for the recapture of intangibles in the event of a sale.

It is irrefutable that, if the independent producer's access to capital funds is cut off, he will be forced to curtail his drilling activity. As an active independent, I can tell you unequivocally that I rely very heavily in my drilling upon the cash flow I derive from my own operation. Based on a study performed at S.P.E.I.'s request by one of the major national accounting firms, drilling and exploration by independents will necessarily be cut by as much as 25 to 30 percent if H.R. 10612 is enacted. This would be a terrible blow to our nation's efforts to achieve energy self-sufficiency in light of the fact that over the years, independents have consistently drilled 85 percent of all domestic exploratory wells. As a result, in 1974, independents found 94 percent of the new fields in the United States.

If the Congress wishes to impair the ability of independents to make significant contributions in oil exploration and drilling, then it should adopt the provisions of H.R. 10612, as passed by the House—for this mose surely will occur. If, on the other hand, the Congress intends to pursue a reasoned, long-range policy course, it will encourage independents to continue finding reserves for our nation's dwindling petroleum inventory.

As an independent producer who can attest to the debilitating impact which an unsound decision by this Committee would engender, I urge you to eliminate disincentives for exploration and drilling by the independent segment of the oil and gas producing industry and to replace them with capital-generating incentives to promote maximum discovery of new reserves.

Thank you, Mr. Chairman.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 2:30 p.m., this same day.]

AFTERNOON SESSION

The CHAIRMAN. To accommodate the witness from Texaco I will call him out of order. Is that witness here?

Mr. YOUNG. Thank you, Mr. Chairman. May we do it with the panel?

The CHAIRMAN. All right.

STATEMENT OF W. T. SLICK, JR., SENIOR VICE PRESIDENT, EXXON CO., U.S.A.

Mr. YOUNG. Thank you, Mr. Chairman.

Mr. Slick of Exxon will deal with the domestic side of this and I would like later to deal with the foreign.

Mr. SLICK. Thank you, Mr. Chairman. I am W. T. Slick, Jr., senior vice president of Exxon Co., U.S.A., a division of Exxon Corp. I am pleased to have this opportunity to appear before this distinguished committee.

Today the Nation is in trouble on energy. No amount of speechmaking or debate can deny the fact that oil imports are increasing and domestic oil and gas production is declining, both at alarming rates. It is time for the Government to decide whether it will use its abilities to reverse this situation or whether it will continue actions which accelerate this obvious and disturbing trend.

My filed statement speaks to the specifics of U.S. energy supply and demand both now and in the future, capital requirements for energy development, and recommended changes in fiscal, regulatory and tax policies. I would like to highlight a few points at this time:

The petroleum industry is in a period of rapidly increasing costs—both inflationary increases and real cost increases. Looking first at inflation, during 1974 and 1975 the CPI went up 10 percent a year. The wholesale cost of industrial commodities used by business in general went up 15.7 percent. In petroleum the construction cost index for a refiner went up 29.5 percent a year; production equipment such as valves, well casing and tubing, tanks and separators, et cetera went up 28 percent a year; and offshore platforms went up 45 percent a year.

In addition to these inflationary increases real cost increases are being felt in all parts of the business. In the future over 60 percent of the reserves which will be added are likely to come from offshore and Arctic areas.

The CHAIRMAN. Could I just ask you this? You say the Consumer Price Index went up by 10 percent a year. How much did the cost of the production industry generally go up?

Mr. SLICK. The production end of business went up somewhere about 35 percent. It was about 28 percent for equipment other than offshore platforms. Offshore platforms went up about 45 percent. So, on a mixed basis it was well over 30 percent a year.

The CHAIRMAN. Thank you.

Mr. SLICK. In the Gulf of Mexico a typical platform facility and wells cost about $75 million. The cost of comparable facilities in a frontier area such as the North Slope is about $200 million. This is about three times greater than Gulf of Mexico costs and some 20 times greater than inland lower 48 costs. In areas such as the Beaufort Sea costs would be even higher.

In addition to the much higher finding and development costs, these reserves are located in remote areas requiring very costly transporta-

tion systems. For example, the trans-Alaska pipeline is projected to cost $7 billion. This amounts to about 10 percent of the petroleum industry's total net investment in fixed assets at the beginning of 1975—just to move North Slope oil to Valdez which is still 1,500–2,000 miles from the west coast markets.

Refiners are also facing real cost increases resulting from increased environmental protection requirements, increasingly stringent product specifications and a lower quality crude supply with increased sulfur content. The cost of a typical grassroots refinery in the late 1970's is triple the cost in the mid-1960's.

Second, the Nation's oil supply/demand situation continues to deteriorate and imports now make up over 40 percent of requirements. The nature of our plight was just recently magnified on March 12 when imports, as reported by API, for the first time in history reached a level of 8,196,000 barrels per day, which exceeded domestic crude oil production, 8,049,000 barrels per day.

Third, the profitability of the petroleum industry is not out of line with that of business as a whole. While profits rose sharply in 1974, much of the increase was illusory, coming from inventories or currency revaluations. Further, profits fell sharply in 1975. Preliminary 1975 data indicate petroleum industry returns on net worth of about 14 percent versus about 12.5 percent for all manufacturing.

I think it is essential that the Nation's fiscal and regulatory policies recognize the need to replace the Nation's dwindling oil and gas reserves, and the sharply higher unit costs and total capital expenditure levels necessary to do the job just can't be ignored. These policies must permit industry the expectation of a reasonable return on new investments as well as adequate earnings on existing production to help finance these investments.

H.R. 10612 does further weaken the petroleum industry under the guise of tax reform. Now obviously we can postulate arguments under such catchy titles as minimum tax, recapture and limitations on artificial losses. But the fact remains the IDC provisions of the tax laws enhance the attractiveness of investments in petroleum. It follows, therefore, that removal of these provisions will decrease the amount of investment capital available to independent producers.

Further, it is essential that ways be found to stimulate capital formation in the overall economy and redress the imbalance which now favors consumption at the expense of savings and investment. Ways must also be found to offset the inflation felt over the past several years.

Proposals which merit consideration include: extension of the investment tax credit, acceleration of capital cost recovery through more rapid depreciation to recognize the damaging effect of inflation on replacement costs, and integration of corporate and personal income taxes to eliminate double taxation of corporate earnings.

Finally, fiscal responsibility at all levels of Government is needed to avoid rekindling the high rates of inflation which have been so detrimental to all sectors of the economy.

Mr. Chairman, that concludes my remarks. Mr. Young has some remarks.

STATEMENT OF WILFORD R. YOUNG, VICE CHAIRMAN OF THE BOARD OF DIRECTORS AND GENERAL COUNSEL, TEXACO, INC.

Mr. YOUNG. Mr. Chairman and members of the Senate Committee on Finance, my name is Wilford R. Young. I am vice chairman of the board of directors and general counsel of Texaco, Inc. I appreciate this opportunity to present my views on U.S. taxation of foreign-source income.

The report on Project Independence issued in 1974 by the Federal Energy Administration idealistically contemplated energy independence for the United States by 1985. The FEA's recent report rejects this thesis, and more realistically assesses the Nation's continued future dependence on imported petroleum.

Available domestic reserves of crude oil and natural gas have been dropping since the late 1960's. At the present time to meet the Nation's liquid petroleum requirements of nearly 17 million barrels per day, the United States is importing about 8 million barrels per day, or about 45 percent of its requirements.

Mr. Slick referred to the fact that for the first time liquid petroleum imports in March exceeded our production in the United States. In fact, it was reported last week that, for the first time in our Nation's history, the volume of petroleum liquids that were imported exceeded domestic crude oil production.

Texaco studies indicate that by 1990 even if the private petroleum industry is permitted to earn and invest capital at a maximum practical rate, foreign imports would be supplying about 50 percent of the Nation's demand for petroleum liquids, or about 12 million barrels a day. If investments should be held at near current levels—as adversely affected by controls and other governmental actions—Texaco estimates that imports would rise by 1990 to more than 70 percent of requirements, or about 20 million barrels per day.

Obviously our Nation must get on with developing its domestic energy resources. But these facts also clearly show the importance of secure sources of foreign petroleum supplies to meet U.S. import requirements. And it is in this context that we ask you to consider the U.S. system of taxing foreign source income.

Our country needs a tax system that, first, will not discourage American oil companies from seeking oil resources overseas; and, second, will permit American oil companies to compete on a favorable basis with foreign companies.

The United States for many years had a reasonable basis for taxing foreign source income. While the U.S. system was not as favorable as that in some countries, such as France and the Netherlands, it was comparable to the systems in many nations and was understood and relied upon by the American companies. U.S. incorporated companies were taxed on their foreign source income at the higher of the U.S. rate or the foreign rate, with credit for foreign taxes allowed in such manner as to largely eliminate double taxation. Tax on the income of American-owned foreign corporations was, very wisely and with some exceptions, not taxed until the income was realized by the receipt of dividends.

But the system has been weakened—substantially weakened—by the Tax Reduction Act of 1975. That act denied to the oil companies, and only to the oil companies, the use of the foreign tax credit on a per-country basis, which has been used since 1932. It also established arbitrary and complex restrictions as to application of the foreign tax credit on the overall basis. The act harmed American companies competitively. It operates against what is clearly the national interest of maintaining a tax system that will assist in providing our country with secure sources of foreign oil.

And now we are confronted with further damaging proposals, some technical and some so drastic as to destroy the entire U.S. foreign tax credit system. These proposals have one feature in common. They would increase the oil companies' tax on foreign source income and would render American companies less able to compete with the companies of other nations. Weakening U.S. companies in this manner would again move against the national interest. If changes are to be made in the U.S. system of taxing foreign income, they should undo the damage inflicted by the so-called Tax Reduction Act of 1975. They should not place a more onerous tax burden on American oil companies which must be depended upon to supply our Nation's crude oil import requirements.

These comments are elaborated upon in a written statement that has been filed on behalf of the American Petroleum Institute.

Thank you for your attention.

The CHAIRMAN. Thank you very much.

I want to ask about just one matter, and I guess Mr. Slick can answer as well as anyone. Can you people get us some kind of study to indicate what the effect has been on employment, somewhat in line with the economic model Dr. Ture set up for the real estate people? He endeavored to demonstrate in his judgment how many jobs would be lost, how much the gross national product of the United States would be reduced, and how much revenue would be lost if we passed the House recommended package with regard to real estate.

Now, admittedly those estimates are imprecise, but when you try to work out an estimate, you find oftentimes that you are not arguing about the figures, you are just arguing about where you ought to put them, whether you ought to put them in one column or whether they should be put in another column. Usually the majority of people tend to arrive at the right conclusion if they have all the facts set before them.

Just computing from the ad I saw by Mobil in the Sunday magazine section—they said that the 29 major companies are plowing back in $2 for every dollar of net profit after taxes are permitted to keep—that would mean a $1.7 billion tax increase would reduce the amount that the companies can spend on developing new energy by $3.4 billion.

Now, if you translate that into jobs, that itself represents a considerable number of jobs. But it also has a secondary effect. Obviously, if you can't hire a man to work on the oil wells, then he can't spend the money he would earn with the fellow down at the grocery store or the man down at the bowling alley. Those fellows, in turn, can't continue to hire as many people as they hired before. It might be helpful if you could arrange to develop some of those estimates, and

it may be that you would want to talk with the people at the American Petroleum Institute or some other group, to try to present us such information.

I think it would be useful to us.

Mr. SLICK. Mr. Chairman, as you so accurately pointed out, those types of studies are inclined to be a little imprecise. I think, if we could get them, they would be illuminating. We would be happy to see what we could do with relation to lost revenue, to lost jobs, which I think is the thrust of your question.

[The material referred to had not been received in time for printing at this point. Please consult the contents in the final volume of these hearings.]

The CHAIRMAN. Your presentation is also proof to what it does to our balance of payments, because that becomes very important.

Mr. SLICK. If I might just comment, sir, we will try to do more studies, but I would like to say for the record we should not lose sight of the fact, and I am sure the chairman doesn't, that the Tax Reduction Act of 1975 actually increased taxes on the American petroleum industry, large and small companies. The loss of the depletion allowance that occurred in that tax bill took $2 billion out of the petroleum industry at the time when capital shortage was a real problem. That was $2 billion that was just not available for exploration and development, and it had an impact on the amount of exploration that could have and should have been done in this country.

The facts remain that the American investments abroad in the petroleum industry have made a positive contribution to the balance of payments in this country, and that has had many rippling effects through the economy over the past decade or more. My own company has brought back to this country several hundred million dollars a year.

After financing we brought back several hundred million a year that was available for investment or dividends, both of which have positive effects on our economy. Last year alone it exceeded $1 billion for our company.

Tax revisions can cut off that source of income like any other source of income. I submit, sir, that such results are not in the best interests of this country.

The CHAIRMAN. People present their facts about what they did do, and they say we made those companies pay and they were getting by without paying what somebody else thought they ought to pay. It is well for us to know how much companies have collected and paid; in addition to that, to know how many jobs we lost because we did impose those taxes.

The independents, I believe, are reporting that they are drilling less wells. If that is the case, that is very unfortunate. We would hope they would be drilling a lot more wells; national policy would have dictated your company to be drilling a lot more wells than you were drilling previously. If your company had been able to do more good than you did in prior years——

Mr. SLICK. No, sir, we did less. When I appeared before this committee in July 1975, I believe I indicated to you that because of the thrust of the tax legislation we were reducing the amount of drilling we were able to do because our funding was limited as well. We did

less drilling as a result of the tax bill of 1975 than we would have done without that bill.

The CHAIRMAN. I am personally convinced that your companies as well as all those in the industry group for whom you are speaking are doing great things for this Nation, and that it is in our interest that you be able to do more of the same. But I am concerned for more reasons than one. There are those who don't seem to share my view about that matter. I am confident that those who want to tax you to the point that you can't do what the national economy has a right to expect you to do are going to want to put the Government in business doing with your tax money that which you would have done if you had been permitted to keep some of it. I on occasion liken that to the efficient practice of some of the earlier operators of the French guillotine where they made the victim carry the basket to the guillotine with him so they could carry away his head in a sanitary fashion.

It seems to me that we should have the facts available to us to demonstrate that you would not need to have the Government drilling for oil if you just let the people in free enterprise who would like to do so, have enough of the revenue they earn in their honest endeavor, to do what they would have done with the same tax money.

Based on the information that I have about your companies, generally speaking, is it not true that the amount that you can do in terms of drilling wells and building refineries and building pipelines to move the oil around, or whatever it takes to do the job, pretty well relates to your cash flow? The rule of thumb seems to be that for large major companies. for $1 of profit after taxes, about the best you could hope to do is put $2 back into the refining and processing industry.

Mr. YOUNG. May I comment on that?

The CHAIRMAN. I would like Mr. Slick to speak to it first.

Mr. SLICK. Yes, sir. We made last year about $1 billion in the United States and we spent almost two. Our expenditures this year will be well in excess of $2 billion, and we will make, if we are lucky, about what we made last year, but certainly no more. But our ratio has been running pretty close to 2:1 in recent years.

Mr. YOUNG. Certainly the amount you can spend has to be related to earnings. Of course, earnings are vitally affected by taxes. For sometime we have had a rule of thumb that by and large for capital and exploratory expenditures you must provide three-quarters of the amount out of earnings and other internal cash generation, and the remaining quarter out of borrowings. But the earnings are an exceedingly important part of the internal cash flow.

Last year earnings were $830 million; our capital exploratory budget was $1.6 billion. Now this year it will not be more and probably somewhat less than $1.6 billion.

The CHAIRMAN. Then it is a correct statement that an additional $500 million of taxes on the larger companies would probably result in twice that much reduction in their drilling and other producing activities.

Mr. SLICK. I think that is a fair statement, Mr. Chairman.

The CHAIRMAN. Thank you very much, gentlemen. I appreciate your presentation here.

I will try to see to it that other Members of the Senate are fully aware of what you have had to say. That sometimes is a chore, and I

might have to ask some of you people to come back and tap on some doors of the Senators who are not on the committee and who were not here to hear what you had to say, because I think you make a good case.

Mr. SLICK. Thank you.

Mr. YOUNG. Delighted to do so, sir.

[The prepared statements of Messrs. Slick and Young follow. Oral testimony continues on p. 830.]

STATEMENT OF W. T. SLICK, JR., SENIOR VICE PRESIDENT, EXXON CO., U.S.A., IN BEHALF OF AMERICAN PETROLEUM INSTITUTE, MID-CONTINENT OIL AND GAS ASSOCIATION, ROCKY-MOUNTAIN OIL AND GAS ASSOCIATION, AND WESTERN OIL AND GAS ASSOCIATION

The United States is in trouble on energy. U.S. energy consumption must increase to permit economic growth. Oil and gas now supply three-quarters of U.S. energy requirements. Even with substantial growth in other energy sources, oil and gas will still supply about two-thirds of domestic energy needs in 1990. However, U.S. oil and gas proved reserves and production are declining and reliance on imports is increasing. The nation is faced with the absolute necessity of replacing these dwindling reserves even to maintain, much less increase domestic production.

The real cost of replacing these reserves will be much greater than the original cost of existing reserves due to their location in deeper horizons and remote and costly frontier areas, much higher transportation costs resulting from longer hauls and changing logistical patterns, and substantially higher refining costs. In addition, the impact of inflation on the petroleum industry has been particularly severe in recent years. The higher real costs coupled with the impacts of inflation will result in a doubling or tripling of annual capital expenditures for oil and gas.

A large portion of these expenditures must be financed internally from profits and capital recovery provisions of the tax laws. However, the domestic petroleum industry is faced with a serious capital formation problem which creates grave concerns about its ability to finance the projected higher expenditures. These concerns are reinforced by the recent industry tax increases resulting from the loss of percentage depletion, the extension of price controls on both oil and natural gas, and so-called tax reform proposals now being considered. All of these actions and proposals further inhibit the petroleum industry's capital formation capability. In addition, the industry is also affected by the numerous factors which inhibit capital formation in the overall economy such as inflation, bias in the tax system against savings and capital formation and government fiscal, monetary, and economic stabilization policies.

What is needed is a sound U.S. energy policy which includes adoption of sound fiscal policies regarding energy exploration and development, capital formation and capital recovery. These policies should include increased fiscal responsibility by government, enactment of proposals to encourage capital formation in the overall economy, and recognition of the damaging effects of inflation on capital recovery allowances. It is imperative that these policies specifically recognize: (1) the sharply higher real cost and capital expenditure levels needed to replace the nation's dwindling oil and gas reserves, (2) the need for the petroleum industry to be provided the reasonable expectation of a profit on development of these new reserves, and (3) the importance of earnings from existing production in financing the devolpment of new high cost discoveries.

In view of the nation's critical energy and capital formation needs measures which further inhibit achieving these needs would be both illogical and irresponsible.

STATEMENT

There has been a wide and growing concern in recent years that the U.S. economy faces capital formation problems of major proportions. Spokesmen from government, academia, and the private sector have repeatedly warned that unless action is taken to stimulate new capital formation the achievement of vital national goals such as full employment, stable price levels, increased productivity, energy independence and environmental quality will be jeopardized. The funda-

mental problem is one of removing institutional constraints on profitability and creating an economic and political climate which stimulates both the means and the incentives for capital investment. The roots of the capital formation problem which affects all sectors of the U.S. economy lie in:

Inflation: which results in shrinking real profit margins, increasing effective tax rates, and underdepreciation of assets valued on a historical cost basis.

Bias Against Savings and Investment in the U.S. Tax System: which results from the double taxation of corporate earnings at the corporate and the individual level and the overall bias toward consumption rather than capital formation in the progressive tax system.

Government Fiscal, Monetary, and Economic Stabilization Policies: which have exacerbated the business cycle, while simultaneously limiting, by ever increasing regulations, controls, and requirements for nonproductive capital expenditures, industry's ability to offset its effects.

These conditions which inhibit adequate capital formation in the overall economy also adversely affect the petroleum industry. In addition, there are certain factors which are unique to the domestic petroleum industry.

U.S. demand for energy must continue to grow if economic growth is to continue.

Although production and use of other energy forms such as coal and nuclear power are expected to grow very rapidly over the next 10–15 years, the U.S. will continue to rely on oil and gas for about two-thirds of its energy needs.

Domestic oil and gas reserves peaked in the mid-1960's. Domestic production has been declining since the early 1970's. The alternative to increasing domestic reserves is sharply increased dependence on oil imports or crippling energy shortages.

The costs of finding, developing and bringing replacement reserves to market will be several times greater than the original cost of equivalent reserves now being produced due to:

Higher real costs due to the location of replacement reserves in deeper horizons and more remote areas;

Inflation which has been significantly higher for petroleum equipment than for the economy as a whole;

Transportation costs, which are vastly greater because of the longer hauls from remote areas and changing logistical patterns;

New refining capacity costs which have increased dramatically due to product quality requirements, poorer crude quality, and increasing processing intensity; and

Facilities for environmental protection, which are required at the production, processing, and marketing stages and which add significantly to costs but not to productivity.

These higher real costs coupled with the impact of inflation and high activity levels will require a doubling or tripling of annual capital expenditures for domestic petroleum requirements.

A large portion of these expenditures must be financed internally from profits and capital recovery provisions included in the tax code.

The elimination of percentage depletion and continuing controls on both oil and natural gas prices serve to reduce the total funds available for replacing U.S. oil and gas reserves.

These factors are discussed in more detail in the following sections of this submission.

U.S. ENERGY SUPPLY AND DEMAND SITUATION

Real and permanent improvement in our national energy situation is dependent on increasing indigenous supplies. The U.S. has a large conventional energy resource base, and its expeditious development can make a significant contribution to our energy independence as well as contributing to a healthy economy. It has been widely emphasized that one of the most critical factors in the development of these resources is the ability of the domestic petroleum companies to generate adequate investment capital.

Unfortunately, in the two years since the embargo the Nation has moved backward not forward. The Tax Reduction Act of 1975 largely eliminated percentage depletion and increased the petroleum industry's tax burden upwards of $2 billion per year at a time when additional capital formation capability was desperately needed to finance the accelerated development of domestic resources.

More recently, the Energy Policy and Conservation Act was passed. In spite of its title, this Act does not give the Nation a much needed energy policy, nor does it promote energy conservation. Senate-passed legislation, to at long last deregulate interstate natural gas, failed in the House. Serious efforts are being made to dismember and restructure the domestic petroleum industry. Meanwhile, domestic oil production continues to decline; oil imports continue to increase; no substantive action has been taken to provide security storage; and the Nation's energy future remains clouded. The deteriorating U.S. supply/demand situation is dramatically underscored by the fact that for the week ending March 12, 1976, U.S. petroleum imports (8196 MB/D) exceeded domestic crude production (8049 MB/D) for the first time in history.

Exxon USA's projections of future energy demand an supply are illustrated in the attached brochure: *Energy Outlook: 1976–90*. During the years prior to the 1973–74 embargo, U.S. energy demand increased at a rate of about 4 percent per year, coincident with rapid economic growth. This relationship between energy and economic growth is well known. Although more efficient energy use is possible and desirable, no one can accurately predict how much the energy/GNP ratio can be reduced and still meet the Nation's legitimate aspirations for jobs and a better quality of life. Because of higher energy prices, conservation, and increased energy efficiency, energy demand growth over the next 15 years is projected to be only about 2.8 percent per year, about two-thirds of the historical rate. This still results in total energy demand increasing 50 percent from an estimated 38 million barrels per day oil equivalent in 1976 to 56 million barrels per day oil equivalent in 1990.

Domestic energy sources available to meet this demand include:

Nuclear power which is expected to supply only 16 percent of energy demand in 1990 even with very rapid growth projections (which may be optimistic in the light of recent public concerns about nuclear energy).

Hydroelectric and Geothermal, which will be limited by the availability of sites and by technological considerations, will supply 3 percent of 1990 needs.

Coal which, although production is projected to double by 1990, will still supply only about 20 percent of energy demand.

Oil and natural gas will continue to be predominant U.S. enrgy source over the next 15 years, supplying about two-thirds of the 1990 demand.

Since the mid-1960's, the U.S. has been consuming more domestic oil and gas than it has been finding, and as a result, U.S. proved oil and gas reserves have been steadily declining with the 1968 Prudhoe Bay discovery providing the only significant break in that trend. By the early 1970's producing capacity reached its peak and both oil and gas production have been declining ever since. Just to maintain production, it will be absolutely necessary to replace these depleting reserves with new discoveries. Given the proper environment it should actually be possible to increase domestic oil production by 20–25 percent. However, over half of total 1990 production must come from reserves which have nt yet been discovered. This same general situation holds true for natural gas. Still, U.S. oil imports will continue to grow to meet the needs of the economy. These conclusions are not new or unusual. However, there seems to be a pervasive lack of appreciation for both the seriousness of the problem and for the magnitude of the capital formation problems which result both from inflation and much higher real costs for the replacement of conventional oil and gas reserves, additions to refining capacity, logistic facilities, and the need to develop new energy forms such as synthetic oil and gas.

RESERVE REPLACEMENT COSTS AND CAPITAL REQUIREMENTS

The costs of replacing the Nation's dwindling inventory of oil and gas reserves will be several fold greater than the cost for an equivalent amount of existing reserves because of their location and the effects of inflation. Even though appreciable opportunities exist for adding new reserves in existing producing areas, it is widely recognized that the unexplored Frontier Areas of the U.S. (the deeper water OCS areas, the Alaskan Arctic, Gulf of Alaska, and Atlantic and Pacific OCS areas) offer the greatest prospect for major additions to U.S. oil and gas reserves and production. For example, less than one-third of the 34 billion barrels of today's proved crude oil reserves are located in the Frontier Areas, while over 60 percent of the reserve additions projected through 1960 will be located in these areas (Attachment 1). This same relationship holds true for production. Only 2 percent of 1975 oil production occurred in Frontier Areas; this is expected to increase to 60 percent by 1990.

To appreciate fully the magnitude of reserve replacement costs in remote and harsh Frontier Areas it is necessary to look at some specific numbers. For example, an exploratory well in the Gulf of Alaska would cost over $5 million as compared to $1–2 million in the Gulf of Mexico. The cost of a typical new offshore platform in the Gulf of Mexico including wells and production processing facilities is about $75 million. While this is greater by a factor of 10 than the cost of comparable producing capacity on shore, a comparable capacity facility on Alaska's North Slope would cost about $200 million or about three times the cost of a Gulf of Mexico facility. In other Frontier Areas such as the Beufort Sea costs will be even higher.

The higher cost of logistical facilities is also a very significant factor. Production from the Gulf of Mexico generally moves relatively short distances to shore where it is essentially "at market" as the result of the existing onshore pipeline distribution system. The opposite, however, is true for North Slope production. An investment of $7 billion is required for the Trans-Alaska Pipeline just to move the production across the state of Alaska to the Port of Valdez, which is stil over 1500–2000 miles from U.S. West Coast ports such as Seattle or Los Angeles. The Alaska Pipeline cost can be placed in perspective by recognizing that the $7 billion cost represents in excess of 10 percent by the U.S. petroleum industry's total net investment in fixed assets at the beginning of 1975 ($59.8 billion excluding chemicals—Source: Chase Manhattan Bank).

In addition to high transportation costs resulting from the remote location of future reserves, changing logistical patterns are having a major impact. Because of declining domestic production in the lower 48, it is now necessary to move crude and products in completely different directions. For example, in the past few years imported oil has begun to move in substantial quantities into the Gulf Coast area. Also, facilities to move crude from the Gulf Coast to the midwest and possibly to the northern tier states, as well as from the West Coast to the mid-continent, will be needed by the later 1970's or early 1980's.

These inherently higher costs for new reserves in constant dollars have been further increased by the effects of inflation which has been particularly severe in the petroleum industry. For example, in 1974 and 1975 inflation in the overall economy (as measured by the CPI and GNP Deflator) averaged about 10 percent per year, and the Wholesale Price Index for industrial commodities in general went up 16.7 percent per year. In contrast, the Wholesale Price Index for oil field equipment increased 17.5 percent in 1974 and 24 percent in 1975; the Construction Cost Index for a refiner increased 29.5 percent per year; the cost of production equipment such as valves, tubular goods, tanks, separators, etc. went up 28 percent per year; and the cost of offshore platforms increased 45 percent per year. Future inflation will obviously continue to increase overall costs and future capital needs.

Because of these higher costs, investments to develop the Frontier Areas could easily total over $80 billion by 1990 (excluding lease acquisition costs). To put this in perspective, it is one-third larger than the domestic industry's total net assets of about $60 billion at the start of 1975. Equally significant is the fact that $20–30 billion (excluding lease acquisition costs) must be spent before any significant production begins.

This sum will represent one-third to one-half of the total U.S. petroleum industry's investment in net assets at the beginning of 1975 and would be invested for a period of several years while interest charges accumulated with no offsetting income from production. This underscores the importance of earnings from existing production in supporting the development of new and higher cost replacement reserves.

It should be noted that while the costs in frontier areas are high, every additional barrel of U.S. domestic oil which can be produced at world prices is beneficial to the U.S. consumer compared with imports. Domestic oil is secure. It creates no balance-of-payments problem. Moreover, the tax and royalty components of the cost of domestic oil are simply a transfer of money within the U.S. economy. It is not a real resource cost as are the tax and royalty components of a barrel of foreign oil. These tax and royalty components of foreign oil give a foreign government a call on American goods and services for a share in American wealth. Thus, obtaining additional domestic oil at world prices is clearly in the best interest of the Nation.

In addition to the sharply higher costs projected for frontier oil and gas reserves, other related costs have increased sharply. For example, the cost of a new grass roots refinery has been affected by the very high rates of inflation

in the process construction industry, more stringent product quality requirements in terms of lead and sulfur content, and more intensive processing requirements due to heavier and higher sulfur crude slates. These factors have substantially increased both investment and operating costs. As a result, the cost of a typical grass roots refinery has tripled from about $100/BBL/Day of capacity in the mid-1960's to over $3000/BBL/Day in the mid 1970's.

The costs of alternative energy sources, such as synthetic fuels and nuclear power, are inherently higher than those for oil and gas. These capital intensive facilities have also been hit hard by inflation over the past few years. Exxon USA estimates that a typical 50 thousand barrel per day shale oil plant would cost upwards of $700 million, and a 250 million cubic foot per day synthetic coal gas plant would cost over $1 billion.

Putting all of these factors together, various sources have estimated that total capital expenditures for oil and gas will range from between $20–30 billion per year (in 1975 dollars) over the next decade. This is double to triple the expenditure levels of $8–10 billion per year during the 1960's and early 1970's (Attachment 2).

FINANCING CAPITAL EXPENDITURES

It is important to examine the petroleum industry's ability to finance these higher expenditures. Capital requirements must be met from retained earnings, new equity, new long term debt, and from reserves for depreciation and amortization. In turn, the availability of funds from each of these sources is strongly affected by fiscal policy.

During the 1960's and early 1970's petroleum industry capital expenditures ranged from $8–10 billion per year. During this same period, profitability, as measured by return on shareholders' equity, had been about the same as the returns for all manufacturing (Attachment 3). The only major exception was 1974 which is now generally acknowledged to be an unrepresentative year because of distortions caused by inventory profits, currency revaluations, etc. Preliminary data for 1975 (First National City Bank) indicate industry returns have fallen to 14.1 percent as compared to 12.4 percent for all manufacturing.

During most of the 1960's, the industry dividend payment rate was about 50–55 percent of earnings, and debt equity ratios over the period rose substantially. In fact, between 1965 and 1972 debt/equity ratios doubled. Note that the debt/equity ratios shown in Attachment 3 include long term debt only. If short term obligations and debt in the form of lease arrangements were included, it is estimated that debt equity ratios would be closer to 50 percent. Since about 1970, debt/equity ratios have stabilized, but this was accomplished by sharply reduced dividend payouts (by 30–50 percent) and greater reliance on retained earnings to finance capital requirements.

During this time period, capital expenditures more than doubled from $9 billion per year to around $19 billion in 1975. In view of the approximately 25 percent reduction in petroleum industry profits during 1975, these results raised serious questions about the industry ability to finance further sharp increases in capital expenditures from debt and/or retained earnings. These concerns are further intensified by the recent loss of percentage depletion, extension of oil price controls, and the continuation of natural gas price controls. Because of these factors the so-called tax reform proposals now being considered are of particular concern.

TAX REFORM PROPOSALS

In the House bill, H.R. 10612, we find not new tax policies to stimulate capital formation, but a multi-prong attack on the current tax treatment of intangible drilling and development costs (IDC) which would aggravate cash flow and capital formation problems as well as creating enormous complexity. The damaging features of the bill are the proposals to limit the current IDC deduction to income from the same property, add IDC to the minimum tax base, subject IDC to "recapture" rules upon certain dispositions, limit the deduction to the amount "at risk" and establish vague limitations on allocation of partnership deductions.

As passed by the House, several of these proposed changes would apply "only" to individuals. However, that is not much comfort to corporate taxpayers that remember that the present minimum tax, as originally passed by the House, applied only to individuals. Even if such proposals should be applied only to individuals, there would still be an adverse impact on many corporate members of the petroleum industry since these proposals would eliminate an important

source of funds for exploration and development programs. And we must not underestimate the importance of the individual independent oil man in the search for oil and gas.

Limitation on intangible drilling costs

Present law provides that intangible drilling and development costs (IDC) may be currently deducted. The House bill would limit the current deduction of IDC on most productive wells to the net income from the same lease or an individual deposit on that lease. Although the bill purports to exempt exploratory wells, the exemption is so narrow as to be virtually useless. Deferral of the IDC deduction would be required, for example, in cases in which a deposit cannot be produced in the year the IDC is incurred because of the time required to install necessary producing and transportation equipment. In some instances, the delay may be for several years, such as the case with the Alaska North Slope. Nevertheless, as a result of this proposal, the IDC deduction in such instances would be deferred even though the taxpayer might have sufficient oil and gas income from other leases to offset a current IDC deduction.

Not only would the IDC limitation decrease current cash flow with respect to drilling and producing operations, but it would tend to distort investment decisions. For example, the exemption from the proposed provisions for dry hole costs lowers the economic threshold at which it becomes more advantageous to abandon a marginal well to obtain the current deduction for IDC as dry hole cost than to continue production and recover such costs as income is received. Such premature abandonment would result in the permanent loss of production. Although the volumes lost might be small, each barrel would have to be replaced by additional imports. Similarly, the two-year requirement for exploratory well status would delay many deeper tests to new formations close to older production.

Minimum tax—Inclusion of IDC

In the case of individuals, the minimum tax base or "items of preference" would include any IDC that is currently deducted after the application of the limitations discussed above. The "preference" would be limited to the excess of the current IDC deduction over the amount which would be deducted in the current year if IDC were recoverable ratably over ten years. No adjustment would be made in later years to reflect higher regular taxes resulting from the lack of a ratable deduction in such later years. Coupled with the other detrimental changes to the minimum tax, i.e., an increase in rate to 14 percent, the abandonment of the "minimum" concept by elimination of the regular tax deduction and reduction of the $30,000 exemption, this proposal would further reduce the cash flow benefits of whatever current IDC deduction remains available to individuals. In fact, taxpayers would be worse off in many cases under the minimum tax proposal than if offered the option to capitalize IDC as part of the well facility cost subject to ADR depreciation and the investment tax credit. Such ridiculous distortion of the IDC incentive clearly underscores one of the basic fallacies of the minimum tax, failure to take into account timing differences.

Recapture of IDC

A new provision would require a portion of the gain on the sale of an oil or gas property to be treated as ordinary income. The amount subject to this "recapture" would be the excess of the IDC previously deducted on a property over the amount that would have been deducted if the IDC had originally been capitalized. However, the proposal overlooks the fact that the IDC incentive relates to the search for and development of new reserves and should not be arbitrarily taken back simply because the producer later sells the property.

Treating a portion of the proceeds from the sale of an oil and gas property as ordinary income would increase the tax cost of the sale, and thus reduce the after-tax benefit to the seller. For most major petroleum companies, the proposal would have little direct effect since they do not often sell producing properties. The primary effect would be on the smaller companies and independents who often sell producing properties to generate funds for new exploration and development. To discourage such activities is obviously contrary to the objective of increasing domestic energy self-sufficiency.

Limitation of IDC to amount at risk

The deduction for IDC would be limited to the amount the taxpayer has "at risk". Expenditures financed through non-resource loans would be deductible only as the loans are paid off. Although the impact of destroying this generally ac-

ceptable financing method cannot be quantified, it is certain to result in reduction in the level of expenditures in the search for oil and gas and is therefore counterproductive.

Limitation on special partnership allocations

The bill would apparently override the provisions of a partnership agreement as to allocation of deductions among partners in accordance with the portion of such costs paid by each, unless each partner can meet the almost impossible burden of showing that the allocation has no significant tax impact. If, as the House Committee Report says, the proposal is intended to reflect current law, there would appear to be no reason to change the current statutory language and create a whole new round of controversy as to the thrust of the new language.

Overall appraisal of tax proposals

We often find ourselves completely immersed in the minute details of complex tax proposals, reform or otherwise, to the extent we fail to see the forest for the trees. Obviously, we can postulate arguments under such catchy titles as minimum tax, recapture, and limitations on artificial losses. But, the fact remains, the IDC provisions of the tax laws enhance the attractiveness of investments in petroleum exploration, not only for producers but for many investors not directly involved in the operation of the business as well. It follows, therefore, that removal of the IDC provisions will decrease the amount of investment capital available to the petroleum industry, particularly to the independent producers. To effect this result in the face of the Nation's obvious energy and capital formation problems defies all sense of logic.

RECOMMENDED MEASURES TO STIMULATE CAPITAL FORMATION

The costs of replacing the Nation's dwindling inventory of oil and gas reserves is high, and the alternatives are limited. Either higher cost domestic resources are developed, thus adding to U.S. economic activity and reducing dependence on imports, or the course of greater reliance on imported oil can be chosen. Imports, however, will not be any cheaper for the U.S. consumer than domestic frontier reserves, and they will increase the Nation's economic and physical vulnerability to future embargoes. A third and even less attractive choice would be legislated energy shortages through mandatory limits on domestic energy consumption, with resulting direct and severe impacts on U.S. economic activity and employment.

The Nation can encourage the development of its domestic resources simply by adopting a sound energy policy. A major element of such an energy policy would be sound fiscal policies regarding energy exploration and development, capital formation and capital recovery. Because of the vital need for new oil and gas reserves and the long lead times involved, it is critical that the difficult problems be addressed now, for both the petroleum industry and for the overall economy as well. These include:

Increased fiscal responsibility at all levels of government to avoid rekindling the high rates of inflation which have had such a severe impact on the replacement costs of all industries, including petroleum;

Enactment of proposals that are designed to redress the bias in the federal tax system against savings and capital investment. Among the proposals are the following:

(*a*) Adoption of measures to integrate the personal and corporate income taxes in order to eliminate the double taxation on corporate earnings.

(*b*) Establishment of a permanent investment tax credit at a minimum level of 10 percent.

(*c*) A reduction in the corporate income tax rate.

(*d*) Modifications to capital gains taxes such as an inflation adjustment to the cost basis to eliminate the payment of taxes on illusory profits created solely by inflation.

Recognition of the impact of inflation on the capital recovery provisions applicable to all U.S. industries including petroleum. Depreciation of capital assets on a historical cost basis has been inadequate to provide for replacements at inflated prices. This problem has been greatly magnified for industries experiencing increasing real costs such as the petroleum industry. Proposals to accelerate capital cost recovery and avoid underdepreciation include: More rapid depreciation provisions; adjustment of the cost bases for depreciation through

price indexing or replacement cost accounting; and extension of accelerated depreciation provisions to depletable assets.

It is imperative that U.S. energy policies recognize the sharply higher costs which characterize Frontier Areas and alternate energy sources. These policies must provide an environment which permits industry the expectation of a reasonable return on investment. Unfortunately, in recent months, the need for the tremendous sums of capital required for Frontier Area development has been obscured by preoccupation with 1974 profits, which were above average due to the extraordinary circumstances discussed above. Efforts arising from this preoccupation have focused on price controls utilizing composite average pricing mechanisms rather than on removing restraints in order to facilitate development of Frontier Areas. It should be recognized that retained earnings from the production of existing oil and gas reserves are a vital source for the capital required to develop the Frontier Areas which are characterized by the high front end costs and the long lead times before production begins. It is critical that prices permitted in the Frontier Areas adequately reflect the higher costs and the sharply higher overall capital expenditures required to achieve the needed energy development.

Finally, it is imperative that proposals put forth under the guise of reform, but which in reality only serve to weaken further the petroleum industry's ability to attract the capital necessary to enhance U.S. energy self-sufficiency, be rejected.

ATTACHMENT 1

POTENTIAL CRUDE RESERVE ADDITIONS THROUGH 1990

	Current		To be added	
	Billion barrels	Percent	Billion barrels	Percent
Inland lower 48	21	62	17	34
Offshore lower 48 (pre-1975 leases)	3	9	2	4
Alaska and OCS frontiers	10	29	31	62
Total	34	100	50	100

CRUDE AND CONDENSATE PRODUCTION DISTRIBUTION

	1975		1980	
	Million barrels per day	Percent	Million barrels per day	Percen
Inland lower 48	7.0	84	3.8	37
Offshore lower 48 (pre-1975 leases)	1.2	14	.5	5
Alaska and OCS frontiers	.2	2	6.0	58
Total	8.4	100	10.3	100

ATTACHMENT 2

Capital expenditure projections (oil and gas only) [1], *1976–85 annual average,* [2] *billions of 1975 dollars per year*

FEA national energy outlook (February 1976)	25
Exxon (December 1975)	24
Sun Oil Co. (March 1976)	27
Standard of Indiana (June 1975)	30
Texaco (October 1975)	23
Standard of Ohio (May 1975)	29
Chase Manhattan Bank (March 1975)	31
Bankers Trust (January 1976)	20
First National Bank of Chicago (May 1975)	32
Joint Economic Committee staff (September 1975)	31.5
Average for the 10 yr 1965–74	9.5

[1] Not all projections are based upon the exact same set of facilities.

[2] In some cases, extrapolations or truncations were necessary to get an average for 1976–1985. Also, some projections were originally stated in other than 1975 dollars.

ATTACHMENT 3

HISTORICAL DATA—PETROLEUM INDUSTRY CAPITAL EXPENDITURES AND FINANCIAL PERFORMANCE

Year	Capital[1] expenditures (billions of dollars per year)	Return on net worth[2] (shareholders, equity)		Dividends as a percent of net income[3]	Debt/equity ratios[3]
		Petroleum	All manufacturing		
1963	6.1	11.5	11.6	49	15
1964	6.8	11.5	12.6	52	15
1965	7.0	11.9	13.9	52	16
1966	7.8	12.6	14.2	50	18
1967	8.3	12.8	12.6	50	20
1968	9.1	13.1	13.3	51	24
1969	8.9	12.1	12.5	56	24
1970	8.9	10.9	10.1	58	27
1971	8.0	11.2	10.8	54	29
1972	9.9	10.8	12.1	56	30
1973	11.5	15.6	14.8	35	29
1974	17.6	19.7	15.5	29	28
1975	[4] 19.0±	[5] 14.1	[5] 12.4	[6] 38	NA

[1] U.S. capital expenditures source: Chase Manhattan.
[2] Source: FNCB.
[3] Source: Chase Manhattan Group of 30. Note debt-equity ratios based on long-term debt only. Other debt forms such as long-term lease arrangements are not included.
[4] Preliminary estimate.
[5] Preliminary estimates from FNCB.
[6] Preliminary Exxon estimate based upon data publicly available at this time.

STATEMENT OF W. R. YOUNG, VICE CHAIRMAN OF THE BOARD OF DIRECTORS AND GENERAL COUNSEL, TEXACO INC., IN BEHALF OF THE AMERICAN PETROLEUM INSTITUTE, MID-CONTINENT OIL AND GAS ASSOCIATION, ROCKY MOUNTAIN OIL AND GAS ASSOCIATION, AND WESTERN OIL AND GAS ASSOCIATION

SUMMARY OF PRINCIPAL POINTS

1. U.S. must continue reliance on foreign source oil

Imports are increasing currently. Energy self-sufficiency cannot be attained by 1985. Under most favorable circumstances foreign imports will supply 50 percent of U.S. demand for petroleum liquids by 1990. If investments remain at current levels largely because of governmental actions, imports could rise to 70 percent by 1990.

2. Our national security requires U.S.-owned oil companies abroad

This is necessary to assure an equitable allocation of oil to the United States, particularly in times of crisis.

3. Tax policies must keep U.S. companies competitive abroad

U.S. foreign tax credit system has historically prevent double taxation. Foreign nations prevent double taxation of their investors and provide other tax and non-tax advantages for foreign investment which exceed benefits available to U.S. companies.

4. U.S. tax policies have not resulted in lessened domestic investment or employment

If forced to abandon foreign investments, petroleum companies will not automatically reinvest similar amounts in domestic oil activities.

If U.S. petroleum companies are forced to retreat from foreign areas, the result will be loss of earnings, jobs, and less total investment in the United States.

Income from American petroleum investments abroad have exceeded net outflows of capital from U.S.

5. Tax Reduction Act of 1975 has made U.S. petroleum companies less competitive abroad

Revisions made by the Act were directed solely at oil companies. They included: (1) restrictions on amount of foreign tax credit available, including

elimination of election to utilize per-country method; (2) adoption of arbitrary distinctions between oil and non-oil income.

6. New tax proposals would further harm operations of oil companies abroad

Proposals to further restrict or eliminate foreign tax credit and to accelerate U.S. taxation of earnings of foreign subsidiary corporations should not be enacted.

My name is Wilford R. Young. I am Vice Chairman of the Board and General Counsel of Texaco Inc., and I am appearing today on behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association. This statement will supplement my oral remarks on United States taxation of foreign source income.

Continued Reliance on Foreign Oil

We must be realistic in forecasting the long term energy supply and demand situation in the United States and in particular the projections of United States petroleum production and the need for imported petroleum. Available domestic crude oil and natural gas reserves have been dropping since the late 1960's and the decline in the petroleum industry's finding rate has been accompanied by soaring costs of exploration and development.

The United States is presently obliged to import about 45 percent of its liquid petroleum needs. Latest figures available to the American Petroleum Institute show that imports during the week ended March 12 rose to a record 8.2 million barrels per day from 7.8 million barrels the previous week. In fact, it was reported last week that for the first time in our Nation's history the volume of imported petroleum liquids exceeded domestic crude oil production.

This reliance on imports will undoubtedly continue. It is an illusion to believe that the U.S. can attain energy self-sufficiency by 1985, as originally envisioned by the 1974 Project Independence report. The recent report by the Federal Energy Administration points out the continued need for imports and makes even more vital the task of increased exploration for domestic oil and natural gas.

Texaco's own studies indicate that under the most favorable circumstances, domestic production of liquid petroleum would only reach 12.9 million barrels a day by 1990. But it is more probable that production in the United States may not rise above 10.5 to 11 million barrels a day, even after oil starts flowing from the North Slope of Alaska.

By 1990, assuming that the private petroleum industry were permitted to earn and invest capital at a maximum practical rate, foreign imports would be supplying about 50 percent of United States demand, or about 12 million barrels a day. However, if investments are held at or near current levels largely through government actions which restrain earnings, such as continued price controls and regulation of virtually all phases of our business, additional imports of liquid petroleum will be required to replace the lower domestic production of both liquids and natural gas. In this case, imports of liquid petroleum could rise to more than 70 percent of requirements by 1990, or about 20 million barrels a day, compared with present levels of somewhat more than 7 million barrels a day. These figures certainly pose unacceptable risks for the national security and the economic well-being of our country.

Need for U.S. oil companies abroad

It is apparent, therefore, that despite substantial efforts to increase domestic production, we will continue for many years in the future to be dependent upon oil imports to meet our energy needs. Moreover, unless actions are taken now to find additional secure foreign sources of supply, the United States will find itself increasingly dependent on oil imports from the Middle East, which is the world's only great reservoir of discovered-but-undeveloped reserves.

Under these circumstances, it is clearly in the best interest of the Nation to protect the competitiveness abroad of American-owned oil companies. In addi-

tion to the oil exploration and development efforts in countries outside of OPEC, e.g., in the North Sea, private international oil companies continue largely to provide the industry's essential needs for efficient logistics and marketing organizations, technological developments, managerial capabilities, and mobilization of capital. The withdrawal of United States oil enterprises from operations abroad would leave this country substantially dependent for its essential foreign supplies upon companies owned in whole or in large part by foreign governments.

With an American presence in the international oil industry, it is much more likely that an allocation of oil supply equitable to the United States, as well as to others, will be achieved in the event of an international oil crisis. This lesson was re-emphasized in the Arab oil embargo two years ago. In the words of the Senate Subcommittee on Multinational Corporations: [1]

". . . U.S. companies decided that 'the pain should be evenly spread' . . . [and] helped to blunt the edge of the Arab oil weapon by redistributing global supplies so that the constriction of supplies was fairly evenly allocated rather than targeted specifically against the United States and the Netherlands.

U.S. tax policies must keep companies competitive abroad

The two primary goals of U.S. taxation of foreign source income of American companies have historically been to assure: (1) that the United States will avoid international double taxation of American foreign investments in order to preserve their competitiveness with foreign based companies; and (2) that the United States will treat like investments at home and abroad equally in order to avoid having tax policy stimulate foreign investment at the expense of domestic investment. This long standing policy must be continued if we are to achieve our energy goals, i.e., to accelerate domestic production and development and at the same time to encourage American firms to continue the necessary search for oil abroad.

Since 1918 the United States has attempted to achieve this equality of foreign/domestic tax treatment and to avoid double taxation of foreign source income earned by its nationals by allowing foreign income taxes as a credit against the United States tax liability on foreign source income.

The foreign tax credit is not, however, the only way to eliminate double taxation. Many other international trading countries adopt in whole or in part the so-called territoriality principle under which foreign earnings are not taxed at all in the home country, generally provided such earnings are subject to tax in the country where earned. The U.S. does not use this system but has instead chosen to tax worldwide income of its citizens and corporations, with the protection of the foreign tax credit.

The U.S. foreign tax credit assures that the foreign operations of U.S. companies bear the higher of the U.S. or foreign income tax rates, and thus neither favors nor penalizes investment abroad relative to investment in the United States. Without the foreign tax credit, U.S. companies generally would bear an income tax rate on foreign operations that is about 50 percent higher than their foreign competitors, thereby making it impossible to compete successfully against the foreign companies.

The foreign tax credit can never be used to offset U.S. tax on U.S. source income. In recent years misunderstandings and mistatements of this principle have become commonplace in the press and among critics of the petroleum industry.

The per-country method of computing foreign tax credit has been part of the U.S. tax law since 1932. Since 1961, and until enactment of the Tax Reduction Act of 1975, the taxpayer has been permitted the flexibility of calculating the limitation on allowable foreign tax credit on either a per-country or overall

[1] U.S. Senate, Subcommittee on Multinational Corporations of the Committee on Foreign Relations, "Multinational Oil Corporations and U.S. Foreign Policy" (Washington: Government Printing Office, 1975) pp. 147–148.

basis. This flexibility which was prohibited as to the oil companies, under the 1975 Act, effective in 1976, is necessary to permit U.S. business to compete internationally with foreign companies. This is particularly the case with smaller companies where a considerable part of their foreign operations consists of risk ventures. It is also true of companies of any size wishing to expand their present operations to new areas, including underdeveloped countries, which involve serious risk of losses. If such companies do not have the option of electing the per-country limitation method, the economics of a new business venture will be worse than those of foreign competitors.

In general, as noted in Appendix II, most trading nations either allow a foreign tax credit or follow the so-called territoriality system in taxing the foreign activities of its citizens and corporations. The obvious result of abandonment of the foreign tax credit concept by the U.S., as has been proposed by some, would be that U.S. companies would rapidly be driven out of foreign activities. Not only do foreign nations prevent double taxation of their investors but they also provide other tax and non-tax advantages for foreign investment which in some cases far exceed the total benefits available to U.S. companies. See Appendix I, attached.

It should be noted that even prior to the restrictions in the Tax Reduction Act of 1975 the U.S. was discriminating in many respects against foreign investment. The investment credit is not today allowable for foreign capital expenditures and the principal benefits of the Asset Depreciation Range system are not available with respect to foreign assets. In general, as pointed out by Treasury Secretary William E. Simon in his appearance before this Committee in June last year, the U.S. system for general capital cost recovery is inferior to that of most foreign countries.

Tax policies have not resulted in lessened domestic investment or employment

Some of the proposals to reduce or eliminate foreign tax credits have been motivated by a desire to force companies to invest in the U.S. as opposed to foreign areas. The proponents seem to believe that if petroleum companies were compelled to abandon foreign investments, they would automatically reinvest similar amounts in domestic oil activities. This reasoning is fallacious. First, domestic investments must themselves be viable from an economic standpoint. Investments will not be undertaken in the U.S. or abroad if the economic return is insufficient. If such investments were undertaken by governments rather than private enterprise, in the final analysis the same rules would apply since Government must finance its activities within its means or suffer a nationwide decrease in national wealth or standard of living.

Secondly, over many years foreign investment has been a revenue-generating source of earnings for international companies. If U.S. petroleum companies are forced to retreat from foreign areas, the result would be loss of U.S. earnings, jobs, and less total investment.

~~Far from~~ exporting jobs the evidence indicates that U.S. international companies in general have increased jobs at home at above average rates. In the petroleum industry, in particular, there are substantial indirect benefits from foreign direct investments. In addition to the oil companies themselves, a great number of U.S. citizens are employed by the technical and contracting firms, and substantial amounts of supplies are purchased in the U.S. relating to the foreign activities of U.S. companies. If our foreign activities should be concentrated further in foreign competitors—and in particular government companies—it is unlikely that this level of purchases and employment in the U.S. would continue.

For many years income remitted to the United States from American petroleum investments abroad has exceeded the net outflows of capital from the United States to finance such investments by an average of about $1 billion annually ($3 billion in 1973) exclusive of about $0.5 billion of foreign earnings reinvested annually abroad. In addition to these direct earnings, United States foreign petroleum investments also resulted in increased income to the United States from substantial American exports of oil-related equipment, supplies and services for use in American-owned facilities abroad.

In the case of Texaco, over the past five years total income earned in the United States has been $2.1 billion and total income earned abroad has been $3.1 billion. Capital and exploratory expenditures incurred in the United States have been $4.7 billion as compared to expenditures outside of the U.S. of $2.7. The data show that during this period expenditures in the United States have been more than twice the earnings in the United States.

The Tax Reduction Act of 1975 has made the U.S. petroleum industry less competitive abroad

Provisions of the Tax Reduction Act of 1975 which were directed solely at the oil industry have had the effect not only of discriminating against the U.S. oil industry as compared to other U.S. industries, but have discriminated against the U.S. oil industry in relation to foreign competitors. The significant changes made by the Act involved (1) restrictions on the amount of credit for foreign taxes, including elimination of the election to utilize the per-country method of calculating foreign tax credit, (2) the adoption of onerous recapture provisions, and (3) the creation of arbitrary distinctions between oil and non-oil income.

The limitation on the amount of creditable tax seriously erodes the principle of the overall credit limitation and the option to use the per-country limitation was denied entirely insofar as oil-related income is concerned.

Fracturing of Income under 1975 Tax Reduction Act

The fracturing of foreign source income between oil-related and other income is arbitrary and discriminatory. No significant distinctions are made between any other types of foreign income. These provisions weaken, for example, the competitive position of fully integrated American petroleum-chemicals businesses in competition with those foreign-based companies whose foreign taxes may be treated as a whole or whose foreign operations are not taxed at all by their home governments.

With respect to the petroleum industry limitation on the overall foreign tax credit, oil companies should be allowed to apply foreign tax credits from extractive activities to all other foreign source income, instead of only to foreign oil and gas related-income. This would help to restore for the oil industry the basic principle of the overall foreign tax credit, which applies without such restrictions to all other industries.

Technical problems of 1975 Tax Reduction Act

In addition, perhaps due to the haste in which the 1975 changes were enacted, there are many technical questions of interpretation which make it difficult for taxpayers to know the tax results of future activities. There are also several technical errors and apparent oversights. In the latter category is the apparent omission of interest income from U.S. incorporated oil companies operating abroad as oil-related income, whereas such income from foreign affiliates would be oil-related.

The loss recapture provisions could lead to double taxation. They require the restoration of losses to U.S. source income and the reduction of foreign tax credits in proportion to the amount of income recaptured. This could result in U.S. tax not only on the income recaptured but also on a portion of foreign income in the year of recapture.

Elimination of so-called "deferral"

As to the other foreign tax proposals now pending, we strongly oppose the elimination of so-called "deferral" of the taxation of earnings of controlled foreign subsidiaries. The reference to deferral is a misnomer in this case since the proposal is really to tax currently unreceived earnings from foreign subsidiaries, and represents a startling departure from international and domestic tax practice in this area. As shown in the attached Appendix II, almost all major countries defer taxation of undistributed earnings.

Foreign income provisions of H.R. 10612

With respect to the foreign income provisions of H.R. 10612 we have the following comments:

1. We favor the provision making rulings under section 367 of the Internal Revenue Code no longer necessary for certain transactions and providing for retroactive rulings in other cases.
2. We oppose the elimination of the per-country limitation for non-oil income and the proposal for recapture of losses.
3. We favor the elimination of the U.S. withholding tax on dividends and interest paid to nonresidents.
4. We oppose the elimination of the earned income exclusion of section 911 of the Internal Revenue Code.
5. We urge that the Western Hemisphere Trade and DISC provisions be continued.
6. We endorse the amendments to section 956 of the Internal Revenue Code to the extent that they allow investments in U.S. property without taxation.
7. We do not favor the gross-up of dividends from less-developed country corporations.
8. We oppose the limitations on the foreign tax credits with respect to foreign source capital gains.

CONCLUSION

In solving U.S. energy needs it would be futile to rely on a purely domestic approach for our petroleum supplies. Even our best efforts in the United States will not prevent a growing energy dependence on foreign nations. To reduce our vulnerability to the concerted actions of a few foreign oil producing nations, we should therefore expand our foreign sources of petroleum supply.

To do this it is imperative that we have a fair and competitive system for taxing income from foreign sources. As a step in this direction, the penalty provisions in the Tax Reduction Act of 1975 should be repealed. The Congress also should give serious consideration to other measures to counter and equalize the competitive advantages created by foreign governments for petroleum companies owned by their nationals.

APPENDIX I

Summary Statement of Tax Treatment and Other Provisions for Foreign Petroleum Operations by Companies Domiciled In:

(1) France, Does not tax. Other Provisions: None for private companies. (Government finances wholly-owned government company and owns substantial interest in large private company).

(2) Japan, Taxes on overall basis with credit. Other Provisions: Allows deductions for reserve for overseas exploration and deductions for reserve for losses in overseas investment. Exploration loans of up to 50% not repayable in the event of failure; government guarantees of bank loans for exploration and development; percentage depletion at 15% with reinvestment requirement; expensing of dry holes.

(3) Netherlands, Does not tax, if taxed by host country. Other Provisions: Allows deduction of foreign losses from domestic income.

(4) United Kingdom, Taxes on per country basis with foreign tax credit allowed limited to average amount of corporation tax attributable to income. Other Provisions: Expensing of all pre-discovery costs & dry holes; expensing of plant and machinery expenditures; rapid depreciation of fixed structures.

(5) West Germany, Tax exempt or taxes on the per country basis with credit. Other Provisions: Expensing of all exploration costs; rapid depreciation of tangibles and intangibles. Allows deduction of a net foreign loss.

(6) United States, For taxable years ending after December 31, 1975, taxes on the overall basis with credit. Other Provisions: Expensing of dry holes and intangibles on producing wells (but not deduction of prediscovery costs other than dry holes, until properties are abandoned). Allows deduction of a net foreign loss, subject to recapture against future oil-related income by limiting the foreign tax credits available with respect to the future years.

APPENDIX II

TAXATION OF INCOME OF FOREIGN BRANCHES: DIVIDENDS AND INTEREST FROM FOREIGN SUBSIDIARIES UNDER THE TAX SYSTEMS OF CERTAIN MAJOR COUNTRIES IN THE FREE WORLD

Country and basis of taxation	Foreign branches		Income from foreign subsidiaries	
	Taxability of income	Treatment of foreign income taxes	Dividends	Interest
Australia: Incorporation	Taxed at normal rates but exempt if subject to taxation by host country. Note: Foreign branch losses are deductible except for cases where net income, if it had been received, would be exempt from taxation.		Exempt if taxed by host country	Exempt if taxed by host country or a foreign tax credit will be allowed.
Austria: Incorporation	Taxed at normal rates. Exempt if subject to tax by host country.[1]	Credit under per country limitation	Taxed at normal rates, with direct taxes as a credit.	Taxed at normal rates.
Belgium: Residence	Taxed at reduced rate. Exempt under most treaties.[2]	Deduction only	90 percent, 95 percent or 105 percent dividend exclusion. Deemed paid credit of 5 percent of net.	Net interest taxed at normal rate. 15 percent deemed paid credit if taxed in foreign country.
Canada: Residence	Taxed at normal rates plus an additional tax of 25 percent on aftertax profits (unless modified by treaty).	Credit under per country limitation with 5-yr carry-over provision.	Exempt	Taxed at normal rates.
Denmark: Residence	Taxed at 50 percent of normal rate. Full deduction of losses.[2]	Credit under per country limitation	Taxed at normal rates. Tax credit under deemed paid system.	Taxed at normal rates.
Finland: Incorporation	Taxed at normal rates. Exempt under most treaties.[2]	Credit under per country limitation. No carryback/forward.	Taxed at normal rates	Taxed at normal rates.
France: Incorporation	Exempt from taxation[1]		Taxed at 5 percent of normal rate and foreign tax credit for direct taxes.	Taxed at normal rate, credit for withholding taxes.
Germany: Incorporation or mind and management.	Taxed at reduced rates. Exempt under most treaties.[2]	Credit under per country limitation	Exempt, or the foreign tax credit may be deducted under deemed paid system.	Taxed at normal rate. Credit for withholding taxes.
Greece: Incorporation	Taxed at normal rates[1]	Credit	Taxed at normal rates	Taxed at normal rate.

See footnotes at end of table.

APPENDIX II

TAXATION OF INCOME OF FOREIGN BRANCHES: DIVIDENDS AND INTEREST FROM FOREIGN SUBSIDIARIES UNDER THE TAX SYSTEMS OF CERTAIN MAJOR COUNTRIES IN THE FREE WORLD—Con.

Country and basis of taxation	Foreign branches		Income from foreign subsidiaries	
	Taxability of income	Treatment of foreign income taxes	Dividends	Interest
Indonesia: Incorporation	Exempt		Exempt	Taxed at normal rates. Foreign tax credit allowed.
Italy: Incorporation	Taxed at normal rates [2]	Credit allowed to a limited extent	Taxed at normal rates and foreign tax credit to a limited extent.	Taxed at normal rates.
Japan: Incorporation	Taxed at normal rates and a foreign tax credit is allowed. Note: Foreign branch losses are deductible except for determination of foreign tax credit.	Credit under overall limitation	Taxed at normal rates. Foreign tax credit allowed.	Taxed at normal rates. Foreign tax credit allowed.
Netherlands: Residence	Income exempt if taxed by host country, losses allowed against domestic income, with a carry-over provision.		Exempt, if subject to tax by country of source.	Taxed at normal rate.
Norway: Residence	50 percent of income taxed at normal rate. Exempt under most treaties.[2]	Deduction	Taxed at normal rates with credit for taxes withheld at source.	Net received taxed at normal rates.
Spain: Incorporation	Taxed at normal rates. Exempt under most treaties if taxed by host country.[2]	Credit under per country limitation	Taxed at normal rate. Foreign tax credit under deemed paid system.	Taxed at reduced rate.
Sweden: Incorporation	Taxed at normal rate. Exempt under most treaties if taxed by host country.	Credit under per country limitation	Exempt	Taxed at normal rate.
United Kingdom: Residence	Taxed at normal rate [2]	Credit under per country limitation	Taxes at normal rate with foreign tax credit under deemed paid system.	Taxed at normal rate.
United States: Incorporation	Taxed at normal rate [2]	Credit, under either the overall or per country limitation (except in the case of the oil industry).	Taxed at normal rate with foreign tax credit under deemed paid system.	Taxed at normal rate.

[1] No tax benefit from net foreign branch losses.
[2] Similar tax treatment for foreign branch losses.

Source: American Petroleum Institute.

Exxon Company, U.S.A.'s Energy Outlook, 1976–90

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INTRODUCTION

At Exxon Company, U.S.A., projecting the nation's energy environment five, ten, or fifteen years into the future is essential to the formulation of long-term business goals. Why look so far ahead? The main reason is that long leadtimes are required to bring an oil or gas field into production, build refineries, construct pipelines, and develop new and improved technology. Consequently, the necessary plans and capital investment decisions must be made many years in advance. Projections of the future energy environment provide an informed basis for these critical, long-range decisions involving millions of dollars.

The most recent of these projections is Exxon USA's assessment of the U.S. energy outlook for the period 1976 through 1990*. The assessment is based on our analysis of activities in the nation's governmental, economic, and technological spheres. Because this study deals with national energy matters that concern all Americans, we present its major findings in this booklet. The projections presented in the following pages are not intended to be firm predictions. Any investigation into the future can deal only in reasonable possibilities, and no single view of the future can satisfactorily accommodate the complexities of the energy problem. It is hoped, however, that this booklet will help clarify basic issues and provide a useful frame of reference for evaluating other perspectives on the nation's energy future.

We will begin our discussion with an outline of the key assumptions on which we have based our projections, followed by the energy supply/demand outlook itself, and a brief concluding examination of U.S. energy policy options that could affect the projections of our Energy Outlook.

BASIC ASSUMPTIONS

The conclusions of Exxon USA's Energy Outlook are tied closely to specific assumptions about future circumstances affecting U.S. energy supply and demand. Our Outlook is, in effect, a scenario of what the U.S. energy environment is likely to be over the next 15 years should certain assumptions hold true. Any significant variation from these all-important bases could considerably modify our projections. We present here some of the more fundamental of these assumptions.

Government policy

Government will not mandate curtailment of energy consumption below levels necessary for adequate national economic growth or enforce use of certain fuels in preference to others. Government policies will facilitate expanded energy development, increase the leasing rate of offshore acreage as well as oil shale and coal acreage, moderate the delays in nuclear plant licensing and sting, and maintain a realistic balance between energy, economic, and environmental goals. Government policies will not reduce the availability or inhibit the formation of capital funds required by the energy industries.

The Economy

The nation will continue its recovery from the 1974–1975 recession. There will be long-term growth toward full employment. Higher energy costs will divert

*This assessment is an update of the one presented in Exxon USA's booklet, "Energy Outlook, 1975–1990." While our new projections differ in degree from the earlier ones, their overall implications for the nation remain unchanged.

some capital from investment in labor-saving equipment, resulting in lower than historic gains in productivity. Primarily for this reason, long-term growth in real GNP will be somewhat below historic growth rates.

The environment

Full attainment of secondary air quality standards will be delayed temporarily to permit greater use of coal. Flue gas desulfurization facilities for coal-fired utility plants are expected to be commercially available by the late 1970's or early 1980's.

Energy demand

Oil imports will be available as needed. Energy prices will increase at about the U.S. inflation rate. Higher energy prices will significantly affect energy consumption, both depressing demand growth and influencing the mix of fuels utilized.

U.S. ENERGY DEMAND BY CONSUMING SECTOR

SHARE OF TOTAL U.S. ENERGY DEMAND

[In percent]

	1960	1976	1980	1990
Nonenergy	9	8	9	9
Industrial	37	34	33	33
Transportation	24	25	24	22
Residential/commercial	30	33	34	36
Total	100	100	100	100

Total U.S. energy demand is projected to increase from an estimated 38 million barrels per day oil equivalent in 1976 to 56 million barrels per day in 1990. High energy costs, conservation efforts, and slower economic growth over the forecast period will cause the growth in U.S. energy demand to average about 2.8 percent annually, compared with 4 percent during the 13 years prior to the embargo, 1960–73. For purposes of evaluation, Exxon divides energy demand into the following sectors:

Non-energy

The Non-Energy sector reflects the utilization of oil, gas, and metallurgical coal as feedstock or raw materials, rather than as fuel, in the manufacture of such products as petrochemicals, asphalt, wax, carbon black and steel. The energy demand growth rate in this sector will show little change from historic rates.

Industrial

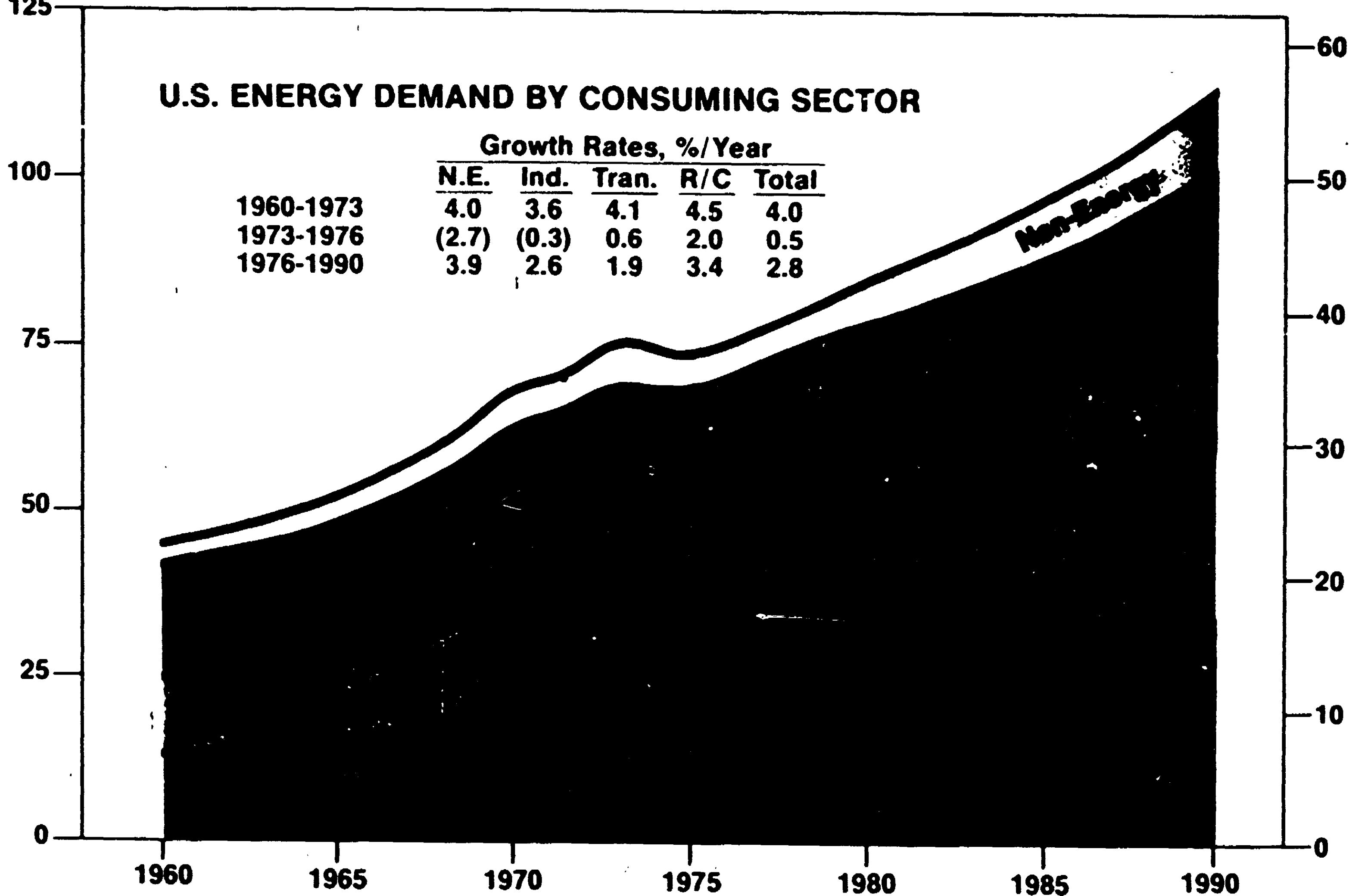
This sector includes all mining and manufacturing industries. The growth rate in industrial energy demand will decline sharply through 1980, due in part to rapid improvements in energy-use efficiency and slower economic growth, then increase as efficiency improvement slows and economic growth continues. Gas, oil, coal, and electricity contribute to the sector, with gas continuing as the predominant fuel but declining in its share of total sector demand from about 50 percent in 1976 to about 30 percent by 1990.

Transportation

Transportation is almost entirely dependent on oil. Average annual energy demand growth will drop significantly below the historic rate. This sector will account for about half of total oil consumed through 1990. Motor gasoline currently accounts for three-quarters of transportation demand; remaining demand is for aviation and diesel fuels, heavy fuel oil, and liquefied petroleum gas.

Residential/Commercial

This sector includes homes, stores, office buildings, hospitals, and schools. The sector's projected growth rate in energy demand will decline from that of the 1960–73 period. Demand growth will be met primarily by gas and electricity. Heating oil consumption will increase only moderately.


QBTU/Y*
M̄B/DOE*
125
100
75
50
25
0
60
50
40
30
20
10
0
U.S. ENERGY DEMAND BY CONSUMING SECTOR
Growth Rates, %/Year
N.E. Ind. Tran. R/C Total
1960-1973 4.0 3.6 4.1 4.5 4.0
1973-1976 (2.7) (0.3) 0.6 2.0 0.5
1976-1990 3.9 2.6 1.9 3.4 2.8
Non-Energy
1960
1965
1970
1975
1980
1985
1990
*2 Quadrillion British Thermal Units Year
1 Million Barrels Day Oil Equivalent

TOTAL U.S. ENERGY SUPPLY

SHARE OF TOTAL U.S. ENERGY SUPPLY

[In percent]

	1960	1976	1980	1990
Nuclear		3	5	16
Hydro/Geo	4	4	4	3
Coal	22	18	20	20
Gas	30	28	22	17
Oil	44	47	49	44
Total	100	100	100	100

Nuclear

Nuclear energy is confined to electric utility use. Although its development continues to be plagued by construction, regulatory, and siting delays, nuclear energy is expected to be the nation's fastest growing source of energy, supplying 16 percent of total U.S. energy demand by 1990, compared with about 3 percent in 1976.

Hydro and geothermal

Hydro and geothermal power will supply about 3 percent of total U.S. energy requirements by 1990, down slightly from today's share. Hydro power's share of electric power generation will decline from a current 16 percent to 10 percent by 1900. The contribution of geothermal power to total electric power generation is expected to remain negligible through 1990. These two energy sources have limited growth potential due to technological problems and insufficient site availability.

Coal

Coal supply will essentially be determined by demand. Coal use by electric utilities is expected to increase rapidly through 1980, then level off as nuclear power captures most of the growth. After 1980, the most rapidly expanding use of coal will be as an industrial fuel.

Gas

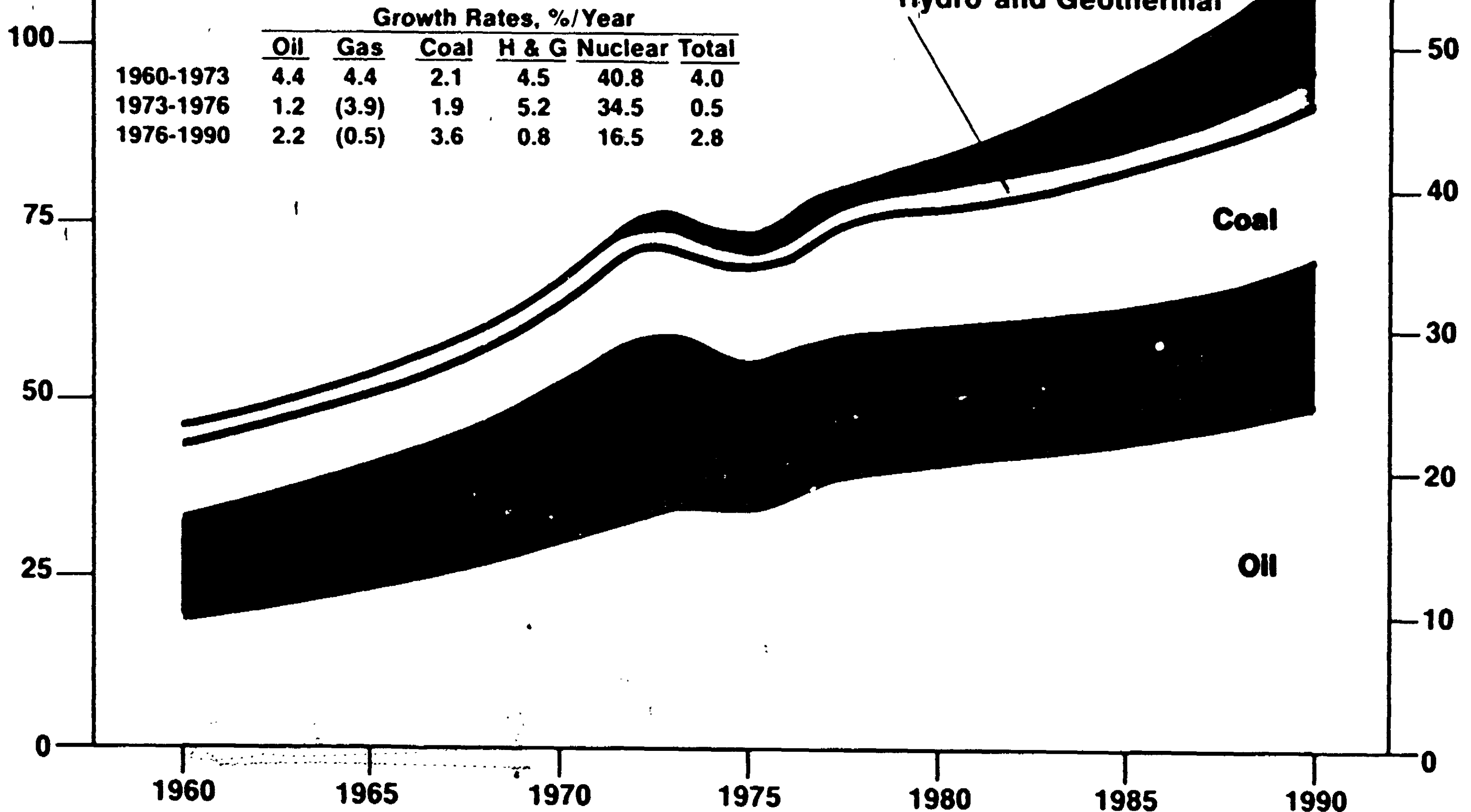
Limited availability of gas will pace additional burdens on other energy resources, particularly oil, to meet industrial fuel needs. Gas consumption by the electric utility sector will decline as coal-fired and nuclear-powered generators become dominant. Gas imports are not expected to increase significantly in the future.

Oil

Oil will remain the predominant fuel through 1990, although its share of total energy demand will return to the 1960 level of 44 percent. Oil consumption by electric utilities in particular will decline from today's levels. Oil imports are projected to increase to 50 percent of total oil demand by 1980 and begin to level off thereafter.

Alternate energy sources

Potential energy sources such as solar power and the breeder reactor are not expected to be commercially available on a significant scale before 1990. One or more of these sources, however, could begin to make an important contribution before the end of this century. Energy from nuclear fusion could become commercially available early in the next century.


QBTU/Y*
MB/DOE*
TOTAL U.S. ENERGY SUPPLY
Growth Rates, %/Year
Oil Gas Coal H & G Nuclear Total
1960-1973 4.4 4.4 2.1 4.5 40.8 4.0
1973-1976 1.2 (3.9) 1.9 5.2 34.5 0.5
1976-1990 2.2 (0.5) 3.6 0.8 16.5 2.8
Hydro and Geothermal
Coal
Oil
125
100
75
50
25
0
60
50
40
30
20
10
0
1960
1965
1970
1975
1980
1985
1990
*2 Quadrillion British Thermal Units/Year = 1 Million Barrels/Day Oil Equivalent

U.S. NUCLEAR SUPPLY

TOTAL U.S. NUCLEAR SUPPLY

	1976	1980	1985	1990
Nuclear capacity (1,000 mw)	48	83	180	300
Uranium requirements[1] (million pounds per year)	24	47	73	117

[1] Includes 8 yr forward reserve.

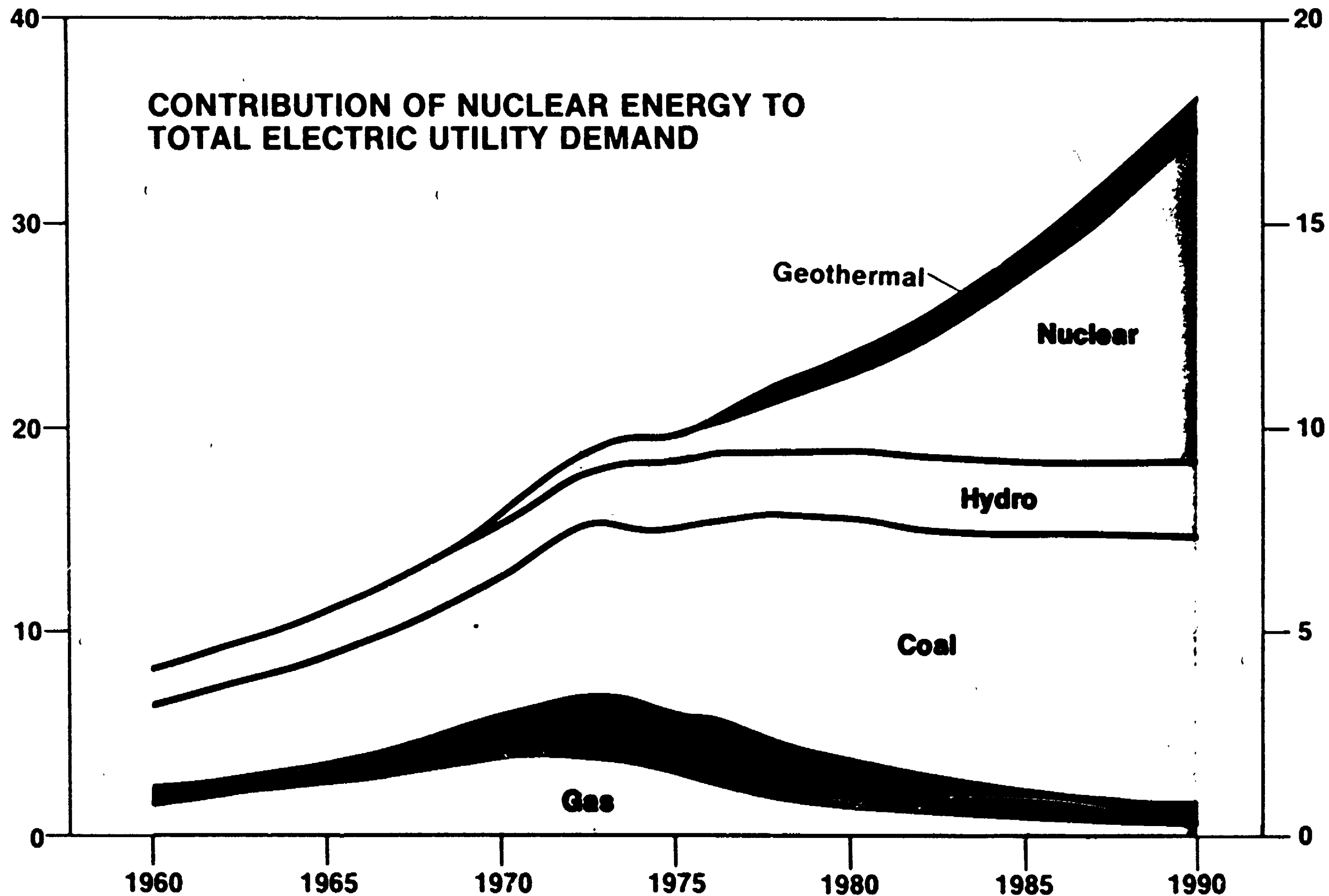
Nuclear energy is confined to the electric utility sector and is therefore shown here in relation to total electric utility fuel demand. Electricity generated by nuclear energy could be the nation's fastest growing energy source, rapidly replacing oil and gas in utilities. By 1990 nuclear could supply about half of U.S. electricity demand, compared with about 10 percent in 1976. Slightly more than 60 nuclear plants with a total production capacity of about 48,000 megawatts are projected to be operating in the U.S. by the end of 1976. Technical, licensing, and financial problems have continued to retard the growth of nuclear capacity. In 1975 alone, 100,000 MW of planned additional nuclear capacity was canceled or deferred. Longer-term, nuclear growth could be limited by uranium availability.

Uranium resources

Approximately 95 percent of known U.S. uranium reserves are located in sedimentary basins in the western U.S. Many such sites have not been adequately explored. Atomic Energy Commission (now ERDA) estimates indicate that existing domestic inventories and proven reserves of uranium, all totaling about 1.0 billion pounds, can meet the nation's needs into the early 1980's. Higher-cost potential reserves could meet capacity projections through 1990. In order to supply forecast nuclear capacity completely from domestic resources, uranium reserve additions would have to average 65 million pounds annually between 1975 and 1990. From 1967 through 1974, an average of 60 million pounds per year was added to reserves. Because eight to ten years are required to develop a uranium mine and associated milling facilities. U.S. self-sufficiency in uranium through 1990 will depend on the success of exploration undertaken in the 70's.

Imports

Nearly two-thirds of the Free World's proven uranium reserves are in Canada, South and Southwest Africa, and Australia. Because of uncertainties as to ultimate domestic uranium potential beyond 1990, the U.S. government plans to gradually phase out uranium import restrictions between 1977 and 1984.



*2 Quadrillion British Thermal Units Year 1 Million Barrels Day Oil Equivalent

U.S. COAL SUPPLY

TOTAL U.S. COAL SUPPLY

[Million tons per year]

	1960	1976	1980	1990
Eastern production	420	580	595	560
Western production	14	80	200	580
Total	434	660	795	1,140

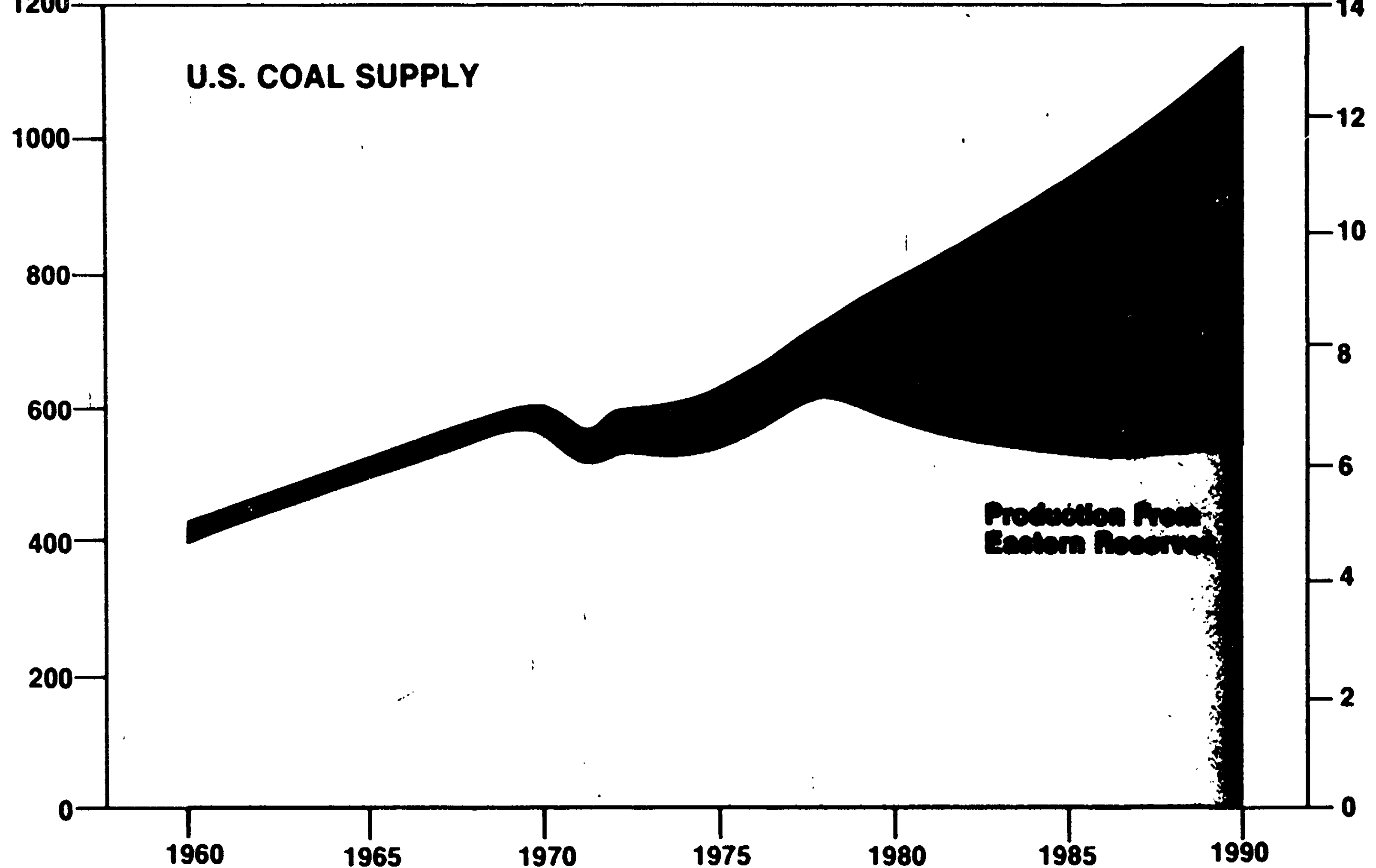
Coal reserves are abundant, accounting for 90 percent of all known U.S. fossil fuel resources. By 1990 domestic production is projected to reach 1.1 billion tons annually, compared with estimated 1976 production of 660 million tons. These figures include exports of metallurgical coal amounting to about 55 million tons annually through 1990. The largest user of coal is electric utilities, accounting for almost three-fourths of domestic coal demand in 1976 and almost two-thirds of domestic coal demand by 1990. The pace at which new coal supplies are developed will depend on such factors as coal prices, availability of skilled manpower, the nature of surface mining legislation, the timely development of flue gas desulfurization technology, government leasing policy, and environmental delays.

Western coal

Western coal, 700–1,000 miles from the major Midwestern coal markets, has been underdeveloped, and will account for only about 12 percent of U.S. coal production in 1976. However, most of the growth in coal supply is projected to come from Western mines as a result of environmental regulations requiring low-sulfur fuels.

Synthetics manufacture

By 1990 about 100 million tons per year, or 9 percent of U.S. coal output, is expected to go toward the production of synthetic oil and gas.



*92 Million Tons of Coal Year = 1 Million Barrels Day Oil Equivalent

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U.S. GAS SUPPLY

TOTAL U.S. GAS SUPPLY

[Trillion cubic feet per year]

	1960	1976	1980	1990
Domestic (conventional)	12.9	19.2	16.8	17.2
Domestic (synthetic)		.3	.3	1.0
Imports	.2	1.0	1.5	1.0
Total	13.1	20.5	18.6	19.2

Since 1954, the Federal Power Commission has maintained the wellhead price of interstate natural gas at levels significantly lower than competition with our fuels would dictate. The effect has been to stimulate demand for gas and, at the same time, to decrease incentives for finding and developing new gas reserves.

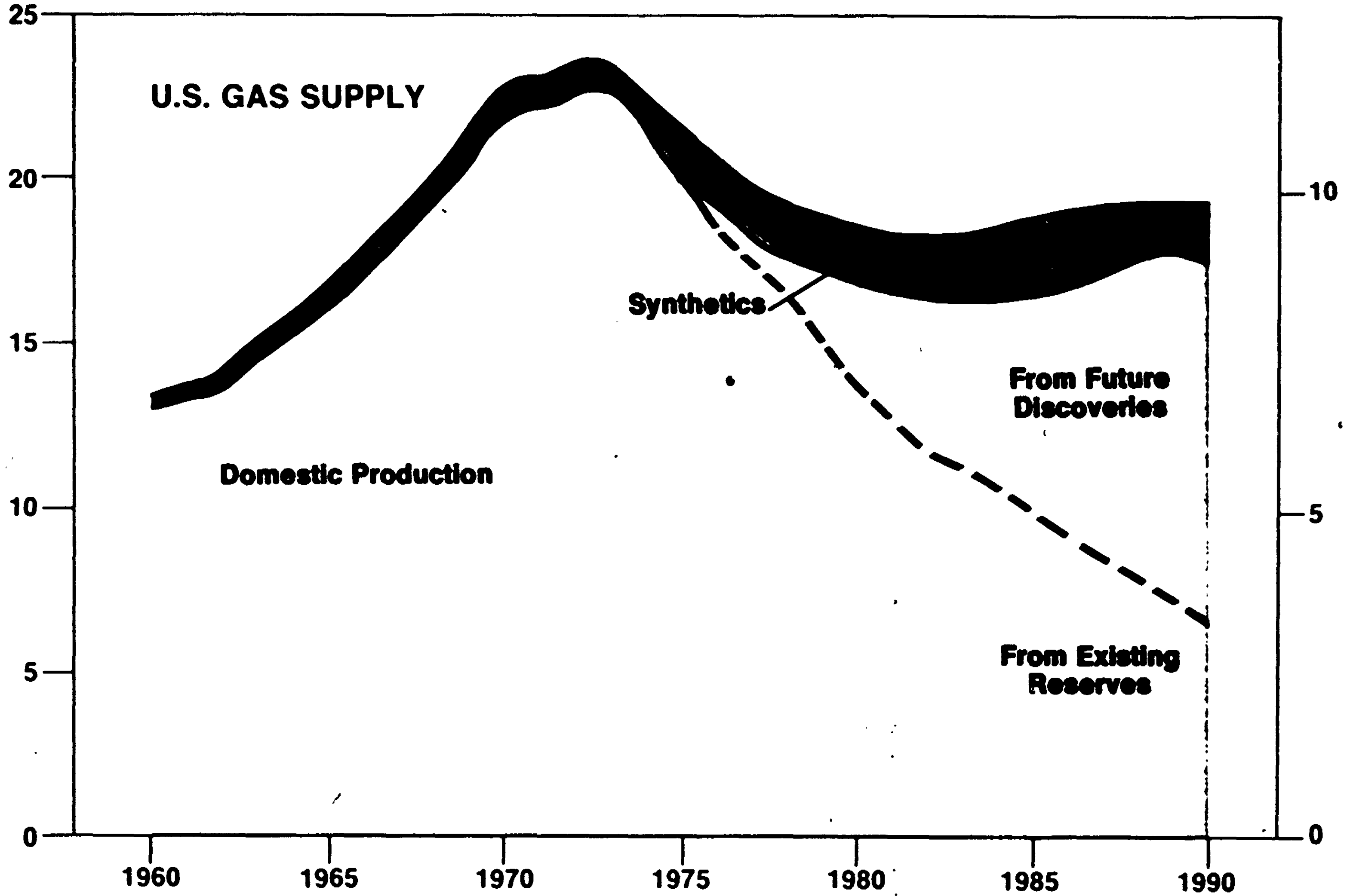
U.S. natural gas production peaked in 1972 and has been declining ever since. Production is not expected to recover to 1972 levels, even with production from new offshore leases and from the Alaska North Slope. By 1990, more than half of total natural gas production must come from reserves yet to be discovered. Most of these discoveries will be in "frontier" areas of Alaska and the Outer Continental Shelf.

Synthetics

Currently, about 0.3 trillion cubic feet of gas per year is produced from naphtha and liquid petroleum gas. Gas from coal is projected to be commercially available beginning in the early 1980's. Synthetic gas production is expected to reach about 1 trillion cubic feet per year by 1990, or about 5 percent of total U.S. gas supply in that year.

Imports

Gas imports are projected to average from 1 to 1.5 trillion cubic feet per year through 1990. Imports of liquefied natural gas (LNG) are assumed to increase as overland imports from Canada decline. However, LNG imports will depend upon considerations of economics and security of supply.



*2 Trillion Cubic Feet of Gas Year   1 Million Barrels Day Oil Equivalent

U.S. OIL SUPPLY

TOTAL U.S. OIL SUPPLY

[Million barrels per day]

	1960	1976	1980	1990
Domestic (conventional)	8.2	10.3	10.0	11.8
Domestic (synthetic):				
Oil shale				.5
Coal				.2
Imports	1.8	8.0	10.5	12.2
Total	10.0	18.3	20.5	24.7

We have left the discussion of oil until last to emphasize its function as the nation's "swing fuel." As the most versatile and the most readily available energy source, only oil is capable of taking up the slack created by the shortfall of any other fuel. Consequently, slower-than-forecast growth in coal, nuclear, or gas would rapidly translate into additional oil imports.

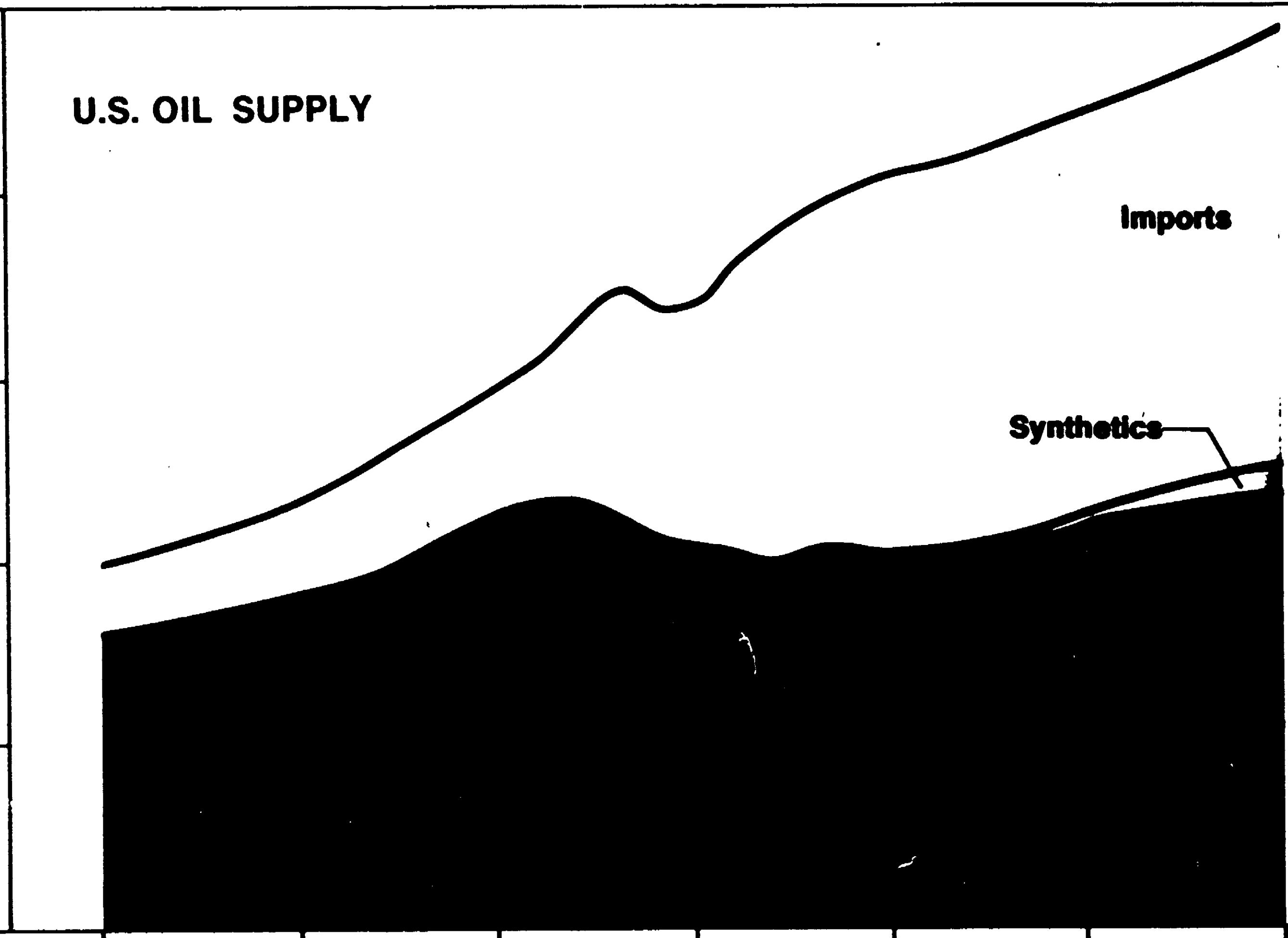
Domestic oil supply leveled off in the early 1970's and is now declining. This decline is likely to continue until late 1977 when North Slope oil will begin moving through the trans-Alaska pipeline. North Slope production will reach 2.0 million barrels per day in the mid-80's. Over half of 1990 domestic oil production must come from reserves yet to be discovered. Most of these new discoveries must come from "frontier" areas of Alaska and the Outer Continental Shelf. Leadtimes between initial exploration and peak production in some of these frontier areas may be longer than ten years.

Synthetic Oil

Oil from shale and coal will not become commercially available for several years. By 1990 combined synthetics liquids production from these sources is expected to be 0.7 million barrels per day and will account for about 3 percent of total oil supply.

Imports

Over the forecast period, U.S. oil demand will grow much more rapidly than domestic oil supply. Consequently, the U.S. will require increasing quantities of imports to fill the gap between domestic supply and demand. Oil imports are forecast to increase from 44 percent of total oil supply in 1976 to about 50 percent of supply by 1980, then maintain about this share through 1990.


U.S. OIL SUPPLY
MB/D*
MB/D*
25
20
15
10
5
0
Imports
Synthetics
1960
1965
1970
1975
1980
1985
1990
*Million Barrels Day

U.S. ENERGY POLICY OPTIONS

The Energy Outlook presented in the foregoing pages is based on what Exxon USA believes to be reasonable assumptions. However, our energy projections are by no means inevitable. They could be altered either positively or negatively by a number of events and actions, particularly in the area of government policy. At present, the nation lacks a coherent long-range energy policy. Current legislative trends are creating political and economic uncertainties that are impeding expeditious development of domestic energy resources and hampering long-term investment planning within the energy industries.

The outcome of the following key policy issues in particular will strongly determine the extent to which the nation succeeds in reducing oil import dependence.

Price controls

Price controls on "old" oil, which constitutes about 60% of domestic production—and the threat of continuing controls and even price rollbacks—are the greatest single impediment to the capital formation that is crucial to domestic energy development. A return to a relatively free market, where price is determined by supply and demand, would provide the dual advantage of encouraging energy conservation and stimulating development of domestic energy supplies. This will lessen U.S. dependence on costly and insecure imports, with consequent benefits to national security and economic stability.

Oil import quotas

Congress has considered proposals that would enforce energy conservation through mandatory import curtailments. In addition to necessitating a complex government rationing program, import quotas would, in effect, amount to a self-imposed energy shortage that could have serious economic consequences for the nation. Moreover, such proposals concentrate only on one-half of the energy problem—demand—and tend to ignore the urgent need to develop domestic energy supplies. This supply development is essential to sustain the long-term national economic growth that is fundamental to expanded job opportunities.

Environmental delays

Environmental protection is of great importance, but this goal must be realistically balanced with the equally vital national priorities of energy development and economic growth. At present, environmental concerns continue to limit industry access to the oil and gas reserves beneath the Outer Continental Shelf. Environmental concerns have been a significant factor in lengthy delays to nuclear power plant construction. A present environmental injunction against expanded coal mining in a five-state Rocky Mountain area, if prolonged, could significantly affect the coal needs of 29 utilities in 15 states by 1980. If a proper balance of the nation's energy, economic, and environmental needs is not achieved soon, the resulting domestic fuel shortfall will necessitate a greater U.S. reliance on imports than has been projected in our Energy Outlook.

Oil company divestiture

Recent legislative proposals would split U.S. oil companies into separate functional companies—production, refining, marketing and transportation—or would prohibit their involvement in non-petroleum activities, such as coal and uranium. Such legislation would significantly reduce the efficiency of the oil companies, retard U.S. energy development, and increase consumer costs and unemployment. We believe that oil company dismemberment is a groundless issue which is diverting attention from constructive efforts to develop a national energy policy.

Environmental protection, nuclear safeguards, energy conservation, adequate energy supplies—as well as the achievement of these goals at reasonable cost—are all important national priorities. Optimum progress toward each of them will require farsighted decisions on the part of all Americans. In view of the long leadtimes involved in developing U.S. energy resources and improving energy-use efficiencies, the necessary decisions must be made soon if the nation is to slow the trend toward increased import dependence.

The CHAIRMAN. Next we will hear from Mr. Charles Fraser, First National Bank of Midland, Tex.; and Mr. Allen Thomas, vice president of the Natural Resources Group of the Central Bank of Denver; and Mr. James C. Templeton, president, Paragon Resources, Inc.

I hope we haven't lost Mr. Templeton during the recess. Will he be back?

Mr. FRASER. No, sir. Mr. Templeton had to leave.

The CHAIRMAN. You can present my regrets to Mr. Templeton. I hope I can talk to him later on and in greater detail.

Mr. FRASER. He asked that his statement be put into the record.

The CHAIRMAN. I will be glad to do so.[1] He is a very fine person and I am sorry I couldn't hear him personally today.

STATEMENTS OF CHARLES D. FRASER, EXECUTIVE VICE PRESIDENT, THE FIRST NATIONAL BANK OF MIDLAND, TEX.; ALLEN THOMAS, VICE PRESIDENT, NATURAL RESOURCES GROUP OF THE CENTRAL BANK OF DENVER; AND JAMES C. TEMPLETON, PRESIDENT, PARAGON RESOURCES, INC.

Mr. FRASER. Mr. Chairman, I am Charles D. Fraser from Midland, Tex. I am an executive vice president of the First National Bank of Midland. My experience in the oil industry began upon graduation from the University of Texas in June 1958. I hold bachelor and master of science degrees in petroleum engineering, and I am a registered professional engineer in the State of Texas.

For over 9 years I have been in the banking business with the principal responsibility of oil and gas lending. Prior to becoming a banker, I was a petroleum engineer with Mobil Oil Corp. for 7 years and an independent petroleum consultant for 2 years. I am a director of the Independent Petroleum Association of America and of the Permian Basin Petroleum Association.

Our bank, with $362 million in total assets and $191 million in total loans, could hardly be considered a giant of the banking industry. However, I know of no bank which is so totally involved in the oil and gas business at the grassroots level.

I might add a comment that is not in the statement. The president of our bank is a petroleum engineer. We have seven on our payroll, and we have six commercial loan officers. Right or wrong, we are heavily loaded with technical talent.

Midland, Tex., is a focal community for oil and gas activities in the geologic region known as the Permian Basin. Geographically this basin underlies western Texas and southeastern New Mexico. We are the largest independent bank in Texas and, by far, the largest oil- and gas-oriented bank in the Permian Basin. Our customers range from the largest multinational oil corporations to the smallest of independents. However, most of our loan and deposit business is generated by individuals or corporations which would be classified as independent oil and gas operators by anyone's definition.

We also serve a multitude of oil industry service businesses including drilling contractors, well-servicing contractors, logging companies, consulting geologists and engineers, equipment dealers, construction contractors, et cetera.

The CHAIRMAN. I might interject I was stranded in Midland, Tex., in World War II. I am pleased to see it has grown so much since that date.

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[1] See p. 840.

Mr. FRASER. There have been times when we wondered. I think it was about 4 or 5 years ago we had some 1,500 to 2,000 vacant houses in Midland and, naturally, our friends did a little bit of service. I am afraid it didn't do the rest of the Nation too much of a service.

I find myself speaking out in opposition to the proposed legislation, the purpose being to do what I can to preserve the viability of our domestic oil and gas industry and specifically I am appearing to oppose the House bill.

From what I have heard today, I may add I hope what I understood Senator Kennedy's suggestion—I might start here by saying that I don't suggest to have the philosophical insight as some who address overall tax reform. My only contribution is a practical comment or two, more or less defensive in the sense that I happen to believe the oil industry is vital to our country, and some considerations obtuse to the needs of our country.

From a banker's view, we are talking about capital availability, the impact of the recent price rollbacks and the now-proposed capitalization of intangibles. I think in the statement reference to attachment 2, would be ample argument to refute the first two comments, currently price does not offset the loss of capital because of price rollbacks, and I would now like to address the capitalization of intangible drilling costs.

One question which might be raised is, could an aggressive bank lend money to offset this loss, and I would also respond by saying "no." I don't think either prices or bank lendings can make up what would happen if the industry is forced to capitalize intangibles.

Banks operate under a multitude of guidelines in oil and gas lending. I won't get into the details. I would just like to mention the two that I consider to be key ones.

We have no risk money to lend; we cannot make venture loans. That is, because we are lending depositors' funds and not our own money.

Senator BENTSEN. At least they don't start out to be risk loans.

Mr. FRASER. We try very hard to keep them from becoming risk loans. We make short term loans. We know what forms our deposits take. They could be withdrawn tomorrow technically and we want our notes to roll over rapidly.

In the case of oil and gas lending we shoot for guidelines of a 36 rollback.

Now, within those guidelines then I would like to comment on how capitalizing intangibles might affect banks and the availability of capital through banking. First of all, I would like to say I feel that there are two basic sources of capital for the industry. One is internally generated funds—I think we are all familiar with that term, and the other would be externally generated funds. With regard to internally generated funds, I believe that the legislation proposed in the House of Representatives would conservatively reduce internally generated funds by a factor of one-half to one-third below their present level on an annual basis.

Now, in our bank this would be money other than existing oil loans, which would become instead of 3-year loans, something like 4- to 4½-year loans, since we recover these loans after tax cash flow. Should

this happen, our bank will be forced to curtail new credit until the overall note case rollover falls back to a prudent level, and we can then go about our business. However, during that time, and subsequently, we will have to reduce the amount of money we can lend on new loans.

The question is again the reduction by approximately one-third to one-half over the level we now have. The net effect of this is that we cannot finance against internally generated funds in any way to offset the loss of intangible drilling expenses or the change of capitalization.

With respect to the externally generated funds our bank will be affected in two ways that intangibles are capitalized. We are continuing deposits for over $40-some-odd million a month. That has raised some outside investors. These moneys come from such places as well-known drilling funds or direct contact with various individual clients or entrepreneurs. We have a multitude of customers involved in raisin third-party money.

Our total deposits are $320 million and we believe that intangibles have to be capitalized. This source of money will dry up, and we would expect a loss of deposits somewhere in the range of $40 million, which would in turn reduce our lending ability about $25 million since these deposits are a general running number on—and, excuse me, Senator, can I continue?

The CHAIRMAN. Go ahead for about a minute or two, if you can, summarize the rest of your remarks.

Mr. FRASER. Sure.

The net effect of it is to say we are also going to suffer another loss in the source of money to lend, and therefore we just can't stand the argument that we would be able to make enough money to offset the intangible expenses.

The only other particular point I would like to make is sometimes we have a great deal of trepidation to come here in Washington and testify in the company of people like Mr. Slick, and it might be that perhaps this is an idea that we can't come with the same quality of numbers. However, back in late November I made some calculations regarding the impact of the proposed Energy Policy Act on the total national activity in the oil business, and attachment 2 is presented in this paper as an update of this statement—the statement is an update of material that was given President Ford by Chairman Mahon predicting that the rig count would drop drastically and demand was going up rapidly.

I would like to point this out to you simply to show that we have not been too far wrong in guessing what impacts some of this legislation is going to have and I happen to believe we are right about having to capitalize intangibles—that if someone wanted to write a recipe to bring independent oil business to its knees and set our bank back, they couldn't choose a better vehicle than that provided by the House of Representatives.

The CHAIRMAN. Looking at these charts that you presented in your statement, one would get the impression that had Congress not acted to roll back the price and double the tax, by now we might have about 60 or 70 percent more rigs out drilling for oil than we have today.

Mr. FRASER. Yes, sir.

The CHAIRMAN. If we had continued that trend of drilling more and more and instead of drilling less and less, we might have achieved the goal of energy in independence in this country.

Do you think we have the potential to achieve it if we provide enough incentives to business to do so?

Mr. FRASER. Mr. Chairman, I don't feel that we can become independent through imported crude oil. I think we could materially minimize our dependence over what we are faced with, and I think the unknown that we tend to overlook is what we might find, that we don't expect to find the projections most people made are based on historical ratios or reserves found in the drilling of a number of rigs running. However, if we could look back, say—which I personally think would not be seen on a day-by-day basis—I would wonder who would really be able to say we don't have some more sleepy giants out there.

If we were wildcatters and optimists instead of bankers, we might have hope of reducing imports materially above what I predicted. The trends we have seen now will make the predictions I have here come out with much worse than if we were just left with the price roll. If we impose LAL on top of it, then I think we are going to be worse off.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. On your chart that you supplied with your testimony, you have a recovery trend line.* Each time it turns down we pass a piece of legislation that is adverse to the oil industry, and it starts up again on the presumption that the recovery trend line could not have turned upward anyway. Would this chart simply say we have delayed the explorative oil—and would continue up despite our legislation?

Mr. FRASER. Well, I think, Senator, first of all, those are not pure numbers.

Senator PACKWOOD. I was looking at your trend, the line.

Mr. FRASER. I would like to be specific on that problem.

If you recall 1964 when the legislation was passed, had that not been vetoed and vetoed, then we would never have seen the return to the recovery trends.

Now, in respect to the Tax Reform Act of 1975, which did become law, we had a long hiatus there of some approximately 6 months while people regrouped to figure out what happened to them, and they started drilling again, but you must recall there was no ceiling on the price of new and released crude oil at that time, and these factors did not change, I think, real significantly to show the immediate sensitivity of the industry in the thing that threatens to take away venture capital.

Now, I think, even under the present conditions, that the drastic downturn we have seen on the Permian Basin is any lower than it has been since 1973.

Senator PACKWOOD. In response to the question I asked earlier, you are telling me that the Energy Act and the oil depletion limitation, these have all worked to turn down domestic exploration?

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*See p. 842.

Mr. FRASER. That is my opinion, yes, sir.

Senator PACKWOOD. You put in your statement you loan to large companies, small companies, particularly individually owned companies on occasion. Who does most of the exploratory drilling in the continental United States?

Mr. FRASER. Senator, I would like to restrict my knowledge to the Permian Basin because I am not a statistician for who drills what in the United States. In our part of the country—and, again, I don't have have the percentages for you—I would say that in terms of the number of wells the majority, like 70–80 percent, are drilled by individual independents and joint venture groups of that type.

Senator PACKWOOD. You say a number?

Mr. FRASER. The total number of wildcatters—I don't mean to deride the contributions by Exxon, because they may come up in one fell swoop, they may spend as much as some of my customers spend drilling a half-dozen wells. As to the dollar contribution, I am not sure that the ratio is still significant.

The trouble in the Permian Basin is the size of the prospect has decreased through the years to the point where the return on venture money is no longer attractive to the larger corporations, where it still is to the smaller fellow. The evidence we have of that is Monday Mobil Oil announced removal of 145 families from consolidating into Houston and New Orleans. Obviously we don't have a big enough deal for them to wildcat for.

As time goes by, I think we must expect a smaller and smaller effort in the Permian Basin from the large companies, and smaller prospects will still be drilled by the smaller individuals and corporations.

Senator PACKWOOD. Is 80–85 percent of new wells for new exploration into the 80–85 percent recovery of oil? Is that a different percentage?

Mr. FRASER. I know I would say that.

If you are talking historically, we fall into the area of how long an individual can go ahead on a drilling venture before he has to make a sale. The traditional practice in the industry has been before for independents to make out sales and/or to drill to discover wells on farmed-out acreage where the larger corporation continues to make the main bulk of the—I think the small operators, the independent producer comes out with a smaller percentage of the reserves for a much larger percentage of the risk in the expenditure.

Something I would be willing to do throughout the years—and I think still is—but, no, I don't think the ratio of wells to reserve control is proportionate. I think independents receive much less.

Senator PACKWOOD. Most of these independents sell off oil as they find they are not in business other than for discovery?

Mr. FRASER. Most of the time they hang on as long as they can. In our bank, a 3- to 5- to 6-year range is a good number. When a man has had a stroke of bad luck, he can't borrow more money, he has to go back to the sale and clean up debts and start over. Most of them like to stay in the producing business. They just tend to get up there so high, they tend to get out.

Senator PACKWOOD. When you say producing, you mean getting oil out of the ground?

Mr. FRASER. Yes. We have no marketers to speak of and no refiners within our family of customers. When I said we do business with major companies, we make no loans on the books to any of the "seven sisters" or way on down the chain.

Now, we have some good depositors, and we appreciate their good business and they are good friends, but they don't borrow money from First National, Midland.

Senator PACKWOOD. Thank you

The CHAIRMAN. Senator Bentsen?

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

Under the new law an independent producer would generally be able to go for percent depletion on the first 1,800 barrels per day production. In 1976, if that producer sells oil and gas or any products derived from oil or natural gas, if he sells it to a man who is in another business, be it a drugstore or he might be selling petroleum products, or be it a dress shop where they might sell some plastic material or a gas product that is made into the fabric, he is denied some of the advantages of the bill that is called the retailer's exclusion. That would really be aimed at some of the major companies with their retail outlets.

I have provided an amendment I am going to attach to this legislation, if I can, trying to clarify that to see if we can't further define what a retail outlet is, because it has been carried far beyond because of the ambiguity of the language.

Have you had some problems with that?

Mr. FRASER. Yes, sir, I might comment I know of the specific instances here in the last 60 days where an individual—he still operates as an individual and he is quite successful in the area of natural gas. During a course of time he also built some gas-gathering systems and was selling gas to irrigation farmers.

Out of the gas he found, he set aside enough and got into the marketing to local irrigation wells. Along the way he sold some gas to one smaller community out there, and this became, according to his account, a retail operation.

Senator BENTSEN. So, it loses depletion.

Mr. FRASER. He is going to lose his depletion and get out of business. We do have cases where this is a problem. One of the big areas is just not being sure, and the accounting fraternity takes a stand if you are in doubt, sell or get out of the potential conflict, and it is serious to us.

Senator BENTSEN. I have another one they are studying over in the Treasury, and I, if you haven't heard of it already, have been talking about a farm arrangement that they would deny a part of the tax deduction for the intangible drilling cost to the taxpayer of the driller who takes the whole risk, even though he is taking the entire risk, even though he incurs the full cost of drilling, even though he would bear the full loss on a dry well.

Would you care to comment on that?

Mr. FRASER. Well, it is just kind of coffee shop gossip. I even heard some people thinking that was already being looked at on their re-

turns. I think it is a ridiculous attitude. I can't see how that man is not entitled to recover his capital out of the interest he retains in that farmout, and I think, for instance, they are attacking the interest procedure, which is common where a man who gives a farmout, thinking maybe it is going to be better than he thought it was, wants to come back in for half interest after the venture money is recovered, and trying to penalize the guy that takes the risk, and think that is backward, but I can't really say much more.

Senator BENTSEN. Thank you very much, Mr. Fraser. I think your testimony has been very helpful to us. I have no further questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I have no questions.

The CHAIRMAN. Senator Byrd?

Senator HARRY F. BYRD, Jr. Mr. Fraser, you say your bank is very heavily involved in the oil and gas business at the grassroots level.

What has been the result of the elimination of the depletion allowance for oil? Have you found it to be detrimental?

Mr. FRASER. Yes, sir; it is really just—in my customer relations it is just really coming to light because these people are just now making their first tax return after the change in law, and there are lots of them being shaken by what has happened to them.

I think we are going to see more of what we are already seeing, a reduction of the level of investment this year out of the realization that they don't have such money to spend as they thought they were going to. This is based on their 1975 tax return.

There is no question it has had an adverse impact on our customers. Most of my customers are too small to be affected by the upper limit of 2,000 barrels a day, although I have probably a few. It will be some while before many of them will grow that fast, but it is always depressing to them to think that once they reach a level of endeavor that gets them up there, they start losing cash flow. So, in that sense there is some psychological impact on my people also.

Senator HARRY F. BYRD, Jr. Have you noticed actual reduction in drilling as a result?

Mr. FRASER. There is no question, Senator. It is hard to be sure that you are pulling out. I mean, the depletion allowance by itself is not the only thing that has impacted on these people. The price rollback is certainly part of it and the fears of what is coming on this intangible question, but I think the recount figures on the Permian Basin speak for themselves. We are down to at least—we are down way below what we were in 1973.

We have some figures in the statement that merely evidence that these people aren't spending their money; they are not asking us for loans they were, say, a year ago on drilling contracts. Our customers have rigs idle and for the first time.

Our bankers were here in the last 3 weeks and had a difficult time with one drilling contractor's line. We just know that we have had a downturn in activity.

Senator HARRY F. BYRD, Jr. Thank you, Mr. Fraser. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, gentlemen.

Mr. THOMAS. Mr. Chairman, I realize we are over on our time. I wonder if I might make a couple of comments here with your permission.

The CHAIRMAN. If you make it brief. The time we had allocated was for the two of you. Go ahead.

Mr. THOMAS. My name is Allen Thomas. I am with the Central Bank of Denver. Our bank is approximately the same size as Mr. Fraser's bank. We have approximately $40 million of accounts in exposure to the business, and we have essentially the same type of portfolio. We have small independent oil men.

My background is very similar to Mr. Fraser's. I am an engineer with two degrees. I spent 8 years at the Chase Manhattan Bank and have been with the Central Bank of Denver for 3 years.

There are several points I would like to make, and I will make them very briefly.

First of all, we make secured loans to oil and gas companies and selves a 50 percent safety factor in all our loans. We lend on proven reserves, with engineering reports behind them. We are very careful to make sure we have predictable cash flow and that we can recover the loans from the production that a man puts up as security and that is, normally speaking, already producing.

We do not lend on what he might find. We lend on what he has found.

The new increase in taxes, which would be caused by LAL, would reduce money for debt payments, would reduce the amount of money I can loan. As Charlie said, it would stretch out payments of existing debts and also would increase our chances of being severely criticized by our examiners, and we don't need that right now.

Outside sources of capital, I feel, would be severely impaired, the drilling fund money, private investment. Money is attracted by a combination of profits and investors' tax position. The tax position determines when he spends his money. The profit potentiality determines where he spends his money.

He could spend it in real estate; he could be spending it in oil, in a number of other ventures. Any attempt to reduce the intangible effects are going to reduce tax attractiveness, and the capital will go elsewhere.

I think this will impact on my customers to the extent of reduction of 50 percent of their outside capital.

My third point is, I would like to define the "independent." He is an engineer; he is a geologist; he is a land man. He worked probably 10 years for a major oil company and he quit because he didn't like the big company. He wanted to be his own boss, and he would like to make some of the money that he is contributing to their profits. He started with no capital. He traded hard; he took a lot of small independents to spread his risk, and he built his income very gradually to be something he can be proud of. He is now seeing his business become too complicated. He has got mountains of paperwork; he has got environmental reports, is it old oil, is it released oil? What is my depletion? Is it 50, 20, or 65 percent? What is going to happen to my intangibles?

What are my preference taxes? I have got legislative uncertainties. The whole trend is adverse to my business. And he is getting discouraged.

Finally, my practical experience in the last year has seen a deferral of expenditures by my customers for investments because they couldn't figure taxes, they didn't know how to calculate profit. He can't figure out what he is going to make on it; he is not going to do it.

Another customer significantly slowed his program for that reason. A number of them are talking about diversification and have said the future is terrible for them, they are going to punch costs, I am going to buy ranches. I am getting into another business, getting in real estate.

This is beginning. I have seen this happen. So, we are experiencing discouragement because of a flight of capital. Historically the independent wants to put his dollars back in the ground. He is an oil man; that is where he grew up. He went on to find out it is the only thing he knows, and I think that we have to create the environment that is going to encourage him to do that.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Let me compliment you, Mr. Fraser, for your excellent testimony. I have had a chance to scan it very hurriedly.

I have one question not directly related to what you testified on. There are a number of bills before the Congress to bring about in the oil business a breakup of four major functions. What effects would these passages of this kind of legislation have upon the independents and what effect would it have on the country?

Mr. FRASER. Senator, that is a very difficult question, and I have not done the level of homework that might be desirable. However, both Allen and I are close to the independent sector and I think that result would be absolutely chaotic for independents. I don't think it would help them compete in any way. I think it is just going to make it tough for them.

I wish Allen would comment from his view in the Rocky Mountains.

Mr. THOMAS. I would say the same thing. My own philosophy is that if the major oil companies are making x dollars of profit, and you want to break them up, you want to allocate that back to various broken up divisions, then you are going to have to say, "OK, we take this profit and if production is so much, refining is so much and marketing is so much," well, traditionally the refiner marketer has not made all that much money. The money has been made in the producing segment.

Now if that happens, then you are going to have to take the production profit, lower oil and gas prices, redistribute over to the refiners, marketers, and it is going to impact on the cash flow of the independents. That is my view.

Senator HANSEN. I have one further question.

If the oil industry were to be forced to divest itself, as has been proposed in some of these bills, would this type of integrated operation, which we now have, result in making of a profit, provided the same amount of profit or contribution to the same economy that we have with the operation can be integrated?

Mr. FRASER. If I want to try, I think you are saying will the sum of the parts be the same as the whole?

Senator HANSEN. Right.

Mr. FRASER. Again in my opinion, no. However, I wish some of my friends would make comments to your response.

Senator HANSEN. I wanted to get your opinion.

Mr. FRASER. That is my opinion. I think it is much less efficient.

The CHAIRMAN. Thank you.

[The prepared statements of Messrs. Templeton, Fraser, and Thomas, follow:]

STATEMENT OF JAMES C. TEMPLETON, PRESIDENT, PARAGON RESOURCES, INC.

I am Jim Templeton, President of Paragon Resources, an independent oil and natural gas exploration company based in Shereveport, Louisiana. I am also appearing in my capacity as Chairman of the Tax Committee of the Oil Investment Institute (hereinafter the "O.I.I."). The O.I.I. is an association of 20 independent oil and gas exploration companies that originate and act as general partners for publicly offered drilling programs. In 1975, the O.I.I. member companies internally and externally generated nearly $300 million for domestic oil and gas exploration. I am pleased to have this opportunity to appear before the Senate Finance Committee today to discuss the implications of the changes in the income tax deduction for intangible drilling expenses included in H.R. 10612, the House-passed tax reform bill.

As other witnesses before the Committee have stated, capital is formed in the independent oil and natural gas exploration industry from three primary sources: (1) cash flow or internally generated funds; (2) equity offerings in the forms of working interest participation; and (3) borrowing from traditional lending institutions.

Because of time considerations, I will outline the main points in my statement and ask that the complete statement be entered into the hearing record.

The subject of my remarks is capital formation in the independent segment of the petroleum exploration industry from equity offerings in the form of working interest participation. I believe the following areas were unfortunately misrepresented during the House debate on tax reform, and that these areas need further examination by this committee.

First, the domestic independent petroleum exploration industry has always, in large part, relied on capital from both the driller and people associated with him.

Second, non-operator investments are a substantial portion of the funds available for independent exploration.

Third, there is conflict in the arguments used by those who would seek to reduce the intangible drilling deduction. These Members argued simultaneously that the Congress could reduce the incentive for individuals to participate in exploration and that individuals would continue to invest. That simply is not true.

Fourth, Secretary Simon stated in his testimony before this Committee last week the need to align tax policy with public energy policy in a compatible manner.

It is our intention to present with this panel a discussion of the third capital source for independents, namely borrowing from traditional lending institutions. Members of this panel are Charles D. Fraser, Vice-President, First National Bank of Midland (Texas), and Allen Thomas, Vice-President Natural Resources Group, Central Bank and Trust Company, Denver.

STATEMENT OF CHARLES D. FRASER, EXECUTIVE VICE PRESIDENT, THE FIRST NATIONAL BANK OF MIDLAND, TEX.

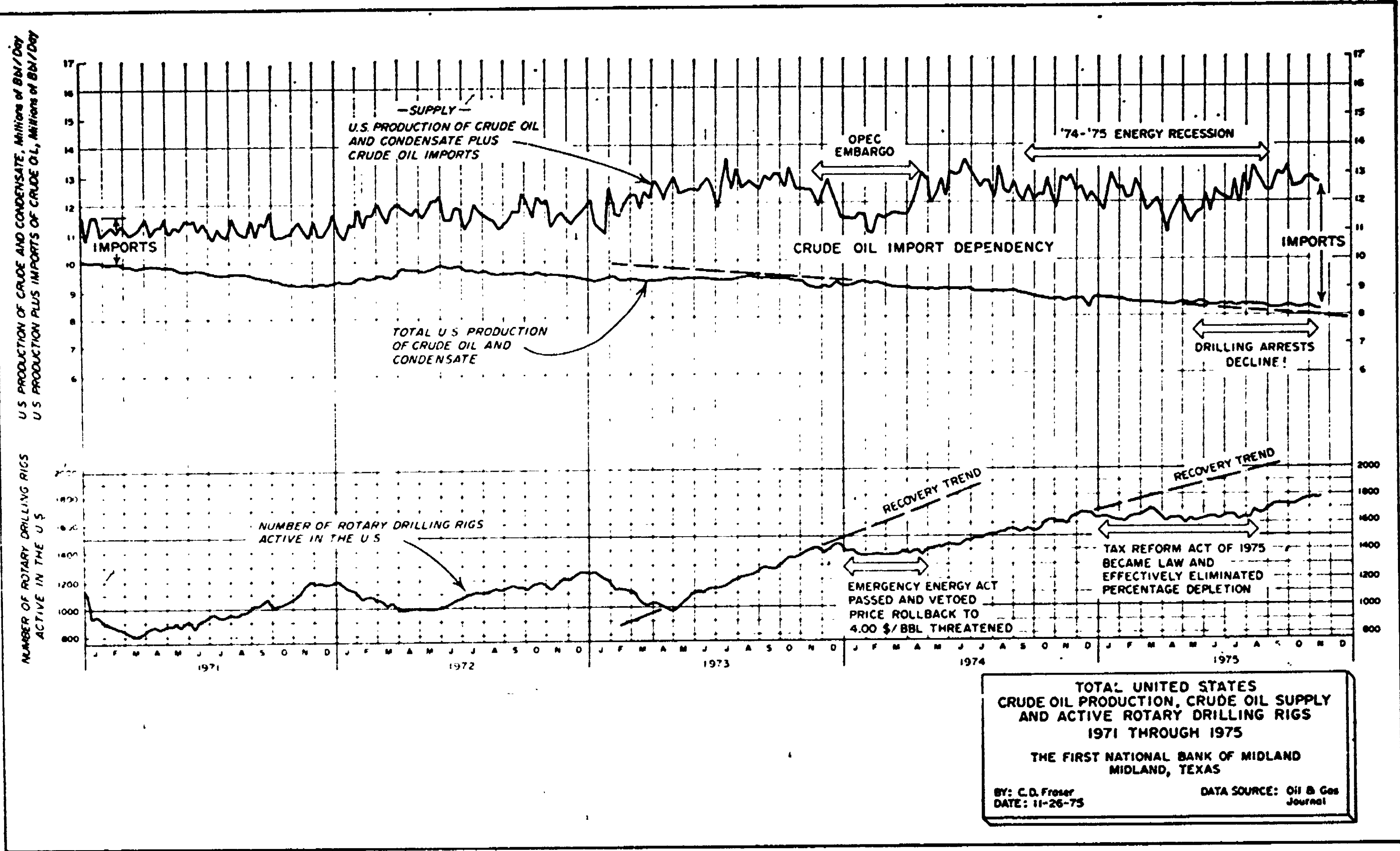
I am Charles D. Fraser from Midland, Texas. I am an Executive Vice President of The First National Bank of Midland. My experience in the oil industry began upon graduation from The University of Texas in June, 1958. I hold Bachelor and Master of Science Degrees in Petroleum Engineering, and I am a Registered Professional Engineer in the State of Texas. For over nine years, I have been in the banking business with the principal responsibility of oil and gas lending. Prior to becoming a banker, I was a petroleum engineer with Mobil Oil Corporation for seven years and an independent petroleum consultant for two years. I am a director of the Independent Petroleum Association of America and of the Permian Basin Petroleum Association. Our bank, with

$362,000,000 in total assets and $191,000,000 in total loans, could hardly be considered a giant of the banking industry; however, I know of no bank which is so totally involved in the oil and gas business at the grass root level. Midland, Texas, is a focal community for oil and gas activities in the geologic region known as the Permian Basin. Geographically this basin underlies western Texas and southeastern New Mexico. We are the largest independent bank in Texas, and, by far, the largest oil and gas oriented bank in the Permian Basin. Our customers range from the largest multi-national oil corporations to the smallest of independents; however, most of our loan and deposit business is generated by individuals or corporations which would be classified as independent oil and gas operators. We also serve a multitude of oil industry service businesses including drilling contractors, well servicing contractors, logging companies, consulting geologists and engineers, equipment dealers, construction contractors, etc.

For many years, our bank has predicted rejuvenation of the Permian Basin oil and gas industry believing that foreign governments would force our nation to recognize the value of domestically owned and secure energy resources. In this sense we predicted the OPEC Embargo of 1973; although, we had not expected this disruption so soon or in such a drastic manner. The rash of punitive legislative proposals directed at the domestic oil and gas industry and not at alleviating the domestic shortage of productivity of oil and gas shocked and surprised us. Once again, I find myself in Washington speaking out in an effort to preserve the viability of our domestic oil and gas industry. Specifically, I am here to oppose the proposed change in federal income tax law which would drastically alter present treatment of intangible drilling and completion expenses. In my view, the effort to maximize domestic oil and gas production has already been seriously hindered by legislative action most of which has occurred subsequent to the OPEC Embargo. Specifically, the industry has suffered from provisions of the Tax Reform Act of 1969 (Pre-Embargo), the Emergency Petroleum Allocation Act of 1973. The Tax Reduction Act of 1975, and the Energy Policy and Conservation Act of 1975. The cumulative effect of these various pieces of legislation has been to reduce the oil industry's ability to generate capital; however, the decline in domestic drilling activity caused by already legislated deterrents will seem negligible compared to the drop in activity which will result if proposals to limit the expensing of intangible costs, such as those passed by the House of Representatives in last 1975, become law.

In December, 1975, I prepared a Critique of then pending Energy Policy and Conservation Act of 1975 at the personal request of the Honorable George Mahon, Chairman of the Committee on Appropriations, House of Representatives. Mr. Mahon subsequently communicated my views to President Ford in an effort to elicit his veto of said legislation. A copy of this Critique is attached. The purpose of attaching this information to my statement, today, is not to whip a dead horse; instead, the purpose is to demonstrate that my arguments should be taken seriously. Attachment I presents a five year history of domestic daily crude oil production, the number of active drilling rigs in the United States, and the total demand for crude oil which is made up of domestic production plus imports. Attachment I is identical to Attachment I of the Critique. Study of Attachment I will reveal a number of interesting facts such as the rapidly increasing dependence of our country on imported oil, the impact of the OPEC Embargo and subsequent recession of 1974 and 1975, rapidly accelerating demand with resultant dramatic increases in the level of imports during most of 1975, response of the oil and gas industry to price increases beginning in 1973, the decline in domestic crude oil production which began in late 1973, the reversal of this decline in late 1975 as a result of increased drilling activity, and suppressions of drilling activity caused by either proposed or legislated punitive actions against the industry.

Attachment II presents historical data for 1975 and a four year forecast of production, demand, and rotary drilling activity. The effective date of these predictions was November 30, 1975, at which time actual data were available through mid-November. Refer to the Critique for qualifying assumptions and comments. Data available subsequent to the date of these predictions have now been added to Attachment II revealing that my fears of a severe downturn in domestic drilling activity have come to pass. Specifically, the number of rotary drilling rigs active in the United States has decreased from 1,800 at the end of November, 1975, to a present level of 1,520 (March 15, 1976). Simultaneously, total demand for crude oil in this country has increased from approximately 12,800,000 barrels per day in mid-November, 1975, to approxi-



ATTACHMENT I

mately 13,800,000 barrels per day on March 12, 1976. Domestic production has remained relatively constant, but, unfortunately, crude oil imports have increased dramatically. The conclusion to be drawn from Attachment II is obvious. The domestic oil and gas industry cannot possibly minimize our dependence on foreign oil in the face of reduced availability of investment capital. I would now submit that passage of any legislation which delays or extends capital recovery rates now afforded the oil industry by virture of its ability to expense intangible drilling and completion costs will insure future levels of dependence on foreign oil well in excess of the predictions shown on Attachment II. Other than by finding our own oil and bringing other domestic energy sources into play, the only way to reduce this dependence will be to accept a lower level of economic well-being for our Nation!

So far, I have made my arguments with respect to the National scene. I am a concerned citizen and I feel that we as a nation must make every effort to minimize our dependence on foreign sources of energy. It is also true that our bank and our local economy are dependent for their well-being on a healthy oil and gas industry. The Permian Basin produces approximately one-fourth of all domestic crude oil supply. During the five year period, 1971 through 1975, the Permian Basin was able to increase its daily production of crude oil; however, we know that this level of production cannot be sustained without a maximum drilling effort. We have already lost our momentum as evidence by a drop in the rig count in the Permian Basin from 290 active rotary rigs in later November, 1975, to a level of 215 active rotary rigs on March 15, 1976. Except for a three week period at the end of September, 1974, the Permian Basin rig count has not dropped to such a low level since September, 1973. I can assure you that any adverse change in the tax treatment of expensing intangible drilling costs will doom our area to rig activity levels which may well fall below the depressed levels of the late 1960's. We find it hard to understand why skilled labor and valuable drilling equipment should be idle in the face of an energy shortage in this nation.

It might be argued that the increased price for domestic crude oil and aggressive lending by banks will compensate for the loss of depletion allowance, the rollback and control of domestic crude oil prices, and the now proposed reduction in industry cash flow through required capitalization of intangible drilling expenses. The record with respect to the depletion allowance and price controls is clear and refutes such an argument. Let me, as a banker, speak to this same argument with respect to intangible drilling costs. Banks work within a series of concise lending guidelines. Rather than labor with a great amount of detail, let me merely point out the two most important guidelines. First, banks have no venture money to lend. As an oil and gas bank, we lend only against established production or other liquid and tangible collateral. We are lending depositor funds and we cannot use these monies to drill wildcat or even less risky step-out exploratory wells. Second, we are short-term lenders. The policy in our bank is to seek a loan payout from oil production within 36 months from the date of the loan. In a few instances, we extend credit out to 60 months; however, the bulk of our oil loan portfolio would be repaid from production income within 36 months. We never intentionally exceed these guidelines.

Capital for investment in new drilling comes from two sources. The sources can be classified as internally generated funds from already existing oil and gas production and externally generated funds provided by persons outside of the oil and gas industry either on a direct contact basis with an oil and gas operator or through such vehicles as the well-known public drilling funds.

Let us first address the impact of capitalizing intangibles on internally generated funds. I believe that the legislation proposed by the House of Representatives will reduce internally generated funds by a factor of one-third to one-half of their present level on an annual basis. In our bank, this means that existing loans which would now payout in three years immediately become four to four and one-half year loans. If this happens, we will be forced to curtail credit until overall loan rollover returns to the prudent level we desire. Additionally, we will have to reduce the amount of money we can advance against existing production by approximately one-third to one-half in order to offset the decrease in after tax income available to service debt.

With respect to externally generated funds, we will be impacted in two ways. I estimate that we are a continuing depository for something in excess of $40,000,000 of venture money raised from outside investors. As public venture money is raised, our customers deposit the funds in our bank pending expenditure for drilling and completion costs. We have a multitude of customers involved in

—SUPPLY—
U.S. PRODUCTION OF CRUDE OIL AND CONDENSATE PLUS CRUDE OIL IMPORTS

US PRODUCTION OF CRUDE AND CONDENSATE, Millions of Bbl/Day
US PRODUCTION PLUS IMPORTS OF CRUDE OIL, Millions of Bbl/Day

CRUDE OIL IMPORTS

UNNCESSARY CRUDE OIL IMPORT RATE, MILLIONS OF BBL PER YR

106

252

427

630

OIL PRICES DECONTROLLED

PROPOSED OIL PRICE CONTROLS

U S PRODUCTION CRUDE OIL AND CONDENSATE

FIRST PRODUCTION FROM NORTH SLOPE ALASKA

NUMBER OF ROTARY DRILLING RIGS ACTIVE IN THE U S

ACTIVE ROTARY DRILLING RIGS IN U S

OIL PRICES DECONTROLLED

PROPOSED OIL PRICE CONTROLS

1975 1976 1977 1978 1979

PROJECTED UNITED STATES CRUDE OIL PRODUCTION, CRUDE OIL SUPPLY AND ACTIVE ROTARY DRILLING RIGS 1975 THROUGH 1979

THE FIRST NATIONAL BANK OF MIDLAND MIDLAND, TEXAS

BY: C D Fraser
DATE 11-30-75

DATA SOURCE: Oil & Gas Journal IPAA

DATA AVAILABLE AFTER 11-30-75

ATTACHMENT II

the raising of outside funds; therefore, we have a continuous inflow of this capital. There is always a significant time lag between date of deposit and the date these monies are used to pay for drilling and completion expenses; therefore, we are able to lend against these funds on a continuing basis. Considering the fact that we have total deposits of approximately $320,000,000, the loss of some $40,000,000 in deposits would be a serious blow and would reduce our ability to lend by an amount exceeding $25,000,000. We would again be forced to curtail credit and let our loan portfolio run down.

I feel that a major portion of these public monies will not flow into the oil and gas industry if the investor is no longer able to shelter outside income by expensing intangible drilling and completion costs. We have made several surveys of our customers and find that a minimum of 75 percent of venture capital raised by these oil and gas entrepreueurs comes from external sources. Once invested, this venture or risk capital results in the discovery of oil and gas reservoirs and provides our bank with proven developed production against which we can lend on a secured basis to provide the additional capital needed to complete development of the discovery. Simply stated, any reduction in the availability of this venture money will take away the source of capital needed to find new deposits of crude oil and natural gas thus reducing the possibility of our making secured loans for development drilling. I would like to reiterate that banks and particularly our bank should not and cannot provide risk capital; therefore, any curtailment in the availability of extrenally generated funds will result in a further decline in drilling activity by our customers. We cannot hope to offset the loss by lending more money!

I assume that each member of this committee fully understands the definition of an intangible cost as related to oil and gas investment. Some easy examples would be the salary paid a consulting well site geologist, the cost of drilling mud and chemicals which after completion of a well are totally worthless, the cost of acid used to stimulate a formation which is recovered from the ground in the form of water and must be disposed of, etc. The ability to expense these costs merely provides the investor in oil and gas ventures accelerated recovery of his capital when compared with depreciation of tangible costs. Opponents of this treatment argue that federal income taxes are thereby avoided. This argument is just not true. Taxes can be deferred, but a successful investor in oil and gas ventures will find himself committed to exponentially increasing levels of investment if he continually tries to minimize his immediate tax liabilities. Traditionally, such investors find that their income from oil and gas plus their external income is insufficient to maintain this ever increasing level of investment required to minimize taxes. The natural step is to borrow against future income until the level of indebtedness becomes excessive. Historically, individuals are able to combine their borrowing power with their income to accelerate their drilling activity for periods of about three to five years at which time debt load becomes imprudent, a series of unsuccessful ventures occurs, the investor reaches an age at which he no longer wishes to take risks, the investor dies, etc. At that point in time, standard practice is to sell the interest acquired and pay a capital gains tax or to stop drilling and pay taxes on the income over the remaining life of the properties developed. In either event, the level of taxation is much higher than it would have been if the intangibles had been capitalized. The only ways I know of for an investor to avoid taxes on the oil and gas income he develops are to give his assets to a charity or declare bankruptcy. For these reasons, I find little merit in the philosophical argument that the present tax laws permit the investor in oil and gas ventures to avoid payment of federal income taxes. Conversely, there can be no doubt that the present treatment of intangibles permits an investor or a corporation to grow, if successful, at a rate far in excess of that which could be accomplished if these costs had to be capitalized.

In summary, I urge this committee to stand firm against any changes in the present tax law with regard to intagible drilling and completion expenses for the oil and gas industry. Irrespective of all other arguments, it appears to me that curtailment of this valuable investment accelerator would be the ultimate step of imprudence in the face of our obvious need to maintain domestic drilling activity at the highest possible level and in the face of presently decelerating drilling activity caused by previous legislation.

CRITIQUE—THE ENERGY POLICY AND CONSERVATION ACT OF 1975

(By Charles D. Fraser, Senior Vice President and Petroleum Engineer, the First National Bank of Midland)

The Energy Policy and Conservation Act of 1975, if enacted into law, will condemn our Nation to a "no win" energy policy. This bill must be vetoed by The

President and his veto must be sustained; otherwise, the domestic oil industry is doomed to Congressional control with the predictable certainty that oil policy will be as ridiculous as political control of natural gas prices at the wellhead has been and with the same miserable "benefit" to the American People. What is wrong with this proposed legislation? Consider the following:

1. The effect of this act will be to reduce oil industry revenue by about three billion dollars ($3,000,000,000) in 1976. Reference to IPAA data reveals that the expenditure by industry in 1973, (latest available), to drill and complete 26,244 wells, was $3,074,532,000.00. This act will reduce oil industry revenue by an amount equal to the total expenditure for drilling and completion costs in 1973! More than 2 billion barrels of new crude oil reserves were found in 1973, excluding Alaska!

2. The value of a barrel of new, domestic crude oil is immediately reduced by a minimum of $2 per barrel or about 15 percent.

3. Any subsequent decrease in the volume of "old" oil must cause an additional decrease in the value of "new" oil assuming continuation of a two tier system.

4. Any substantial increase in new oil production will force the price for existing new oil down; viz., why should anyone explore for new oil knowing that success will reduce the value of existing production?

5. The virtual certainty that oil from the north slope of Alaska will be included in the composite for domestic pricing devalues all other domestic oil prospects which might otherwise be developed in the interim.

6. The concept that the initial $7.66 price per composite barrel can increase by the lesser of 7 percent per annum or the GNP deflator insures that the real purchasing power of income from domestic oil production will decline in the face of accelerating costs of oil field equipment and services which costs have been and will certainly increase faster than the national rate of inflation.

7. The possibility of a 3 percent per annum incentive price increase above the maximum 7 percent per annum inflation factor is taken away by granting either House of Congress veto power over the President.

8. Enactment will vest future control of the oil business in Congress; viz., the industry will be effectively Congressionalized leaving but one short step to be taken before nationalization. Who really believes that Congress will relinquish control of the oil industry after 40 months?

9. Authorizing the President to require maximum rates of production of crude oil and natural gas from designated fields coupled with the requirement that employees and officers of FEA and the Department of Interior "disclose their financial interest in oil, natural gas, and coal" in an effort to legislate "objectivity of administration" will insure ultimate waste of hydrocarbon reserves by taking authority over producing rates away from eminently qualified State agencies and placing same in the hands of unqualified, politically motivated, neophytes.

Considering the above, The Energy Policy and Conservation Act of 1975 should be renamed the Energy Dependency Act of 1975.

There are certainly additional arguments to be made against The Energy Policy and Conservation Act; however, those made above should suffice to elicit and sustain a veto provided one can demonstrate that existing policy is working in a demonstrably superior manner. Readily available statistics reveal the following:

1. The domestic oil and gas industry began to revitalize in the second quarter of 1973, in response to increasing prices for domestic crude oil. Active rotary rigs increased in number from 812 in March 1971, to 1760 in November 1975.

2. Domestic crude oil and condensate production declined steadily from a peak rate of about 10,000,000 bbl per day in 1970, to the present rate of about 8,250,000 bbl per day. The peak rate of decline in domestic production was about 7 percent per year over the period from August 1973, to April 1975; however, the decline trend began to flatten in April 1975, and domestic production of crude oil and condensate has been almost constant at about 8,250,000 bbl per day for the last 3 months. We have arrested the decline trend!

3. Each attempt to enact punitive legislation against the oil and gas industry has been reflected immediately in decreased rig activity and has delayed our recovery effort. Examples are:

a. Emergency Energy Act of 1974.—Price rollback to $4.00 per barrel—passed Congress, vetoed, and veto sustained—rig count dropped and stayed flat for 4 months.

b. Tax Reform Act of 1975.—Allowance for percentage depletion eliminated for most of industry and severely restricted for all of industry—rig count dropped and stayed flat for 7 months.

4. Our dependence on foreign supply for crude oil was clearly shown by the OPEC Embargo which caused the energy recession of 1974–75. The United States cannot permit its economy to be dominated by foreign governments.

5. The Tax Reform Act of 1975, the proposed price rollback of 1974, the current attack on tax treatment of intangible drilling and completion costs, and the pricing features proposed in The Energy Policy and Conservation Act of 1975, represent a continuous succession of illogical proposals on National energy policy which suppress our oil industry as graphically evidenced by available statistics.

Attachment I presents the five year statistical history upon which the above arguments are based. We conclude that the oil industry is responding to our need to maximize domestic crude oil supplies despite the hindrances already imposed by Congress. What will happen if this new act becomes law? Attachment II is a graphical presentation of our forecasts assuming decontrolled prices versus controls proposed by this act. Key conclusions are:

1. Rig activity will decrease: We estimate a drop in the activity rate of about four hundred rigs per year. This prediction results from our estimate that a $6,700,000 investment will be required by industry to sustain the activity of one rig for a full year in 1976; thus, a three billion dollar loss of revenue converts to 44 percent fewer active rigs per year.

2. Based on 1974 statistics, we estimate that one rig over a year's time found about 740 bbl per day of new crude oil productive capacity. If this energy act becomes law, we project a productive capacity loss of: (1) 106 million barrels per year by January 1, 1977; (2) 252 million barrels per year by January 1, 1978; (3) 427 million barrels per year by January 1, 1979; and (4) 630 million barrels per year by January 1, 1980.

3. Stating argument (2) differently, passage of this act is forecast to result in loss of domestic crude oil productive capacity totaling 1,730,000 barrels per day by 1980.

4. Assuming that OPEC increases oil prices by no more than 10 percent per year, we will be paying about $18 per barrel for imported oil by 1980, and this act will have reduced our capacity to produce our own oil by about 630 million barrels per year. The rate of cost for the additional imports necessitated by passage of The Energy Policy and Conservation Act of 1975 will exceed eleven billion dollars per year in 1980.

5. Based on 1973 and 1974 additions to crude oil reserves (IPAA), this act will prevent future additions to reserves in the approximate amount of one billion barrels annually.

The specific numbers quoted above are subject to debate; however, we may well have erred on the conservative side. For instance, U.S. demand for crude oil is assumed to be the same whether domestic crude oil prices are controlled or decontrolled. This surely results in a minimum estimate of import dependency recognizing that a rollback in domestic prices encourages consumption; furthermore, we assume that Congress and The President will not decide to penalize our industry further by forcing capitalization of intangible drilling costs as proposed by the House Ways and Means Committee. Perhaps we are overly optimistic! Whether or not our numerical estimates can be explicitly defended is immaterial, the overall conclusion that enactment of The Energy Policy and Conservation Act will do irrevocable harm to this Nation's efforts to gain energy self-sufficiency is irrefutable. Just suppose another Prudhoe Bay or East Texas Field lies beneath Atlantic coastal waters. Can we permit this "energy act" to discourage the search?

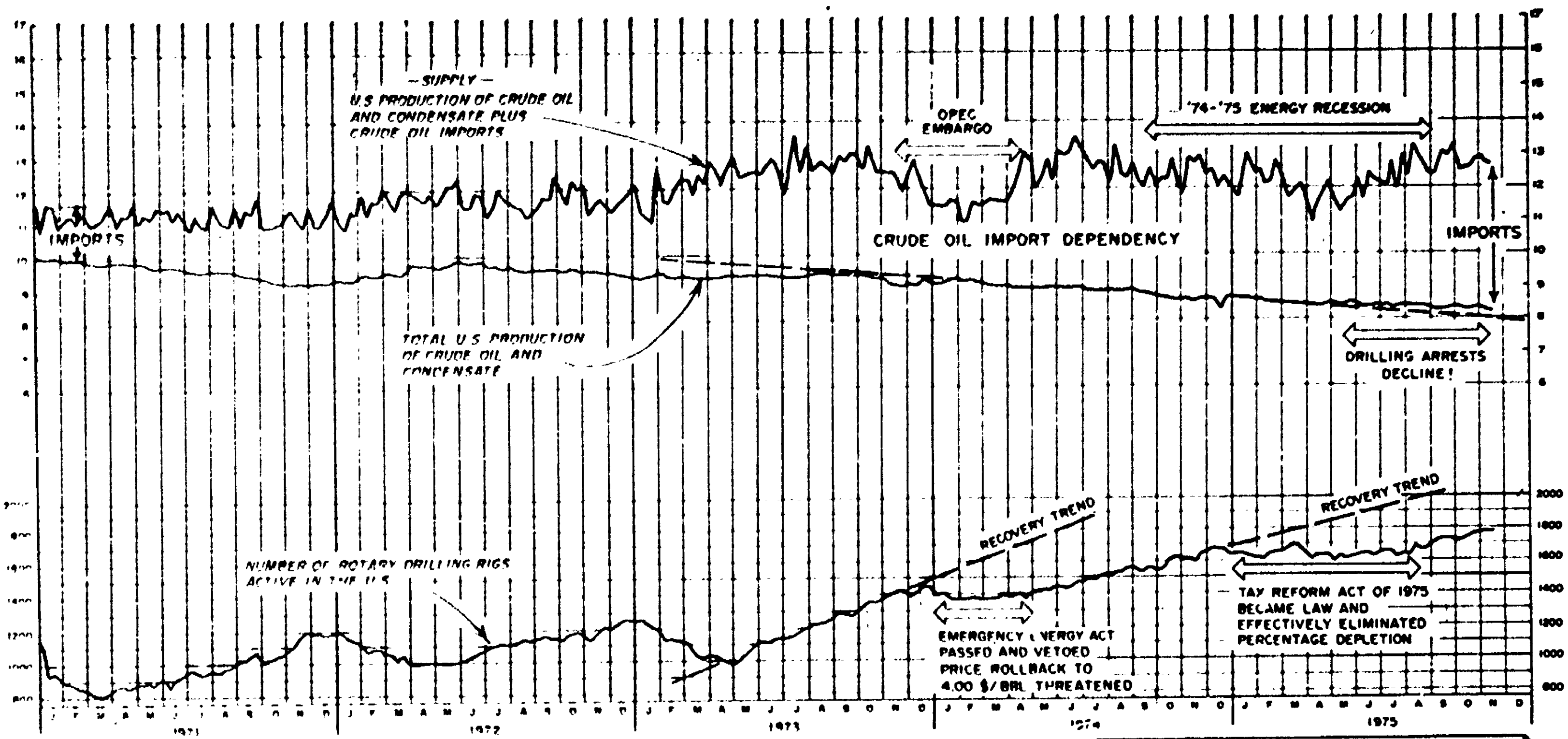
The arguments presented above can be summarized by three questions.

1. Is it in our national interest to insure success for the OPEC cartel?

2. Is it in our national interest to kill industry efforts to rebuild domestic productivity and reserves of crude oil?

3. Is it in our national interest to buy OPEC oil which we could have produced ourselves particularly considering the fact that, if our domestic oil industry received the same price as OPEC for these new barrels, the consumer cost would be identical?

The Energy Policy and conservation Act dictates a yes answer to each question! This is a "no win" policy! We believe the American people would counter with a positive no if their elected representatives will explain the simple facts of our energy dilemma and quit using the situation for political gain at the expense of our Nation's future!



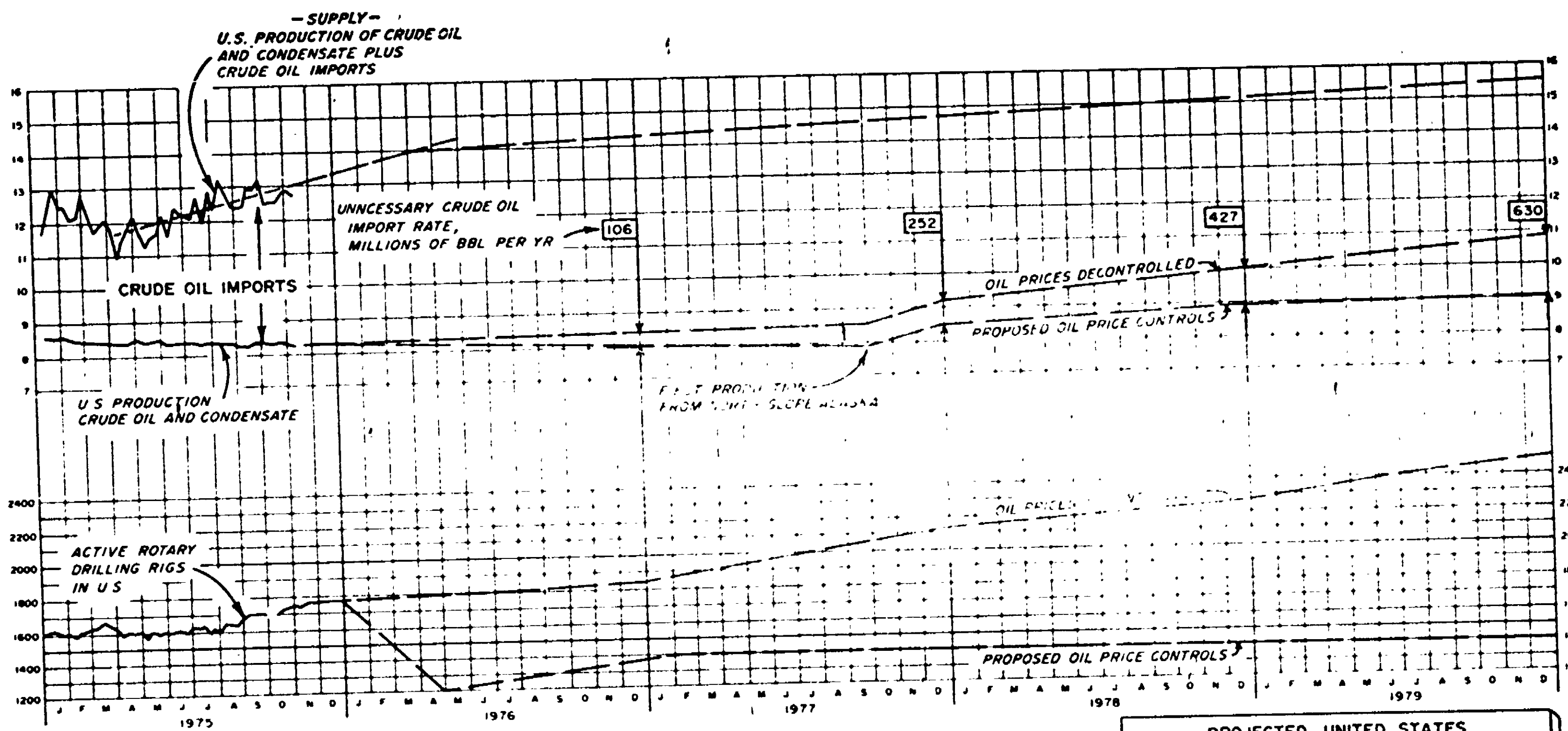
TOTAL UNITED STATES
CRUDE OIL PRODUCTION, CRUDE OIL SUPPLY
AND ACTIVE ROTARY DRILLING RIGS
1971 THROUGH 1975

THE FIRST NATIONAL BANK OF MIDLAND
MIDLAND, TEXAS

BY: C.D. Fraser
DATE: 11-26-75

DATA SOURCE: Oil & Gas Journal

ATTACHMENT I



ATTACHMENT II

STATEMENT OF ALLEN THOMAS, VICE PRESIDENT, NATURAL RESOURCES GROUP OF THE CENTRAL BANK OF DENVER

Mr. Chairman, my name is Allen Thomas. I am Vice President of the Natural Resources Group of the Central Bank of Denver.

As an energy banker dealing solely with the independent segment of the petroleum industry, I feel well qualified to appear today to present the viewpoint of a medium-sized bank toward proposed changes in petroleum taxation. My background includes bachelors and masters degrees from Pennsylvania State University in Petroleum and Natural Gas Engineering and four years of business and corporate finance at New York University. My work experience includes three years as an oil field roustabout, roughneck, and reservoir engineer for the Mobil Oil Corp., eight years as a petroleum engineer and loan officer for the Chase Manhattan Bank, and three years in my present position.

The Central Bank of Denver is the fourth largest bank in Denver and in the State of Colorado, having holdings of approximately $400 million. For over 20 years, Central Bank has been a leader in the financing of the operations of independent oil men. Our petroleum portfolio to date consists totally of small- to medium-sized independent explorers and producers, drilling contractors, service companies, geologists and landmen.

Since I deal daily, and very personally, with the independent segment of the oil business, I feel quite concerned about the adverse impact that H.R. 10612 will have on their operations and on the financing practices and capabilities of our bank.

To illustrate my concern, let me explain briefly how oil and gas loans are made.

First, oil and gas exploration is an extremely risky business. Great care must be exercised before a bank will lend money for drilling activities. Banks will not take greater risks in lending money for oil ventures than they will in lending money for a normal commercial venture. In fact, if properly designed, oil and gas loans are structured to reduce risks below those associated with a normal commercial loan. This can be accomplished only through careful analysis and selection of collateral.

The primary collateral of an oil and gas loan is proven, developed oil and gas reserves. In addition, most bankers insist that the loan be self-amortizing—i.e., the loan must be repaid from the income realized from the sale of oil and gas from the collateralized property.

Bankers are aware that oil and gas are depleting assets. Therefore any delay in repayment necessarily leads to a diminution of the underlying collateral. Thus, it can be clearly seen why bankers will lend only on the basis of well proven and developed reserves, not new risk ventures. They must know from the outset of the transaction that the collateral pledged as consideration will enable repayment even if the new venture proves unsuccessful.

A typical example, then, of an oil loan transaction would involve financing of the development of a lease offsetting a new discovery or an extension of an existing field. Our bank would evaluate the collateral offered as a basis for the loan in terms of payout possibilities and, then, would advance the needed funds for a period of up to five years.

The production disincentives contained in H.R. 10612 are incompatible with this process because they would arbitrarily reduce the cash flow available to a producer, thereby reducing his ability to repay his loans. This, in turn, would expand the repayment period, particularly for outstanding loans, beyond the period reasonably anticipated. In some cases it would delay repayment to a date which we would consider inappropriate for the risk involved, thereby exposing the bank to potential problems with the bank examiner. The resulting devaluation of pledged collateral would necessarily reduce the amount of funds available to our bank to make new loans, thereby further stemming the amount of capital available to independent producers, who are heavily reliant upon capital.

Under these circumstances, independents would be forced to seek large amounts of capital from external sources. In our experience, such capital would come from primarily three areas: First, from small, private partnerships; second, from publicly registered multi-growth programs; and third, from end-use investors.

Capital is attracted through a combination of potential profits and investors' tax considerations. Because of the considerable risk in oil and gas drilling, even in development situations, tax benefits are a major inducement to participation.

By reducing investment incentives, the proposed limitation of the intangible expense deduction to related income would discourage investors and increase producers' financial risks.

In my view this action would be counterproductive to this country's attempts to increase energy self-sufficiency because it would reduce venture capital investments to independents by at least 50%. Recent legislation and proposed changes under H.R. 10612 have combined to create elaborate rules and regulations which impose debilitating restraints on exploration by independents and psychological impediments growing out of independent producers' loss of confidence in their ability to survive. As independents' attention has been increasingly diverted from finding and developing production to administering costly and complex accounting systems and tax plans, legislative uncertainties, higher costs, and growing administrative burdens have resulted in the deferral of expenditures and costs, as well as a move by independents toward diversification of investment in order to protect hard-earned capital.

In 1973–74, the increase in oil and gas prices noticeably raised the level of drilling in the U.S.; and, until the latter part of 1975, activity was still increasing. During 1975, however, the changes in the depletion allowance, the oil price roll-back, and the passage by the House of H.R. 10612 created a slackening in drilling activities. During the week of March 15, 1976, 176 rigs were running in the Rocky Mountain region compared to 263 a year ago. The rig count is a significant indicator of reduced activity, and signs points to a continued decrease in drilling in this area of the country. Across the country as of March 15, 1976, 1,520 rigs were running compared to 1,672 a year ago. One of our drilling contractor customers reports that five out of his eighteen rigs are idle. Last year at this time all of his rigs were running.

This trend is clearly the opposite of what is needed to find more oil and gas, especially due to the fact that our Rocky Mountain region is considered by many to be the least explored, highest potential on-shore area in the country. Traditionally, the independent has had the courage to take risks, confident of his ability to survive. When successful, his increased cash flow has been returned to the ground in the form of increased drilling activity. The current legislative climate fosters an uncertain economic environment in which each new change reduces the will and ability of the independent to finance drilling to enlarge his search for oil and gas. A more productive approach would be to stabilize the economics of energy exploration and production and to create improved incentives for increased spending which would stem the decrease, and encourage the replacement, of domestic reserves.

The CHAIRMAN. Next we will hear from Mr. Robert Nathan, speaking on behalf of the Small Producers for Energy Independence.

We are very happy to have you, Mr. Nathan.

STATEMENT OF ROBERT R. NATHAN, ROBERT R. NATHAN ASSOCIATES, INC., ON BEHALF OF SMALL PRODUCERS FOR ENERGY INDEPENDENCE

Mr. NATHAN. Thank you very much, Mr. Chairman.

I am very happy to be here because I do believe that this energy situation, about which I earlier testified before this committee, is one of critical importance for the national economy and for our whole economic and security posture domestically and internationally. I believe it is critical that there be testimony from the economic point of view.

Let me say, first, Mr. Chairman and members of the committee, that I will not be commenting on specific, precise tax proposals, but I will be talking about the general nature of these tax provisions, and also I would just like to summarize this statement and leave the total with all of the tables and charts to go into the record as it is.

If I may, sir, just talk about two things briefly before dealing with the specifics we are concerned about. I feel that the United States

has made precious little progress in the solution of our energy problems in the past couple of years. It is now roughly 2½ years since the embargo was imposed and since we faced a crisis which had the country deeply disturbed. Unfortunately, too many of our people have now forgotten. Too many assume there was never a crisis or have the attitude if there was a crisis, it is all gone and we don't have to have any more energy.

True, some can drive at rapid speeds and keep the temperatures high in winter, low in summer and all the other elements which are incompatible. But, I regret that there aren't enough people in the United States who are sensitive to the fact that we are now importing not only a very high ratio of our total requirements of oil, but that it is a very rapidly rising ratio from last year of roughly 38 percent. The other day there was a report that in 1 week imports exceeded 50 percent of total use.

Members of the committee, I do not think we continue in the direction which we have been going or have our policies persist in those directions.

Let me turn to another aspect of the subject that has to do with inflation. I do think that the legislation that is before this committee ought to be thought of not only in the context of the energy crisis, but also in terms of inflation. I don't believe we are out of the woods on inflation. There continue to be threats of rising prices of a serious magnitude.

While we have had 2 or 3 months in which prices looked pretty good, on the whole it isn't that good. In the last 6 months wholesale prices of industrial commodities rose at an annual rate of almost 8 percent; in the last 6 months consumer prices of services rose at the annual rate of 10 percent. It is only food prices that have slowed considerably.

There are still threats in other areas. I think it is incumbent on us then to think of how we can solve this energy problem with a minimum impact on inflation as well as the maximum benefits in terms of energy. I do believe that we have certain policy choices.

One policy choice has to do with imports of oil versus domestic production, and I don't believe anybody has to dwell on that, because it seems very clear in the national interest that we have got to do nearly the impossible to get our domestic oil and gas production up as such as possible.

Another alternative would be to go exclusively through the price route in seeking maximum domestic output. We can try to push prices up and up as the way of trying to get increased oil supplies in the United States, and I think what this would do to raise problems of an inflationary nature ought to be taken into account.

Clearly, risks have increased in energy, oil, and gas production in the United States, and as these risks have increased, we did see some adverse responses. We did have a long down trend in drilling in the United States, and that is perfectly understandable because the economic cost of producing oil rose further and further and further above the market price. The result was that the incentives to produce

diminished and the drilling trend went down very, very substantially for at least a decade prior to the embargo. Then with the embargo, domestic as well as import prices did rise dramatically.

We have had a response in terms of rising drilling, but I venture to say here that anybody would look carefully at oil production and exploration activities in the United States and say that the modest increase we have had in drilling ought not to be jeopardized now. Rather, we ought to do everything in our power to increase it substantially.

Further, if we are going to move with any degree of success toward energy self-sufficiency, we must understand the problems as to how we are going to get more energy independence.

I believe that what we have had in the United States in the last 2 years is a set of policies, which are about as perverse in relation to what is in the national interest as anybody could conceive.

If somebody sat down and said, "Let's figure out a way to avoid progress toward energy self-sufficiency and to avoid energy independence," I don't think they could have pursued a set of policies that could have been worse than what we have.

As you remember, Mr. Chairman, I came before this committee about 1 year ago and other committees and presented studies that had been made. I think it was the first time it was ever done, and we worked with a petroleum consulting group down in Texas, which showed the estimated cost of new production—rather, the cost of oil production of, I think, $12.84 a barrel.

There are differences that people have about the specific numbers, but I think the fact that new oil prices were decontrolled and got up around $13, induced more drilling and more exploratory activities. Now, the first thing we have seen is a reduction in raw oil prices. I didn't think there is any question that it is a discouraging element. Maybe it isn't reducing drilling yet, although in the last 3 months drilling has slowed, but it will in time have a bad impact.

Again, I would emphasize before any congressional group that what we need is not only to prevent a further decline like we had from 1960 to 1973 in drilling, but we need to increase drilling activity very, very substantially.

Second, the change in depletion was very contrary to stimulating drilling activity in the United States. The $12.84 cost, Mr. Chairman, which we came up with as the economic price of oil about 1 years ago, was estimated without taking into account any change in the depletion provisions. If we recomputed that, Mr. Chairman, today on the basis of the change in depletion, I think we would come up with an economic cost of about $14 a barrel, not $12.84.

If we took into account rising costs since then, I think we may even be above $14 a barrel. The economic cost was aggravated by a depletion change which diminished the incentives for new oil production or, to put it another way, raised the economic cost, because if you take away a benefit and try to recover that via prices, it means you have to have a higher price.

Well, sir, if those two measures were not bad enough in terms of discouraging our moving toward energy self-sufficiency or energy independence in the United States, now comes this intangible business. While one can argue from the equity point of view, there just couldn't be a worse time to even think about doing this from the energy point of view. Maybe 20 years ago when Louisiana and Texas and Oklahoma had limits and restraints that you could only produce 4 days a month or 5 or 8 days a month, it was proper to fight for lowered incentives. But not now.

One might have said a decade ago, why give all these incentives to increase production and find new wells. But now there is an energy crisis and it is desperate that we increase our domestic energy production and our energy output. At thi time to take away the incentives that have been there for 50 years is utterly incompatible with the best interests of the United States.

So, I conclude, Mr. Chairman, that what is desperately needed now is a very, very careful consideration of what the major objectives and major purposes are with respect to oil and gas activities in the United States. The major purpose should be to maximize, to expand, to increase, to get as much production as we possibly can, and that translates into large-scale drilling, exploration in the fullest possible measure, and that is only going to be achieved by providing incentives both on the cost or price side and on the incentive side, on the price side so that if it is successful, the rewards will bear some relation to the risk and cost; and on the incentive side so that the risk can be minimized.

I hope, Mr. Chairman, that when this committee takes a good look at these details, that these diminutions of incentives from taxes will be taken out as they were passed by the House, and I would hope we might even turn around and liberalize our depletion on new oil and gas.

The CHAIRMAN. Thank you very much for a very fine statement, Mr. Nathan.

The reason that some Members found it necessary to leave while you were speaking was because those five lights showing on the clock behind you indicate a Senate vote is in progress. You made a very fine presentation, just as you did last year, and I want to assure you that all this fine information, including these very useful charts that you presented to us, will be helpful to us.

Can you help us to determine the extent to which these tax increases have resulted in less employment in this industry and the extent to which these further proposed increases will result in less employment in America?

Mr. NATHAN. Mr. Chairman, let me try to see what we can do about that. We do have a great deal of information on input and output analyses, and on the secondary, and tertiary, and multiplier effects in terms of increased expenditures, revenues, and taxes available for investment. I will see what we can do to try to come up with some estimate of the impact on employment and on production that would arise from these tax increases.

Senator FANNIN [presiding]. We certainly appreciate your testimony—I will read it with a great deal of interest as you are reputed to have a great deal of knowledge in this area of taxation.

What has just been explained to me illustrates that you are concerned with what this Congress can do. Recent reports continue to point to the increase in oil imports. They are up to where we thought they would be several years from now. This is very disturbing news.

I personally appreciate your testimony and the committee is very appreciative of your appearing here today and furnishing the information that you have, and I thank you on behalf of the committee.

Mr. NATHAN. Thank you very much for the opportunity, sir.

[The prepared statement of Mr. Nathan follows. Oral testimony continues on p. 879.]

TESTIMONY OF ROBERT R. NATHAN, ON BEHALF OF THE SMALL PRODUCERS FOR ENERGY INDEPENDENCE

ENERGY, INFLATION, AND TAX POLICY

Mr. Chairman, my name is Robert R. Nathan. Last year, I testified before this Committee on the economic cost of finding oil in the United States. I did so at a time when the Congress was considering an omnibus bill that would fix the price of domestic oil. The purpose of my testimony was to establish the historic relationship between oil price and domestic oil supply. I appreciate the opportunity to testify again today because what the Committee is dealing with now—namely the tax treatment of intangible drilling costs and the taxation of independent producers—also directly affects the domestic supply of oil.

In legislating changes in the tax treatment of the independent segment of the oil and gas producing industry, the Committee will in effect be shaping far-reaching U. S. energy policies. I urge that these policies be formulated with full consideration not only of the serious energy crisis confronting the United States, but also of the serious and debilitating inflation which has persistently plagued this country for more than a decade. The energy policies established by Congress—including tax policies affecting oil and gas production—should be designed to reduce reliance on imported oil and to enhance our energy independence.

A brief look at both the energy crisis and the inflation situation should be helpful in formulating appropriate tax policy proposals in the energy area.

The supply outlook.—Unfortunately, too many Americans think that the crisis situation associated with the oil embargo of 2½ years ago has disappeared. Many people believe either that the crisis has been resolved or that there never was a crisis; that it was all manufactured for the benefit of special interests and that we have and can supply plenty of gasoline, oil, natural gas and other forms of energy for decades and generations to come.

In fact, we have been dangerously lulled into a false sense of security. True, the supply situation at gas stations is not what it was during the embargo. There are no long lines for service, and purchases are not limited. However, consumers forget or do not realize that more and more of these "abundant" supplies are coming from outside the United States. Domestic oil and gas supplies are becoming increasingly inadequate in relation to current and prospective demands. Our dependence on imported oil, especially from the Middle East, is rising at an alarming rate.

Proved reserves of crude oil in the United States, including Alaska, reached a peak in 1970 and have been declining ever since. The discovery of oil in Alaska in 1970 accounted for that year's showing peak reserves. Alaskan activity since then has not revealed new reserves to offset the drop in reserves in the United States as a whole. Similarly, proved reserves of natural gas peaked in 1970, the year of the Alaskan discovery. As with oil, they too have shrunk significantly since then. (See charts 1 and 2.)

Production of crude petroleum and of natural gas in the United States also reached peaks in 1970 and 1973, respectively, and has since been declining, substantially and steadily (charts 1 and 2).

While oil and gas reserves and production have declined since 1970, crude oil imports have more than tripled. Crude oil imports in 1969 and 1970 were about 23 percent of domestic supply (production plus imports). In 1975 imports accounted for about 38 percent of U.S. supply. The relationship is worsening as our production falls and as imports rise (charts 3A and 3B).

The demand for energy in all forms has grown relentlessly, despite the economic recession and conservation efforts, and with economic recovery it is up sharply. The last official report on energy demand, released earlier this month by the Federal Energy Administration (FEA) in its National Energy Outlook, projects that the country's total energy demands will grow at a compound annual rate of 2.8 percent through 1985. Growth rates of this order of magnitude have also been estimated by various economists. FEA makes several sets of assumptions in developing its projection of the rate of growth. Among the assumptions underlying its 2.8-percent rate of growth is that of "business-as-usual," and that oil prices will remain unchanged in terms of 1975 dollars. It aso assumes that electricity output will grow about twice as fast as overall energy demand, that consumption will shift gradually from oil and gas to coal and nuclear power, and that no early significant contribution will be made by new energy sources, such as solar, geothermal and synthetic fuel sources.

If we stimulate the economy to recover steadily and rapidly from the present economic recession, we shall encounter greater and greater pressures for energy growth. For example, increased electricity output is already reflected in the sensitive index of electric power output for industrial use. After an 8-month decline, it turned upward in June 1975 and has been rising strongly ever since. (See chart 4). Total electric production for all uses is moving up sharply even in the early stages of recovery.

There are, of course, many uncertainties entailed in predicting U.S. oil and gas reserves and production, and the demand for energy as a whole and for oil and gas in particular. Yet, we can be sure that there will be increasing pressures on supplies, whether domestic, foreign, or both. Unless we achieve much greater success in conservation and much more progress in expanding domestic production of all energy sources, energy self-sufficiency will become more and more remote. The only way we are going to reverse the downtrend in domestic production and the growth of imports is to adopt realistic policies that will encourage domestic output of energy supplies. Price and tax policies are key elements in such policy efforts.

Inflation.—The second aspect we must consider in developing energy policies is inflation.

We have experienced more than a decade of severe and persistent inflation. It has been perverse in that it has continued through two economic recessions, one of which was the most severe since the Great Depression. Also, inflation has restrained many leaders from supporting vigorous recovery measures because they are fearful of rekindling the inflation. This apprehension has often been reflected by Arthur Burns, Chairman of the Federal Reserve Board, who remarked to the Joint Economic Committee on February 19 of this year that "The only sound fiscal and monetary policy today is a policy of prudence and moderation." He repeated his concern about inflation just this week before the Senate Budget Committee. President Ford and his two economic advisers repeatedly warn against the pursuit of rapid recovery because of the dangers of worsening inflation. It is questionable whether the policies being pursued are wise, but there is little basis for confidence that we are firmly on the road to price stability. In fact, recovery, even if moderate, may bring worsening inflation under existing policies. The solution does not lie in fighting recovery, but rather in seeking both recovery and greater price stability. This will require wise policies on a broad front, and the energy sector is of critical importance.

Policies affecting oil and gas demand and supplies can have major impacts on petroleum prices and on price levels across the board. The embargo imposed in October 1973 by foreign oil producing countries against this country and much of the rest of the world was soon followed by a quadrupling of oil prices. This led to a significant increase in wholesale and retail prices in most of the economies around the globe, bringing serious curtailment of output and employment as restrictive monetary and fiscal policies were initiated. Seldom have decisions by suppliers of any commodity had such widespread and serious impacts in so many nations.

As chart 5 shows, wholesale prices of crude petroleum, gas, and coal skyrocketed in 1974. Petroleum and gas prices continued upward in 1975. The wholesale price of electric power rose along with fuels, although at a lesser rate because of regulatory processes. The increase in wholesale oil and gas prices was an

important factor in the disturbing rise we saw in the level of wholesale prices for all commodities in 1974 and 1975. Chart 6 shows the rise in consumer prices. Particularly noteworthy is the rate of increase following the imposition of the oil embargo.

By now, most of the repercussions of the huge OPEC price increases have worked themselves through the price system, leaving long-term, if not permanent, damage in their wake.

Over the last few months, we have seen a slackening in the rate of inflation, but this abatement has been primarily the result of stable or falling food and farm prices. While in general prices are not advancing nearly as much as the extraordinary rates of 1973 and 1974, increases over the past several months are still very high by historical standards and especially high in view of the depth and duration of the recession. Over the past 6 months, wholesale prices other than farm and food products have risen at an annual rate of nearly 8 percent. Over the same half year, the prices consumers paid for services have risen at an annual rate of 10 percent. We are far from out of the woods on inflation.

Because oil plays such an important role in the functioning of our economy and because oil price increases constituted such a major factor in the rampant inflation of 1974 and 1975, we need to avoid policies that would exacerbate those inflationary pressures that would result from increasing reliance on imports or from sharply raising the price of "lower-tiered" oil.

Policy choices.—When I appeared before this Committee last July to discuss the energy problem, I said that we needed to decide on the trade-off between increased oil imports and increased domestic oil production. I proposed that we help in the fight against inflation by holding down the price of "old" domestic oil. I did recommend giving incentives to the production of "new" domestic oil by permitting its price to reach levels that would allow investors in exploratory drilling ventures to cover all costs of production and earn a fair return relative to the economic risks involved. My proposal sought to accommodate both the serious inflatonary outlook and an alarming decline in the supply of domestic oil.

Incentives need to be considered in relation to the risk factors in the oil and gas industry. These risks relate largely to costs involved in discovery of oil reserves. A major element in the drop in reserves was the marked decline over the years in exploration and drilling for new oil. That situation continues to be a source of serious concern. Chart 7 shows the decline in the search for oil in terms of the numbers of seismic crews that are active. Seismic crews are groups of geophysicists who search for oil on land in the United States and in the adjacent seas. Trends in seismic crew activity are regarded as leading indicators of oil exploration.

Seismic crew activity, which had been declining for many years, turned upward in mid-1970. This was attributable largely to the increased exploration for natural gas reserves to be sold in intrastate markets. In late 1974, however, despite the expectation that because of the OPEC embargo and price hikes the United States would increase its search for domestic reserves, seismic crew activity actually dropped sharply. Seismic crew activity has continued downward into 1976.

Chart 8 shows a sharp drop in oil well drilling for well over a decade through 1973. Less than half as many wells were drilled in 1973 as were drilled in either 1959 or 1960. This reflected the inadequacy of domestic prices of oil relative to the rising costs of exploration and drilling in the United States. The upper line in the chart is based on the number of exploratory and developmental oil wells drilled annually. The lower line on the chart shows the number of exploratory oil wells drilled. (These numbers include the estimated number of the wells drilled unsuccessfully in search for oil, in contrast to those drilled unsuccessfully in search for gas.)

Over the years 1959–75, the level of drilling activity for oil fell by about 40 percent. Over those years, the yield of each successful oil well tended to become slimmer, and the barrels of oil annually added to reserves from wells drilled each year in the lower 48 states and adjacent waters dropped between 1959 and 1974, the latest full year for which data are available. After the oil embargo of 1973 and subsequent skyrocketing of prices, well drilling picked up. Later, however, cost pressures intensified and exploratory drilling activity became less expansive. Then Congress rolled back the price of "new" oil and reduced the depletion allowance. The House moved to further restrict tax

incentives for new drilling. The prospects for energy independence are getting dimmer.

A study prepared at my request, by La Rue, Moore & Schafer, a petroleum consulting firm in Dallas, Texas, was presented to this Committee last July. The economic cost of finding, developing and producing crude petroleum in the lower 48 states in 1974 was estimated in that report to be $12.84 a barrel. The economic cost was defined to include a 15 percent return on capital to stimulate and sustain exploration. All costs incurred in the drilling of wells—producing wells and dry holes—were taken into account. All tax incentives, such as intangible drilling costs and percentage depletion (before its partial elimination by Congress last year), were added to cash flow in arriving at a price needed to yield the stipulated rate of return. The rate of return was calculated on the discounted cash flow basis widely used by investors in oil and other industries and was the aftertax product of calculations.

The method was designed to determine, through available cost data, the level of new oil prices required to yield a return that would induce a potential investor in this highly speculative activity to put his money into exploration and drilling for new oil. These calculations were examined in detail by members and staffs of congressional committees, by other witnesses and by many experts interested in the problem. As with all such analyses, there were differences concerning the precise figures, but it was commonly agreed that the price of oil had long been far below the average economic cost of producing oil. Clearly, that had been a significant factor in the protracted falling-off in exploratory drilling. While some 10,000—or about 50 per cent—of the independent drilling in this country abandoned operations prior to 1973, there were some who experienced better-than-average luck and who continued to invest their funds. But their perseverance merely stemmed what would otherwise have been an even sharper decline.

Higher prices or higher direct incentives? The Administration has urged total decontrol of oil prices as its primary instrument for solving the energy crisis. The President and his advisers have expressed the conviction that higher oil prices will effectively serve the double purpose of shinking demand and of increasing supply.

At present, however, we have legislation and a regulatory system that holds the prices of "old" oil below those of "new" oil. That system also sets limits on the amount of price liberalization that may be provided to either old or new oil. In my view, no useful purpose would be served either by immediately removing price controls on old oil or by setting much higher prices for it. Rather, I believe we should pursue techniques that will increase the search, discovery and production of new oil and gas and do it quickly and aggressively.

In short, it is necessary that the Congress scrutinize carefully the level and pattern of incentives needed and appropriate for moving toward energy self-sufficiency and away from high and growing reliance on oil and gas imports. In deciding on the incentives, the Congress should be considering not only price measures but tax measures as well. They need to be considered in relation to each other, and they need to be adequate. I believe that inadequate incentives may be worse than no incentives because they will likely lead only to false expectations and frustration.

Tax incentives in the oil and gas area must be probed in the light of present-day realities. Circumstances have changed drastically from the time when we were setting limits on production of oil and gas to avoid excess supplies. Twenty years ago, when Senator Paul Douglas was arguing for the repeal of the percentage depletion allowance and the end of the intangible drilling cost deduction on oil and gas, state regulatory commissions were sharply restricting the production of oil in order to maintain its price and to avoid overproduction. Today, we need all the oil and gas we can produce.

Senator Douglas argued—and by and large I agreed with him over a period of years—that 27½ percent depletion and the allowance for intangible drilling cost deductions gave an undue advantage to one class of taxpayers, without commensurately serving the overriding national interest. Again, I emphasize, that was many years ago.

More recently, the following events have occurred:

The threat of increased dependence on foreign oil has made it essential that the United States, as a matter of national policy, stimulate the maximum production of oil and gas.

During the 1960's and early 1970's, there was a widening gap between the "incentive" or "economic" price for oil (including all costs) and the actual market price. The costs increasingly exceeded the market price. As a result, half the independent producers in the country went out of business. It is the independents who account for the preponderance of oil exploration in the lower 48 states. Their continued and growing inability to mobilize resources to continue, let alone expand, their efforts made it less and less likely that the United States could maintain an adequate amount of domestic production. They provide the key to maximizing our oil output.

The huge price increases of 1973 and 1974 by OPEC, of course, made possible a rise in price of domestic oil. These higher prices induced a number of independents to get back into the business of exploring for and developing oil reserves. In a state like Kansas, for example, where only independents are active in exploration, the long decline in production was halted by an unprecedented burst of drilling activity.

However, the Congress, disturbed by the very high profits of the major firms associated with the re-pricing of inventories in 1974, not only repealed the percentage depletion allowance for the majors, but also substantially reduced its value to independents. As a result of that legislation, independents during the next 10 years will receive a steadily declining depletion allowance on a steadily declining amount of production. They are also limited, in making use of depletion, to 65 percent of their taxable income. The cost impacts of that legislation were not taken into account when we computed the economic price of oil in 1974. Clearly, the new depletion provisions resulted in a higher economic cost of domestic oil.

Further, late in 1975 Congress enacted a price-control bill that had the effect of reducing the new oil price by about $2 per barrel, from the $13.25 range that had prevailed prior to the new law to the $11.28 level set under the provisions of the new law. The incentive price for new oil in 1974—the price necessary to enable U.S. producers operating in the lower 48 states and off-shore to pay their costs, taxes and royalties, and to earn a 15 percent rate of return on the oil they found—had been computed to be $12.84 per barrel. This price assumed the continuation of the percentage depletion rate at 22 percent. With percentage depletion wholly or partially repealed, the economic or incentive price would tend to approach $14. Thus, by both cutting the price back to $11.28 per barrel and by reducing the depletion allowance benefit, the gap between the incentive price and the market price has been widened. Once again prices tend not to cover full costs. The effect is certain to be reflected in the level of drilling. That impact will be seen gradually and increasingly as costs rise. Not only has the combination of lowered prices and reduced depletion benefits taken away incentives to explore for new oil, but it also takes at least $2 a barrel from those producers who need those funds to finance exploratory and development operations.

Finally, the House of Representatives has now adopted an amendment of tax laws that would further shrink incentives by severely curtailing the use of the intangible drilling cost deduction. Apparently the original motivation behind the amendment was to limit the expensing of these intangibles by investors, namely those professionals and businessmen who invest by taking participating interests in oil and gas ventures. If the amendment did only that, it would have had the costly impact on oil and gas exploration of cutting off a substantial source of funding for many independents. But the amendment goes much further. It serves to limit the value of intangible drilling cost deductions by the producers themselves, and therefore, it cuts down the incentives to these independent producers. Further, should the House provision become law, money that the independents have been earning and which they would expect to invest in developing new oil properties will have to be put aside for taxes. The capital so removed from the independents cannot reasonably be expected to be replaced through loans and investments from outside institutional sources. This is the kind of "risk money" which is not really fungible with other investment funds. These risk funds cannot be expected to flow readily from most other channels of savings and investment.

To sum up this history, Congress acted on oil prices and incentives during 1975 in a way more appropriate to conditions prevailing 20 years ago—a time when there was no nationally recognized need to develop capital for oil ventures and for expanded oil and gas production. It struck, first, at the percentage depletion allowance, and then at the intangible drilling cost deduction, both

of which are now more warranted and more needed than ever before. It rolled back the price of new oil, and that is the oil accounted for primarily by the independent producer. At a time when almost everyone agrees that the United States must produce more oil from its own sources, Congress thus took two steps, and the House has taken a third, to discourage that production.

What is most distressing is that the total impact of these measures hits hardest at the independent. It is the independent who relies most heavily on an incentive price for new oil; who needs the tax incentives that help limit the high risks associated with exploratory drilling; who, along with his financing participants, pays the increased minimum tax that would be imposed on intangible drilling cost benefits; and whose ability to compete with the major companies is, ironically, the subject of much concern by the very Members who voted for these bills. It cannot be emphasized too strongly that it is the independent who is the principal finder of new reserves and who needs the incentives more than any other segment of the oil and gas industry.

Put in medical terms Congress prescribed a strong depressant for the patient who most needs a forceful stimulant. In an effort to achieve some reform in the tax laws and to restrain oil price increases, Congress, by depriving the independents of the capital they need for exploration and development, has aggravated our energy crisis by making it less likely that independents can compete with the majors, less feasible for them to discover new reserves through wildcat operations, and aggravated the inflation prospects by making more certain our increased reliance on high-priced imports.

Virtually everyone agrees that a great deal more capital is needed to increase greatly our own energy resources—whether they be oil, gas, coal, nuclear or other sources. Also, that capital in the oil and gas sector is most fruitful when it is associated with risk-bearing and venturesome independents who find most of the new oil and gas fields in the lower 48 states. The independent oil and gas producer has a fairly limited number of options in acquiring that capital. His is, emphatically, an enterprise of considerable risk. When four out of every five exploratory wells that are drilled prove to be dry, investment capital is simply not going to flow into that activity unless there are substantial price and tax incentives to attract that capital through adequate rewards and limited risks.

Adequate prices serve to reward the investor when producing wells are discovered. Tax incentives serve to reduce the risk of the investor. A number of Members of Congress seem to feel that the price increases of the past 3 years should be sufficient to attract the capital needed for a full-fledged exploratory effort. But, as I have said, the Congress late in 1975 rolled back the price of new oil below what I believe to be its true incentive level. That in itself will serve to discourage many independents from drilling for new oil reserves. To also remove or curtail tax incentives is to truly undermine the fight for energy self-sufficiency.

Some policy-makers believe it would be possible to develop additional capital for drilling by sharply increasing the price of "old" oil, or "lower tier" oil as it is now called. In my judgment, to do so would be very costly and highly inflationary. The old oil cost much less to produce than oil being found today, meaning that big price increases would yield large windfalls. Further, the increases in capital flows into oil exploration by dramatically increasing the old oil price are quite speculative. A swift rise in the price of old oil would amount to enlarging the earnings, by and large, of the major companies which do not conduct a great deal of the exploratory activity we need.

One other point needs to be made here, and that is with respect to inflation. The highest-priced oil we now consume comes from foreign sources. To the extent we do not encourage production from our own sources, we must make greater and greater purchases of that high-priced foreign oil. That will surely augment the inflationary pressures in our economy. Also sharply rising prices of old oil will aggravate inflation. We should not neglect the noninflationary role of tax incentives in maximizing our own oil and gas production.

If new oil prices have been depressed to a level inadequate to support an expansive drilling program and if the lowering of tax incentives persists, we need to ask ourselves seriously, where else can the incentive be found that will attract the large amounts of capital we need to generate major exploratory and developmental efforts. Because of inflated costs, these efforts require bigger dollar vol-

umes of total funds and funds per foot drilled than ever before. We have to recognize that the independent develops capital from production income, from attracting outside investors, and to some degree from bank loans. With the price option either restricted by controls on import prices in the case of new oil, or limited by controls and inflationary considerations in the case of old oil, the only alternative for developing and attracting capital that I can see is in the realm of tax incentives. Congress has already and substantially reduced one of the incentives—the depletion allowance. And now there is pressure to reduce the value of the intangible drilling cost deduction. I have heard reputable producers say that the impact of the change in the treatment of intangible drilling costs that has been voted by the House would be to reduce the amount of drilling they will do by perhaps one-fourth or one-third. This sounds reasonable.

Neither I nor anyone else is qualified to quantify precisely for you what the impact of that intangible tax change will be on the production of oil in the United States. There are more dry holes being drilled today than five years ago, and the amount of oil being found per producing well is less than it was. Most important, the cost of drilling has skyrocketed.

But one thing is clear: Less exploratory and development drilling will mean less domestic oil. It will mean greater reliance on imports at the OPEC-dictated price. In the past 2 years, as I have said, the declining curve of domestic oil production has flattened out in several states owing to the higher price of oil, which induced increased drilling activity. But, that helpful development has been slowed by the rollback in oil prices and is further jeopardized by changes in the tax law which hit hardest at the independent producer.

The Congress must really make up its mind about oil policy and what it wants to do concerning the goal of energy self-sufficiency. It cannot have it both ways. Last year, after nearly a year's effort, Congress arrived at an energy policy which fixed the average price of domestic oil and allowed for a certain amount of growth in that price over the next 40 months. It was concluded that a composite price of $7.66 (with a beginning new oil price of $11.28 set by FEA under the terms of the legislation) would be sufficient to generate the capital and the initiative to drive the engine of oil production. What Congress thought it was doing on the price front, however, would inevitably be seriously undermined by a tax statute that required producers to set aside for taxes what they had expected to put into rigs, pipes, lease-hold costs, and labor and that, in effect, raises the cost and economic price of oil. These statutes—depletion, price controls, intangible drilling costs—are interrelated. They cannot be viewed as discrete elements of national policy. They all have the most serious impact on exploratory activity and therefore on the level of oil production in this country and hence on the degree of our reliance on imported fuel. I strongly urge the Committee not to impose additional restraints on the productive capacity and will of our domestic producers.

TABLE 1.—END-OF-YEAR ESTIMATES OF PROVED CRUDE OIL RESERVES AND PRODUCTION IN THE UNITED STATES, 1969-74

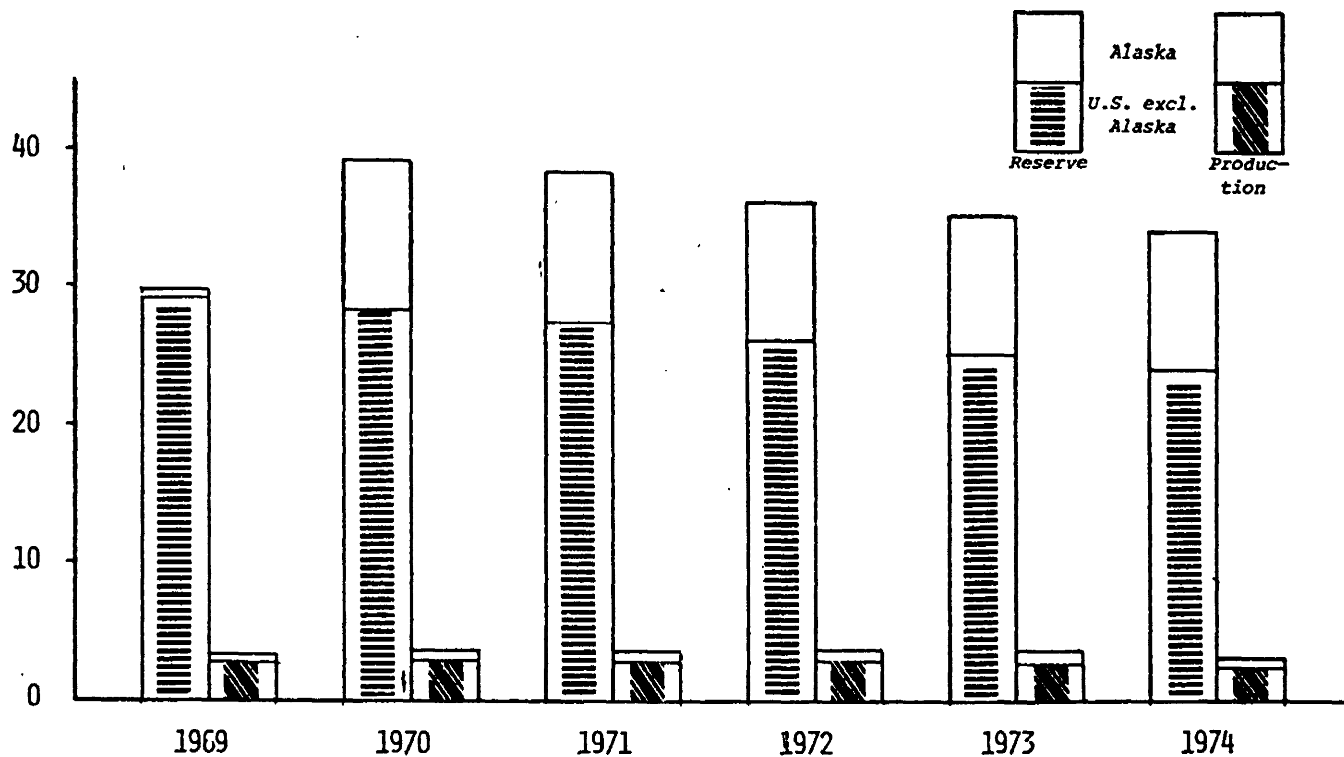
[In billions of barrels][1]

Year	Proved reserves at end of year, U.S. total	Proved reserves at end of year, Alaska	Proved reserves at end of year, excluding Alaska	Total U.S. production	Alaskan production	U.S. production, excluding Alaska
1969	29,631,862	432,300	29,199,562	3,195,291	73,098	3,121,193
1970	39,001,335	10,148,824	28,852,511	3,319,445	82,735	3,236,710
1971	38,062,957	10,116,195	27,946,762	3,256,110	77,952	3,178,158
1972	36,339,408	10,096,282	26,243,126	3,281,397	72,770	3,208,627
1973	35,299,839	10,112,213	25,287,626	3,185,400	72,322	3,113,078
1974	34,249,956	10,094,099	24,155,857	3,043,456	70,609	2,972,847

[1] 1 barrel equals 42 U.S. gallons.

Source: "Reserves of Crude Oil, Natural Gas Liquids, and Natural Gas in the United States and Canada and U.S. Productive Capacity as of Dec. 31, 1974," vol. 29, published jointly by American Gas Association, American Petroleum Institute, and Canadian Petroleum Association, May 1974.

CHART 1.
END-OF-YEAR ESTIMATES OF PROVED CRUDE OIL RESERVES AND PRODUCTION
IN THE UNITED STATES, 1969-1974
(BILLIONS OF BARRELS OF 42 U.S. GALLONS)



SOURCE: TABLE 1.

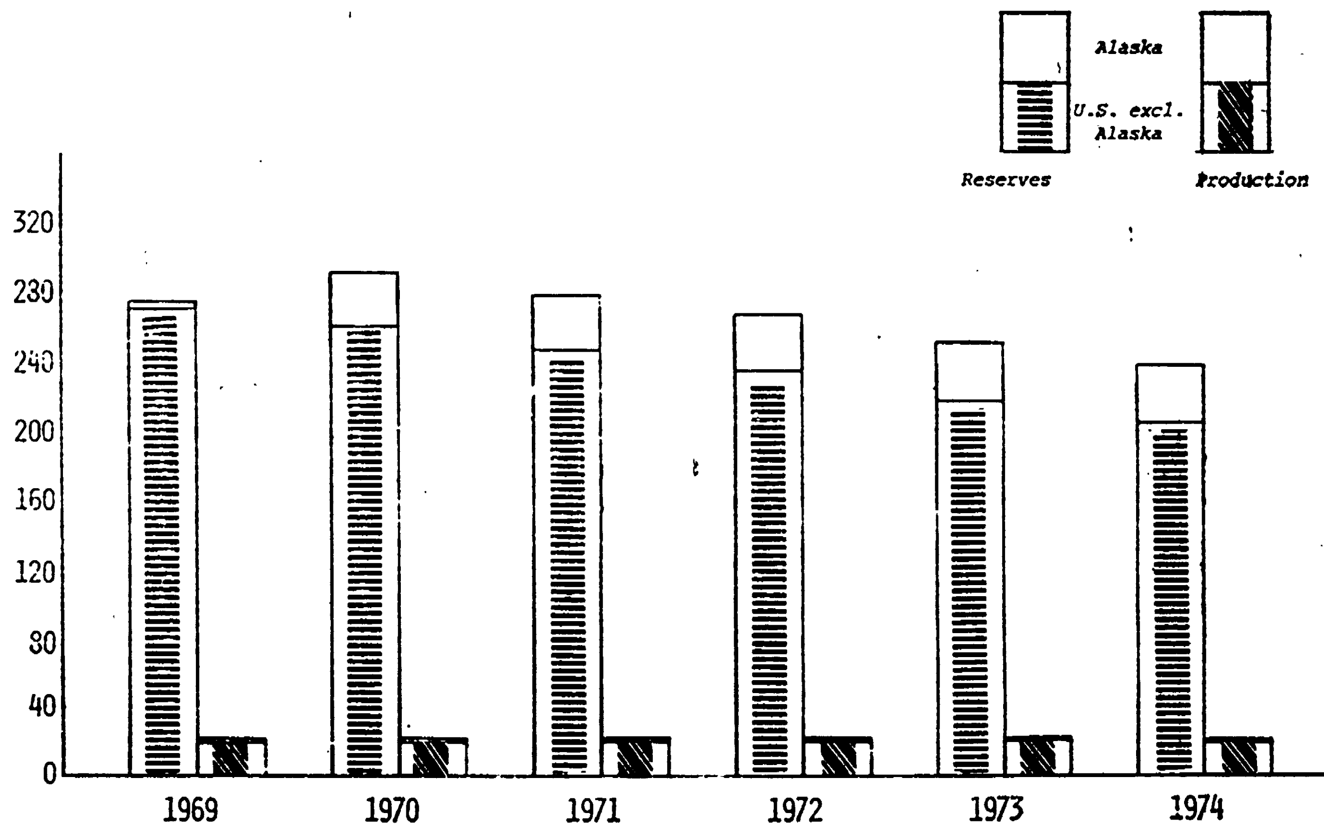
TABLE 2.—END-OF-YEAR ESTIMATES OF PROVED NATURAL GAS RESERVES AND PRODUCTION IN THE UNITED STATES, 1969-74

[In trillions of cubic feet—15.73 p.s.i.a., at 60°F]

Year	Proved reserves at end of year, U.S. total	Proved reserves at end of year, Alaska	Proved reserves at end of year, excluding Alaska	Total U.S. production	Alaskan production	U.S. production, excluding Alaska
1969	275,108.835	5,202,143	269,906,692	20,723,190	81,458	20,641,732
1970	290,746,408	31,130,751	259,615,657	21,960,804	145,200	21,815,604
1971	278,805,618	31,365,341	247,440,277	22,076,512	153,547	21,922,965
1972	266,084,846	31,455,443	234,629,403	22,511,898	147,338	22,364,560
1973	249,950,207	31,642,626	218,307,581	22,605,406	136,389	22,469,017
1974	237,132,497	31,866,612	205,265,885	21,318,470	143,930	21,174,540

Source: "Reserves of Crude Oil, Natural Gas Liquids, and Natural Gas in the United States and Canada and U.S. Productive Capacity as of Dec. 31, 1974," vol. 29, published jointly by American Gas Association, American Petroleum Institute, and Canadian Petroleum Association, May 1975.

CHART 2.
END-OF-YEAR ESTIMATES OF PROVED NATURAL GAS RESERVES AND PRODUCTION IN THE UNITED STATES, 1969-1974
(TRILLIONS OF CUBIC FEET)



SOURCE: TABLE 2.

TABLE 3.—DOMESTIC PRODUCTION OF CRUDE OIL, CONDENSATES AND NATURAL GAS LIQUIDS, IMPORTS OF CRUDE OIL AND REFINED PRODUCTS, AND RATIO OF IMPORTS OF CRUDE OIL AND REFINED PRODUCTS TO DOMESTIC PRODUCTION OF OIL AND GAS LIQUIDS PLUS IMPORTS, 1969–1975

[In thousands of barrels per day]

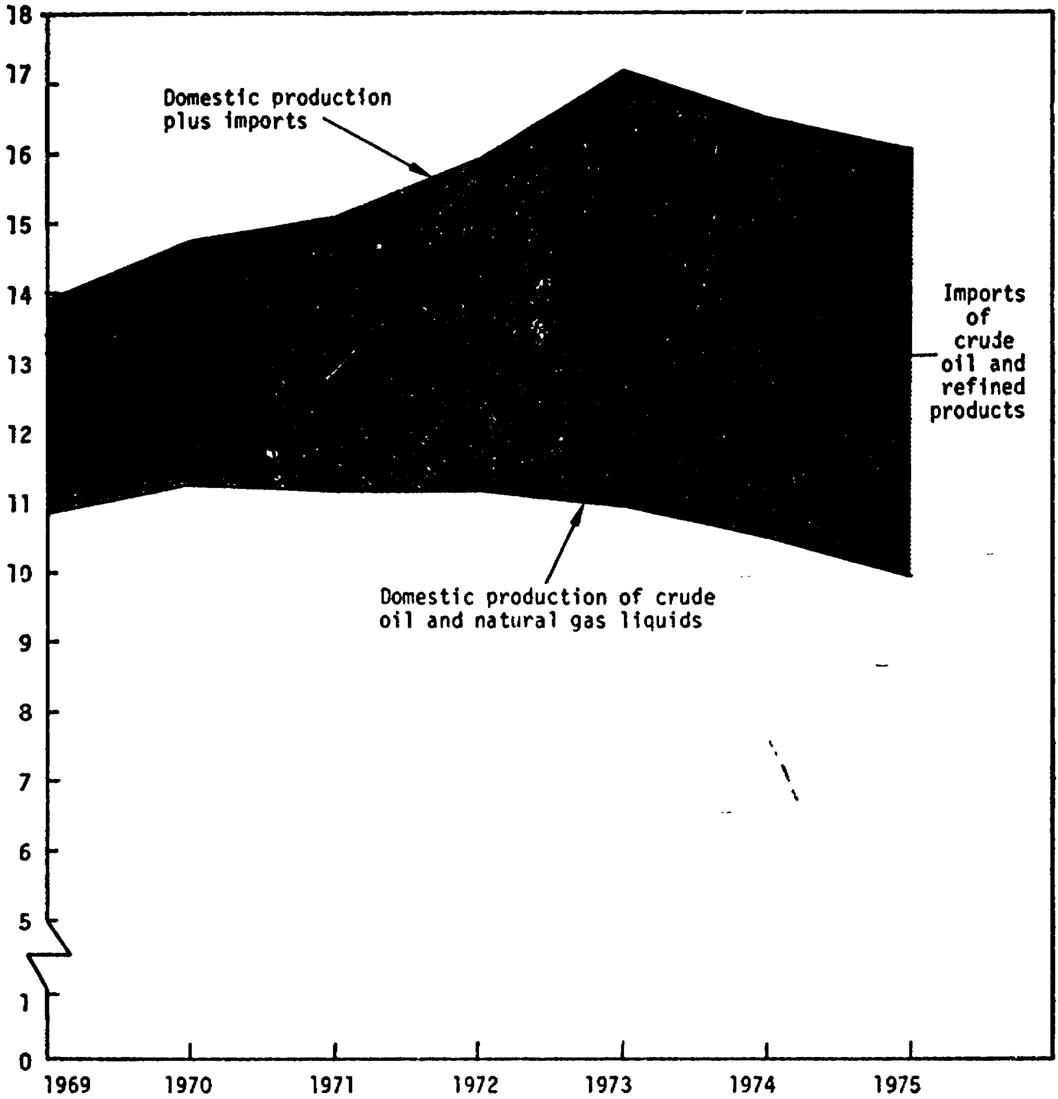
Year	Domestic production			Imports			Total imports of crude oil and refined products plus total domestic production of crude oil and natural gas liquids	Percent of total imports to total domestic production plus total imports
	Crude oil and condensates	Natural gas liquids	Total production	Crude oil	Refined products [1]	Total imports		
1969	9,237.7	1,589.7	10,827.4	1,408.5	1,757.4	3,165.9	13,993.3	22.6
1970	9,636.8	1,660.0	11,296.8	1,324.1	2,095.2	3,419.3	14,716.1	23.2
1971	9,462.8	1,692.6	11,155.4	1,680.6	2,245.1	3,925.7	15,081.1	26.0
1972	9,440.9	1,743.8	11,184.7	2,216.2	2,524.8	4,741.0	15,925.7	29.8
1973	9,208.0	1,738.1	10,946.1	3,243.8	3,012.3	6,256.1	17,202.2	36.4
1974	8,765.3	1,687.9	10,453.2	3,477.1	2,611.1	6,088.2	16,541.4	36.8
1975 [2]	8,353.5	1,631.2	9,984.7	4,101.6	1,951.0	6,052.6	16,037.3	37.7

[1] Included unfinished oil and plant condensates.
[2] 1975 figures reflect estimated monthly data for October, November, and December 1975.

Source: U.S. Bureau of Mines.

CHART 3A.. DOMESTIC PRODUCTION OF CRUDE OIL AND NATURAL GAS LIQUIDS AND IMPORTS OF CRUDE OIL AND REFINED PRODUCTS, 1969-1975

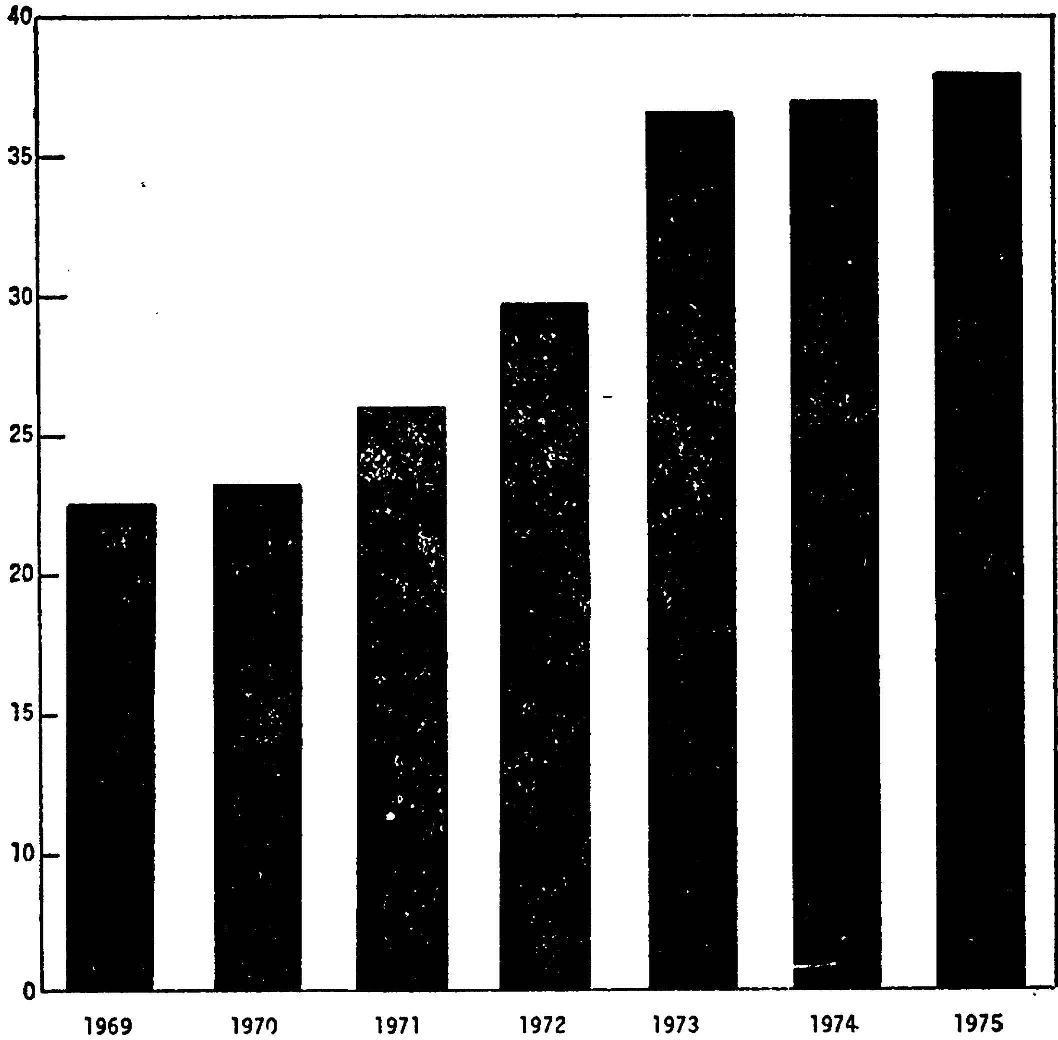
(Millions of barrels per day)



Source: Table 3.

CHART 3B. RATIO OF IMPORTS TO DOMESTIC PRODUCTION PLUS IMPORTS, 1969-1975

(Percent)



Source: Table 3.

TABLE 4.—INDEX OF ELECTRIC POWER OUTPUT FOR INDUSTRIAL USE, QUARTERLY, 1963-75

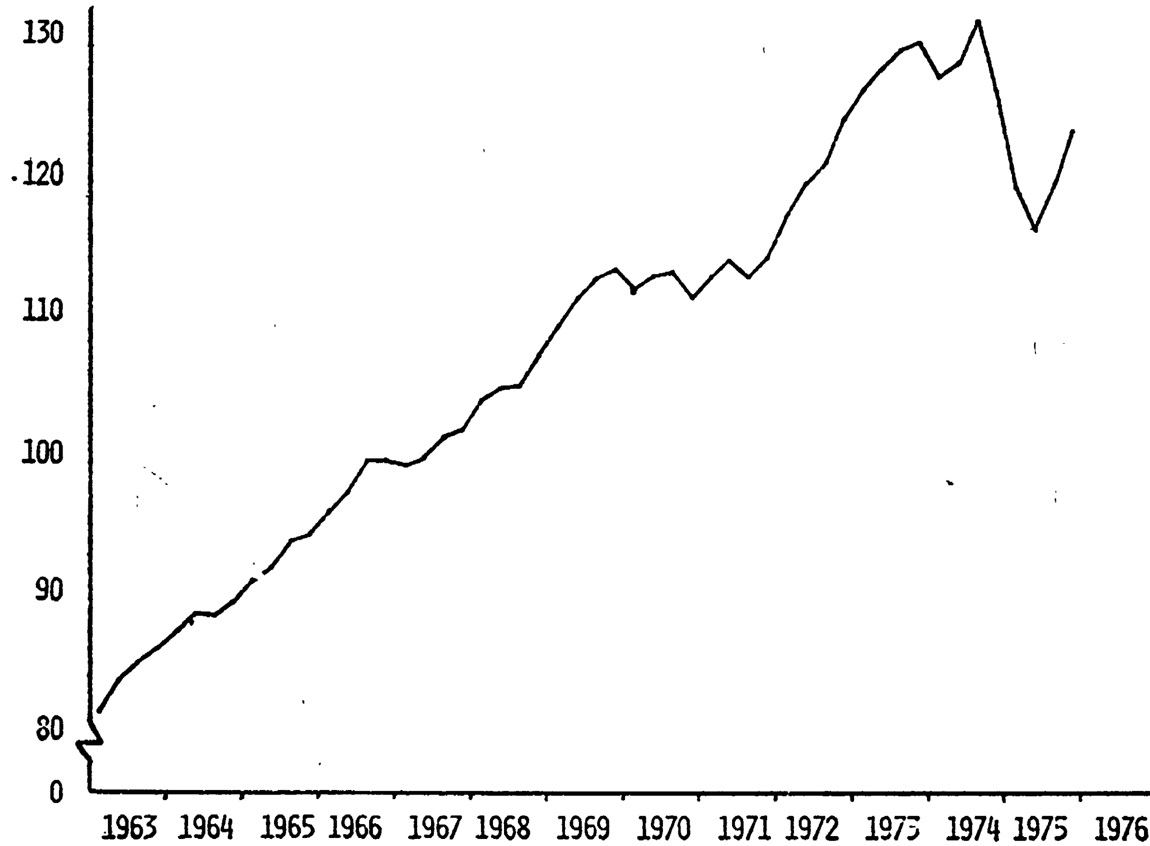
[1967=100]

Year	Electric power output			
	Q1	Q2	Q3	Q4
1963	80.7	83.0	84.3	85.2
1964	86.5	87.8	87.7	88.6
1965	90.3	91.3	93.2	93.6
1966	95.3	96.6	99.0	99.0
1967	98.6	99.2	100.7	101.4
1968	103.4	104.1	104.3	106.6
1969	108.8	110.6	112.1	112.8
1970	111.4	112.3	112.6	110.8
1971	112.4	113.5	112.3	113.7
1972	116.9	119.0	120.5	123.6
1973	125.8	127.2	128.6	129.2
1974	126.8	127.8	130.6	125.8
1975	118.9	115.7	119.0	122.8

Note: Electric power sold by utilities for industrial use, electric power used by utilities, and power generated by industrial plants excluding sales to utilities. Utilities include large cooperatives and government agencies—such as Bonneville, the Tennessee Valley Authority, and municipally owned utilities—as well as investor-owned companies.

Source: Industrial electric power use series, Board of Governors of the Federal Reserve System.

CHART 4. INDEX OF ELECTRIC POWER OUTPUT FOR INDUSTRIAL USE,
QUARTERLY, 1963-1975
(INDEX: 1967 = 100)



SOURCE: TABLE 4.

TABLE 5.—WHOLESALE PRICE INDEXES: AGGREGATE AND FOR COAL, GAS FUEL, CRUDE PETROLEUM AND ELECTRIC POWER, MONTHLY 1971-76

[Index: 1967=100]

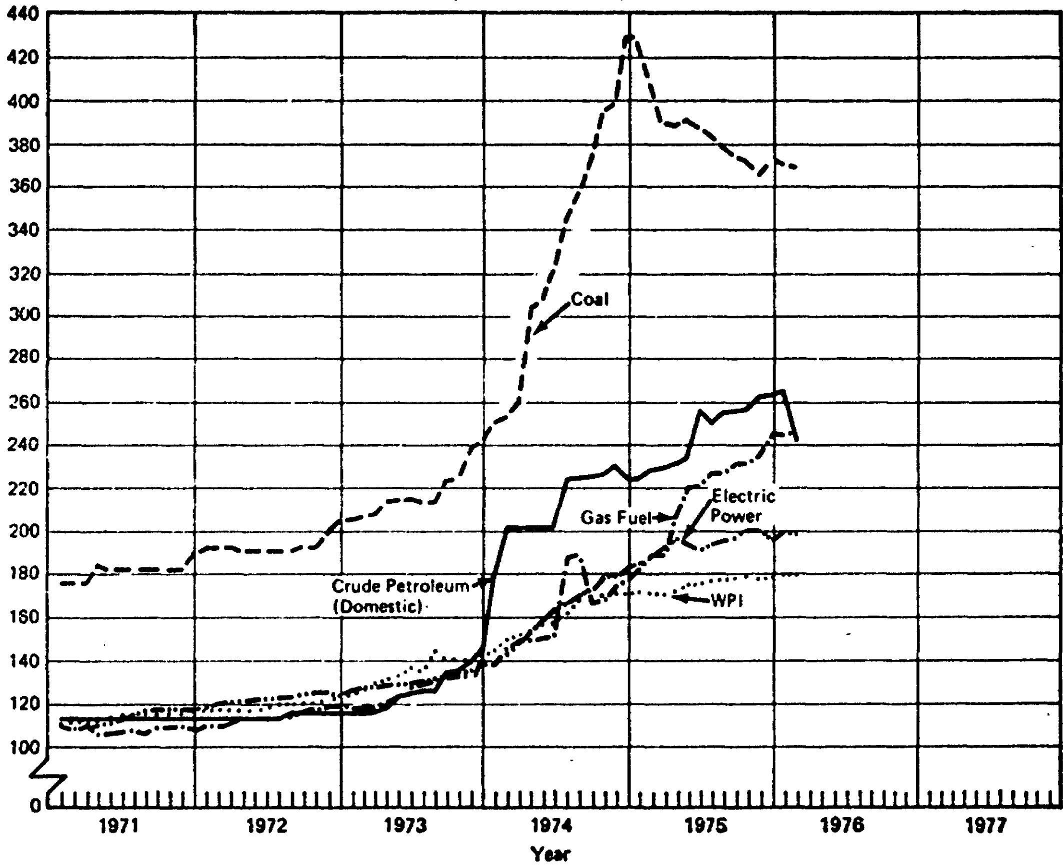
Year and month	Wholesale price indexes: All commodities	Coal	Gas fuels[1]	Crude petroleum (domestic)	Electric power[2]
1971:					
January	111.8	176.0	109.3	113.2	109.8
February	112.8	176.0	108.1	113.2	110.2
March	112.0	176.0	109.4	113.2	111.1
April	113.3	184.0	105.9	113.2	112.3
May	113.8	182.8	106.9	113.2	112.6
June	114.3	182.5	107.5	113.2	113.0
July	114.6	182.9	107.7	113.2	113.5
August	114.9	182.9	107.2	113.2	115.3
September	114.5	182.9	108.4	113.2	116.4
October	114.4	182.9	108.8	113.2	116.3
November	114.5	182.9	108.8	113.2	116.2
December	115.4	190.2	107.9	113.2	116.3
1972:					
January	116.3	192.7	110.0	113.2	118.9
February	117.3	192.6	110.2	113.2	120.0
March	117.4	192.6	110.9	113.2	120.0
April	117.5	191.2	112.5	113.2	120.5
May	118.2	191.2	113.0	113.2	121.2
June	118.8	191.2	112.9	113.2	121.5
July	119.7	191.2	113.2	113.2	122.1
August	119.9	191.5	114.3	114.7	122.1
September	120.2	192.2	116.7	114.7	122.6
October	120.0	192.4	117.5	114.7	123.1
November	120.7	201.2	119.0	114.7	123.0
December	122.9	205.5	119.2	114.7	122.9
1973:					
January	124.5	205.5	118.4	114.7	123.8
February	126.9	206.9	118.6	114.7	125.9
March	129.8	207.4	118.9	114.9	126.8
April	130.5	123.8	120.1	117.1	127.6
May	133.2	214.2	121.4	122.0	128.2
June	136.0	215.1	128.0	125.3	128.4
July	134.3	214.0	128.7	125.8	129.0
August	143.1	214.4	130.4	125.8	129.1
September	139.7	222.6	132.2	133.3	130.9
October	138.7	224.1	133.4	133.3	132.1
November	139.2	239.0	133.1	139.3	133.5
December	141.8	240.7	137.6	146.2	135.9
1974:					
January	146.6	249.3	137.1	178.4	137.5
February	149.5	252.9	146.4	201.7	142.2
March	151.4	259.3	148.6	201.7	148.9
April	152.7	303.7	149.0	201.7	153.4
May	155.0	307.7	150.0	201.7	159.7
June	155.7	321.5	151.4	201.7	164.7
July	161.7	344.0	187.4	224.4	167.6
August	167.4	357.7	189.9	225.2	170.6
September	167.2	371.8	166.6	225.4	173.8
October	170.2	394.3	167.2	226.2	178.3
November	171.9	398.0	175.5	231.0	179.7
December	171.5	428.4	177.2	223.0	180.3
1975:					
January	171.8	428.8	181.0	223.1	183.3
February	171.3	409.9	188.5	228.6	186.5
March	170.4	388.3	188.1	230.2	191.1
April	172.1	387.3	206.9	232.2	194.6
May	173.2	389.3	219.1	234.2	192.9
June	173.7	385.9	220.0	256.0	190.6
July	175.7	283.2	226.4	250.4	192.6
August	176.7	377.9	226.8	256.1	195.2
September	177.7	373.3	231.5	256.1	197.5
October	178.9	371.3	231.6	257.8	199.5
November	178.2	364.6	235.3	261.0	199.3
December	178.7	371.2	245.6	262.0	197.6
1976:					
January	179.4	370.3	244.0	263.2	198.4
February	179.4	369.3	246.7	242.3	198.9

[1] BLS monthly release states "Prices for gas except LPG (05-31), are lagged 2 mo."
[2] BLS monthly release states "Prices lag 1 mo."

Source: U.S. Department of Labor, Bureau of Labor Statsitics, Wholesale Prices and Price Indexes.

CHART 5. WHOLESALE PRICE INDEXES: AGGREGATE AND FOR COAL, GAS FUEL, CRUDE PETROLEUM AND ELECTRIC POWER, MONTHLY 1971-1976

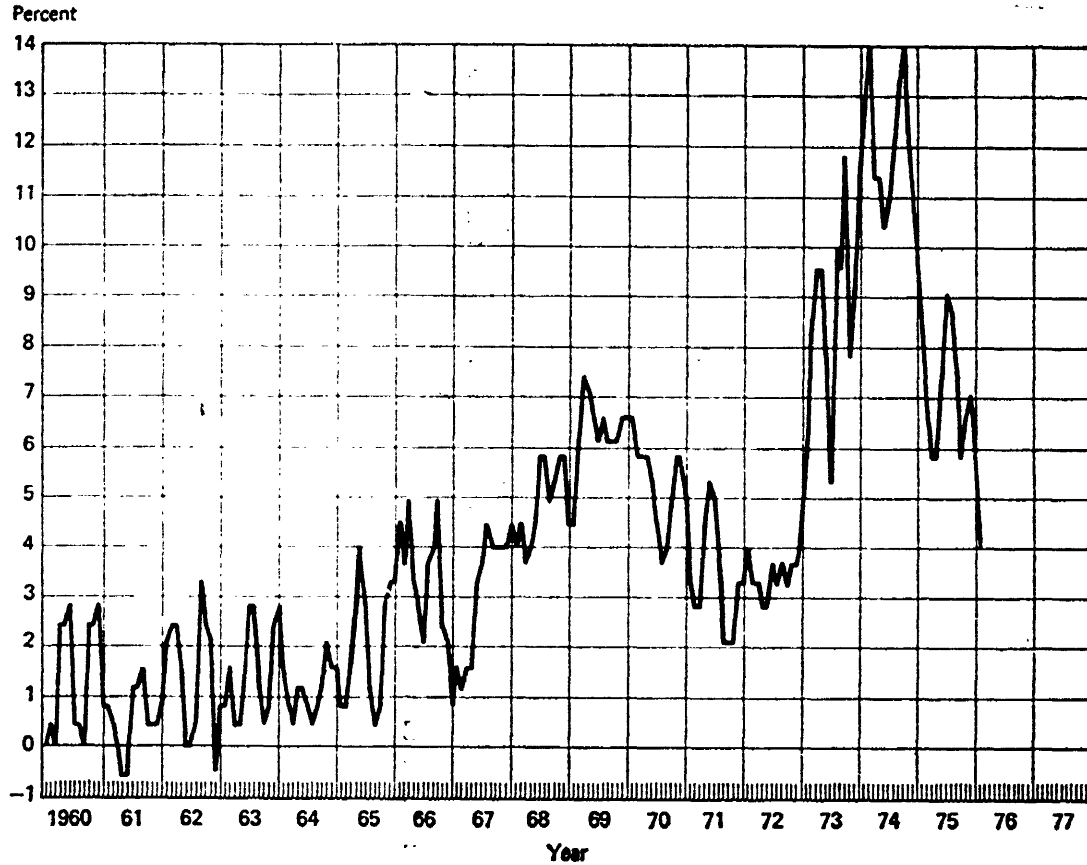
(Index: 1967 = 100)



Source: Table 5.

CHART 6

CONSUMER PRICE INDEX - ALL ITEMS
MONTHLY PERCENT CHANGES, AVERAGED OVER 3 MONTHS,
SEASONALLY ADJUSTED ANNUAL RATES, 1960-76



Source: Table 6.

TABLE 6.—CONSUMER PRICE INDEX, ALL ITEMS—MONTHLY PERCENT CHANGES, AVERAGED OVER 3 MONTHS, SEASONALLY ADJUSTED ANNUAL RATES, 1960-76

Year and month	CPI seasonally adjusted, month-to-month rate of change (1)	3 mo moving average of month-to-month rate of change (2)	3 mo moving average of annual rate of change [1] (3)
1959:			
November	0		
December	.1		
1960:			
January	-.1	0	0
February	.1	0.03	.4
March	-0	0	0
April	.5	.20	2.4
May	.1	.20	2.4
June	.1	.23	2.8
July	-.1	.03	.4
August	.1	.03	.4
September	0	0	0
October	.5	.20	2.4
November	.1	.20	2.4
December	.1	.23	2.8
1961:			
January	0	.07	.8
February	.1	.07	.8
March	-0	.03	.4
April	-.1	0	0
May	0	-.03	-.4
June	-0	-.03	-.4
July	.3	.10	1.2
August	0	.10	1.2
September	.1	.13	1.6
October	-0	.03	.4
November	0	.03	.4
December	.1	.03	.4
1962:			
January	.1	.07	.8
February	.3	.17	2.1
March	.2	.20	2.4
April	.1	.20	2.4
May	.1	.13	1.6
June	-.2	0	0
July	.1	0	0
August	.2	.03	.4
September	.5	.27	3.3
October	-.1	.20	2.4
November	.1	.17	2.1
December	-.1	-.03	-.4
1963:			
January	.2	.07	.8
February	.1	.07	.8
March	.1	.13	1.6
April	-.1	.03	.4
May	.1	.03	.4
June	.3	.10	1.2
July	.3	.23	2.8
August	.1	.23	2.8
September	-.1	.10	1.2
October	.1	.03	.4
November	.2	.07	.8
December	.3	.20	2.4
1964:			
January	.2	.23	2.8
February	-.1	.13	1.6
March	.1	.07	.8
April	.1	.03	.4
May	.1	.10	1.2
June	.1	.10	1.2
July	0	.07	.8
August	0	.03	.4
September	.2	.07	.8
October	.1	.10	1.2
November	.2	.17	2.1
December	.1	.13	1.6

See footnote at end of table.

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TABLE 6.—CONSUMER PRICE INDEX, ALL ITEMS—MONTHLY PERCENT CHANGES, AVERAGED OVER 3 MONTHS, SEASONALLY ADJUSTED ANNUAL RATES, 1960-76—Continued

Year and month	CPI seasonally adjusted, month-to-month rate of change (1)	3 mo moving average of month-to-month rate of change (2)	3 mo moving average of annual rate of change [1] (3)
1965:			
January	.1	.13	1.6
February	0	.07	.8
March	.1	.07	.8
April	.3	.13	1.6
May	.3	.23	2.8
June	.4	.33	4.0
July	−0	.23	2.8
August	−.1	.10	1.2
September	.2	.03	.4
October	.1	.07	.8
November	.3	.23	2.8
December	.4	.27	3.3
1966:			
January	.1	.27	3.3
February	.6	.37	4.5
March	.2	.30	3.7
April	.4	.40	4.9
May	.2	.27	3.3
June	.1	.23	2.8
July	.2	−.17	2.1
August	.6	.30	3.7
September	.2	.33	4.0
October	.4	.40	4.9
November	0	.20	2.4
December	.1	.17	2.1
1967:			
January	.1	.07	.8
February	.2	.13	1.6
March	0	.10	1.2
April	.2	.13	1.6
May	.2	.13	1.6
June	.4	.27	3.3
July	.3	.30	3.7
August	.4	.37	4.5
September	.3	.33	4.0
October	.3	.33	4.0
November	.4	.33	4.0
December	.3	.33	4.0
1968:			
January	.4	.37	4.5
February	.3	.33	4.0
March	.4	.37	4.5
April	.2	.30	3.7
May	.4	.33	4.0
June	.5	.37	4.5
July	.5	.47	5.8
August	.4	.47	5.8
September	.3	.40	4.9
October	.6	.43	5.3
November	.5	.47	5.8
December	.3	.47	5.8
1969:			
January	.3	.37	4.5
February	.5	.37	4.5
March	.7	.50	6.2
April	.6	.60	7.4
May	.4	.57	7.1
June	.6	.53	6.6
July	.5	.50	6.2
August	.5	.53	6.6
September	.5	.50	6.2
October	.5	.50	6.2
November	.5	.50	6.2
December	.6	.53	6.6
1970:			
January	.5	.53	6.6
February	.5	.53	6.6
March	.4	.47	5.8
April	.5	.47	5.8
May	.5	.47	5.8
June	.3	.43	5.3
July	.3	.37	4.5
August	.3	.30	3.7
September	.4	.33	4.0
October	.5	.40	4.9
November	.5	.47	5.8
December	.4	.47	5.8

See footnote at end of table.

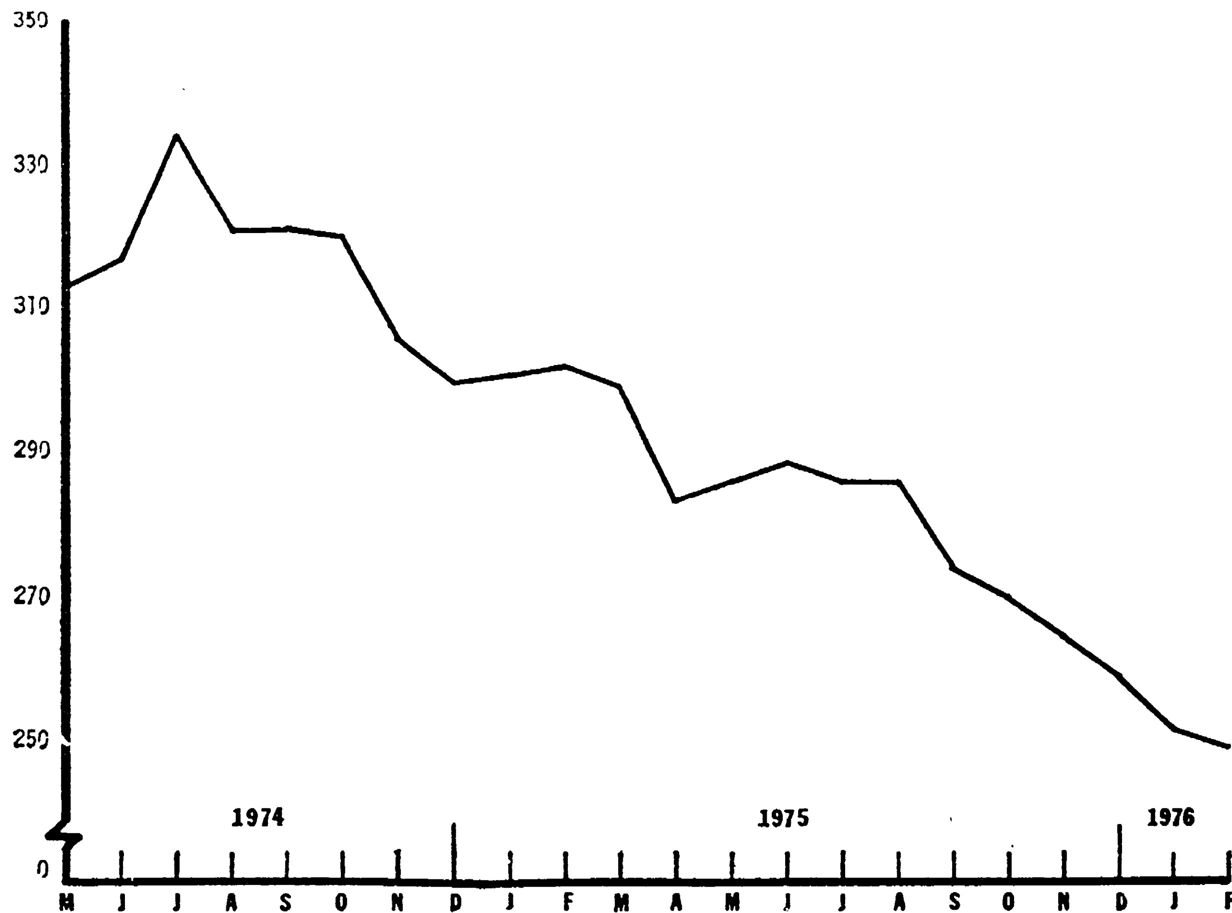
TABLE 6.—CONSUMER PRICE INDEX, ALL ITEMS—MONTHLY PERCENT CHANGES, AVERAGED OVER 3 MONTHS, SEASONALLY ADJUSTED ANNUAL RATES, 1960-76—Continued

Year and month	CPI seasonally adjusted, month-to-month rate of change (1)	3 mo moving average of month-to-month rate of change (2)	3 mo moving average of annual rate of change [1] (3)
1971:			
January	.3	.40	4.9
February	.1	.27	3.3
March	.3	.23	2.8
April	.3	.23	2.8
May	.5	.37	4.5
June	.5	.43	5.3
July	.2	.40	4.9
August	.2	.30	3.7
September	.1	.17	2.1
October	.2	.17	2.1
November	.2	.17	2.1
December	.4	.27	3.3
1972:			
January	.2	.27	3.3
February	.4	.33	4.0
March	.2	.27	3.3
April	.2	.27	3.3
May	.3	.23	2.8
June	.2	.23	2.8
July	.4	.30	3.7
August	.2	.27	3.3
September	.3	.30	3.7
October	.3	.27	3.3
November	.3	.30	3.7
December	.3	.30	3 7
1973:			
January	.5	.37	4.5
February	.6	.47	5.8
March	.9	.67	8.3
April	.8	.77	9.6
May	.6	.77	9.6
June	.5	.63	7.8
July	.2	.43	5.3
August	1.7	.80	10.0
September	.4	.77	9.6
October	.7	.93	11.8
November	.8	.63	7.8
December	.7	.73	9.1
1974:			
January	1.2	.90	11.4
February	1.1	1.00	12.7
March	1.0	1.10	14.0
April	.6	.90	11.4
May	1.1	.90	11.4
June	.8	.83	10.4
July	.7	.87	11.0
August	1.3	.93	11.8
September	1.1	1.03	13.1
October	.9	1.10	14.0
November	.9	.97	12.3
December	.8	.87	11.0
1975:			
January	.7	.80	10.0
February	.5	.67	8.3
March	.4	.53	6.6
April	.5	.47	5.8
May	.5	.47	5.8
June	.7	.57	7.1
July	1.0	.73	9.1
August	.4	.70	8.7
September	.4	.60	7.4
October	.6	.47	5.8
November	.6	.53	6.6
December	.5	.57	7.1
1976:			
January	.4	.50	6.2
February	.1	.33	4.0

[1] Computed by averaging, for each month, seasonally adjusted rates of change for that month and the preceding 2 mo (that is, a 3-mo moving average, plotted on the 3rd mo) and by converting to compound annual rates of change.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

CHART 7. COUNT OF SEISMIC CREWS ENGAGED IN OIL AND GAS EXPLORATION IN THE UNITED STATES AND U.S. WATERS -- MONTHLY, MAY 1974-FEBRUARY 1976



Source: Table 7.

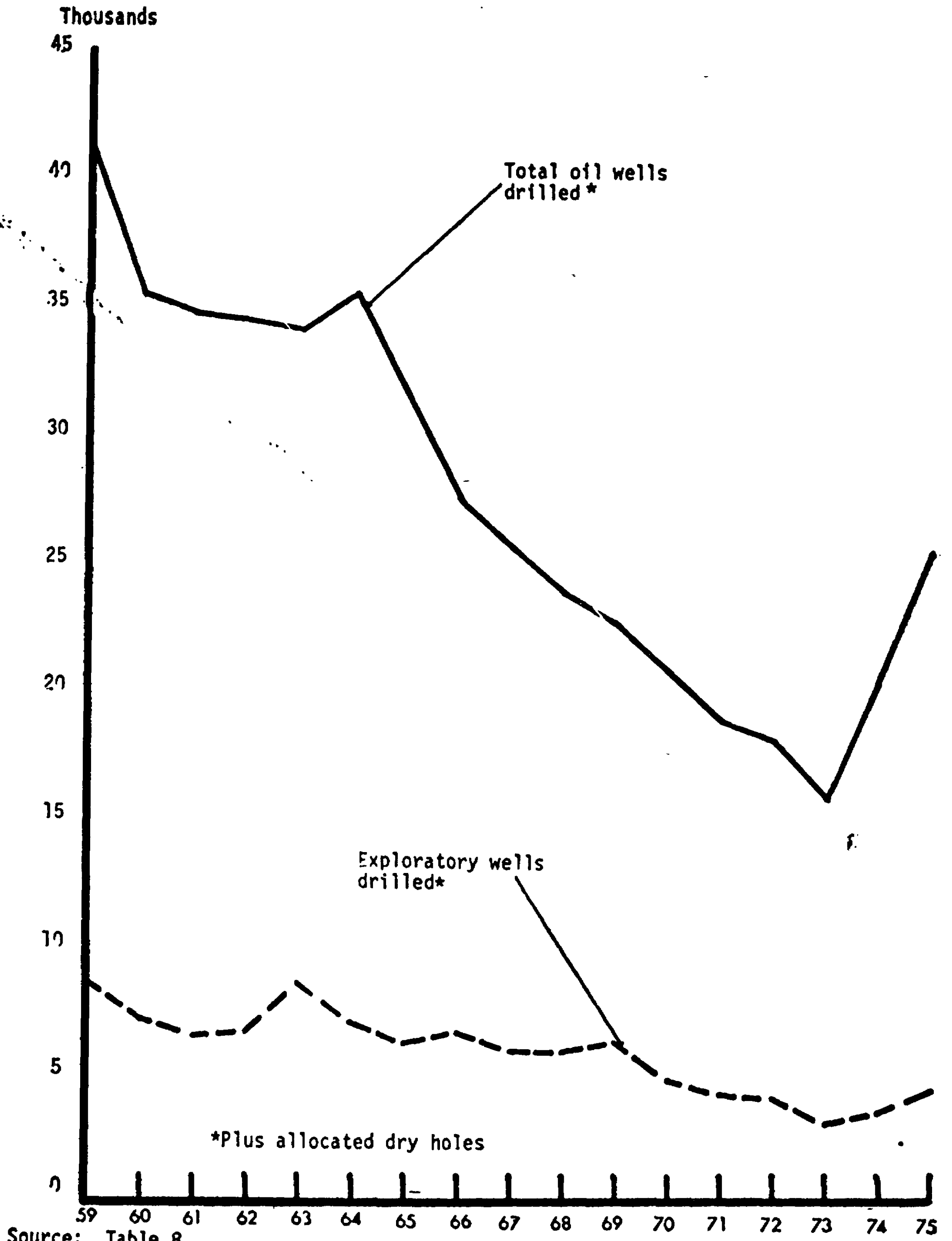
TABLE 7.—COUNT OF SEISMIC CREWS ENGAGED IN OIL AND GAS EXPLORATION IN THE UNITED STATES AND U.S. WATERS—MONTHLY, MAY 1974 to FEBRUARY 1976

Year and month	Count of crews
1974:	
May	313
June	317
July	334
August	321
September	321
October	320
November	306
December	300
1975:	
January	301
February	302
March	299
April	283
May	286
June	289
July	286
August	286
September	274
October	270
November	265
December	259
1976:	
January	252
February	249

Note: Count comprises land crews and crews on marine vessels.

Source: Society of Exploration Geophysicists.

CHART 8. NUMBER OF OIL WELLS DRILLED IN THE UNITED STATES: TOTAL WELLS AND EXPLORATORY WELLS, ANNUALLY, 1959-1975



Source: Table 8.

TABLE 8.—NUMBER OF OIL WELLS DRILLED IN THE UNITED STATES: TOTAL WELLS* AND EXPLORATORY WELLS, ANNUALLY, 1959-75

Year	Total wells drilled					Exploratory wells drilled				
	Total	Oil	Gas	Dry holes	Oil wells plus allocated dry holes	Total	Oil	Gas	Dry holes	Oil wells plus allocated dry holes
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1959	49,563	25,413	5,049	19,101	41,347	13,191	1,702	912	10,577	8,589
1960	44,133	21,294	5,262	17,577	35,387	11,704	1,321	868	9,515	7,063
1961	43,988	21,204	5,674	17,110	34,700	10,992	1,157	813	9,022	6,455
1962	43,944	21,402	5,858	16,684	43,501	10,791	1,211	771	8,803	6,589
1963	41,853	20,678	4,779	16,396	33,994	10,664	1,978	644	8,686	8,480
1964	43,486	21,012	4,874	17,600	35,298	10,747	1,219	497	8,951	7,013
1965	39,596	18,857	4,772	15,967	31,599	9,466	946	515	8,005	6,129
1966	34,521	15,856	4,060	14,605	27,483	10,313	1,030	578	8,705	6,605
1967	31,538	14,935	3,558	13,045	25,470	8,878	1,039	556	7,464	5,901
1968	29,576	13,767	3,324	12,485	23,824	8,879	863	430	7,586	5,926
1969	29,481	12,915	3,927	12,639	22,607	9,701	1,084	616	8,001	6,185
1970	27,177	12,547	3,844	10,786	20,803	7,683	790	481	6,422	4,781
1971	25,040	11,405	3,679	9,956	18,932	6,922	651	437	5,834	4,141
1972	26,443	10,753	5,086	10,604	17,951	7,539	684	601	6,254	4,012
1973	26,244	9,705	6,427	10,112	15,787	7,466	619	900	5,947	3,042
1974	31,698	12,784	7,240	11,674	20,237	8,619	814	1,195	6,610	3,492
1975	37,099	16,338	7,502	13,259	25,424	9,258	988	1,171	7,099	4,328

*Excluding service wells and stratigraphic core tests.

Notes—Column:
(1) Col. (2)+col. (3)+col. (4).
(2) Source: JAS survey, sec. 1.
(3) Source: JAS survey, sec. 1.
(4) Source: JAS survey, sec. 1.
(5) [Col. (2)/(col. (2)+col. (3))]×col. (4)+Col. (2).
(6) Col. (7)+col. (8)+col. (9).
(7) Source: Same as cols. (2), (3)+(4).
(8) Source: Same as cols. (2), (3)+(4).
(9) Source: Same as cols. (2), (3)+(4).
(10) [Col. (7)/(col. (7)+col. (8))]×col. (9)+col. (7).

Senator FANNIN. The next witness or the witness as it is on the schedule is A. F. Jones, president of the Independent Petroleum Association of America.

I understand you have someone with you. We are pleased to have you with us today. I had the pleasure of knowing your group for quite some time, as you realize, and have certainly admired the work you have done and your association has done, and the cooperation you have given this committee and other committees of Congress.

It is important that we do have a cross-section of the information, and you represent a very important group of people as far as solving our energy problem is concerned and, of course, we are holding these hearings from the standpoint of what can be done, and this particular committee's standpoint is to assist in that regard and try to be fair and equitable with all of the companies involved with the people of our Nation, consumers, and we are very pleased to have you with us and welcome you.

You can handle your testimony as you desire, sir. You have furnished us with a written statement.

STATEMENT OF A. V. JONES, JR., PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. JONES. Thank you, Senator.

I would like to say that I am an independent oil producer from Albany, Tex., and I am representing the Independent Petroleum Association of America. That association represents about 4,000 independent operators around the country. Our statement is also presented in behalf of 10 other State, regional and national associations of independent oil and natural gas producers.

I am going to paraphrase my written statement. I would like the whole statement in the record.

Senator FANNIN. Your complete statement will be placed in the record after your summary.

In that case you can drop us a hint as to what page you are on.

Mr. JONES. We want to say that the opportunity to express our serious concern about the tax bill is appreciated.

Oil and natural gas supply three-fourths of our energy needs. There is no basis to anticipate that they will play a lesser role in the next decade or so. Even by limiting growth in consumption to some 2 percent yearly, the demand for oil and gas will rise about 6 million barrels per day or 22 percent in the next 10 years.

Our dependency on Middle East and North Africa oil has increased more than 50 percent since the 1973 embargo. To trustingly proceed under the assumption that another embargo of this kind cannot happen again is a risk that we cannot afford. If the domestic industry is going to attract the venture capital to accomplish the expanded effort to reduce our future dependency on OPEC oil, it must have the encouragement of sound and consistent governmental policies.

Instead, it is confronted with one adverse proposal after another.

The chart "U.S. Oil Production and Reserves" shows that the domestic industry has been unable to add reserves equivalent to annual production in every year since 1967. Projections of these trends indicate that by 1980 annual domestic production will have declined by some 1.25 billion barrels in the decade of the 1980's. Unless these trends are halted and reversed, dependency on foreign oil will reach almost 60 percent of the U.S. requirement just 5 years from now.

The next chart, "U.S. Oil Wells Completed," shows oil well completions declined persistently from 1955 to 1973. The oil wells drilled in 1973, in fact, were less than one-third the number drilled in 1955.

Some have argued that the lack of drilling prospects rather than economic incentives caused the decline in activity. These facts, however, do not support this argument.

The new oil reserves found for each oil well completed have increased over the past 20 years. Clearly the progressively declining rate of drilling that began in the 1950's and continued through 1973 is the primary and overriding cause of our deteriorating reserve position.

As illustrated in the chart "U.S. Oil Demand and Producing Capacity" the first year in which the United States had to have imports to meet its day-to-day needs was 1968, a scant 8 years ago.

In these 8 years we have increased dependency on foreign oil by an average of 5 percentage points a year with imports supplying 40 percent of our requirement in 1975.

In the past 2 years the Congress through punitive tax and price legislation has voted consistently for increased dependency. Not a single legislation act has been adopted designed to increase future domestic petroleum production by a single barrel of oil or a cubic foot of natural gas.

The repeal of percentage depletion in March 1975 effectively removed more than $2 billion of what otherwise would have been available for exploration and development.

Congress through the Energy Policy and Conservation Act of 1975 reduced by another $3 billion the 1976 revenues which would have been available to the domestic industry by the rollback price of new and stripper well oil. By legislative action in 1975, therefore Congress reduced by more than $5 billion potential exploration, drilling, and production funds from the domestic industry.

The political fixation on denying the domestic industry the means to expand the search for production of domestic petroleum was further reflected in the recent adoption by the House of adverse legislation; namely, H.R. 9464.

The message is coming through to many producers that a majority in the Congress are not convinced that maximizing U.S. petroleum exploration and production is important or that reducing U.S. dependency on foreign oil is a pressing priority. It is significant that the impact of these actions on industry revenues are already evident in a downturn of domestic industry activity.

The chart "U.S. Rotary Rigs Running" is very significant. It shows that the average rig count in the month of February 1976 was a decline as opposed to significant increases in rig activity in February for the past 2 years. In fact, for 4 years running we had a nice increase in February.

February 1976 shows a downturn and that downturn has intensified since this chart was made. There has been a distinct relationship between wellhead values and drilling expenditures for the past 20 years. Unless this relationship changes significantly, which is unlikely, drilling expenditures will be limited in 1976 to approximately $5.9 billion under the composite pricing scheme imposed by Congress on domestic crude oil.

Under the incremental adjustments in controlled prices the anticipated drilling expenditures in 1977 will rise only $½ billion to $6.3 billion, which would contain drilling at a virtually stable level in relation to 1975.

As illustrated on the chart "Producing Oil Wells Completed," these limitations on drilling expenditures will not provide any meaningful increase in oil well completions in this 2-year period. To keep the drilling resurgence, which started in 1974, on track, oil well completion should rise to 21,600 in 1976 and to 25,000 in 1977.

To achieve this level of oil well completions, drilling expenditures would have to increase to $7.8 billion this year, and to $9.5 billion in 1977.

Much of the adverse legislation that has come from Congress in the past several months was directed, according to its sponsors at the integrated oil companies. However, in the case of the IDC changes, there is no pretense that it is directed at the big oil companies. The change would affect only independent producers who rely on outside funds for exploration and development programs.

As shown on the chart, "Role of Independence," the independent segment accounts for 89 percent of domestic wildcat drilling, 75 percent of discoveries and for almost 54 percent of all oil and gas reserves which are found. The proposed changes in IDC treatment would impact on the area where oil and natural gas resources can be made available to consumers with relative immediacy.

Senator FANNIN. Mr. Jones, the time has elapsed. I would appreciate your summarizing your recommendations.

Mr. JONES. I have some recommendations.

We could recommend that:

One: We should terminate price controls. Congress should enact legislation at the earliest possible date to remove Government price controls from crude oil and natural gas.

Two: Retain the present IDC provisions. Reject completely the ill-conceived proposals contained in H.R. 10612 to change the present tax treatment of intangible drilling and development costs. These proposals were offered initially under the misconception that the present tax provision tends to encourage inefficient investments which make no contribution toward increasing discovery and the production of domestic petroleum reserves.

The inaccuracy of this assumption is demonstrated by the direct correlation between (1) total drilling expenditures, (2) producing oil wells completed and (3) new additions to reserves.

Three: Reject any proposal to expand minimum tax for individuals.

Oil and gas producers presently are subject to taxes which effectively require them to reinvest their incomes in new exploration and drilling activities or pay a substantial additional tax. To impose new so-called minimum tax provisions would force producers to withhold substantial additional sums from exploration-drilling activities in order to have the dollars with which to pay such taxes.

Four: We urge you to adopt tax credits for exploration and development. To encourage new investment in exploration and development activities, adopt positive new tax incentives such as an exploration and development investment tax credit similar in concept to present investment tax credits for machinery and equipment.

Five: Revise the percentage depletion provision of the 1975 Tax Reduction Act. Specifically we propose:

(a) That the retailers exclusion provision in the exemption for independent producers be coupled with the small refinery exclusion;

(b) Revise the transfer of property provision to eliminate ambiguity and to make it clear that this does not extend to nominal transfers of title which do not relate to actual changes in beneficial ownership of property; and

(c) Revise the provision which limits percentage depletion to 65 percent of taxable income. This provision constitutes a substantial disincentive to wildcatters who historically have been responsible for a substantial proportion of the new fields discovered.

Six: Defer depletion phasedown. In order to offset price control we recommend that there be a moratorium—for at least the duration of price controls—on the present annual reduction in the number of barrels of crude oil eligible for percentage depletion.

We urge this committee to initiate positive actions which will enable domestic oil and gas producers to get on about the business of finding and developing our vast potential reserves of crude oil and natural gas.

I apologize for running over a little bit, gentlemen.

Senator BENTSEN. I just want to say to my colleague here that Mr. Jones is a very able and distinguished businessman, an oil man from my State, and I am pleased to have him here representing a very fine organization. I apologize I haven't been able to be here for your testimony, but I have been handling an amendment on the floor of the Senate on the airport development bill to take care of some of our problems back in Texas.

We have another vote.

The CHAIRMAN. I would like to hear what the witness has to say. Senator, maybe you ought to run and answer the rollcall right now. I will chair the hearing until somebody gets back from the vote.

Mr. JONES. I had finished, Senator Long, my prepared statement. I think they were getting ready to ask some questions there, and realizing that you do have other priorities, the thrust of our statement was——

The CHAIRMAN. Here is something I want to ask. Can you tell me what has happened to drilling by independents is the last year?

Mr. JONES. We can correlate it to independents. Of course, we could make the point that last year, Senator, independents did 89 percent of the wildcat drilling and found 75 percent of the new fields.

I also presented charts here, which show that in February of the past 5 years what the big count was. In 1972 it was 1,071 rigs; 1973, 1,126: 1974, 1355; 1975, 1,611. It got up to almost 1,800 rigs later in 1975 prior to the omnibus energy bill being passed this fall. In February of this year it was back down to 1,594, and right now down to 1,500, probably on the way to 1,300 or 1,400 in the next couple of months.

The CHAIRMAN. I hope you will help us get some of the figures to show us how many jobs that cost us, and how much employment we would have had if that had not been done. I think we ought to know what will happen if these big tax increases are put on your industry, as Senator Kennedy wants to do, such as requiring you to capitalize a hole in the ground, which is basically what his proposal amounts to. I think we ought to have some kind of analysis to show what these proposals will do to the Nation's economy and also our balance of payments, and while you might not be able to make this analysis all by yourself, I think maybe some of the other people who appeared here today can help in preparing the study. I have asked the Treasury to analyze the secondary and tertiary effects of these proposals, because when you quit drilling, then the fellow who has planned to sell you some pipe is not going to make a sale and there is no point in producing pipe, if the people have on hand more than they can use, the way it is now.

There is no use mining more if you cancel what you have on hand already. And it means that you need less truck drivers if you are going

to haul less pipe on location, and you need less gas to operate automobiles.

We need an analysis of what all that type of reform would do to the economy, because I think not enough people understand it.

Now, the last time the Senate had a tax bill affecting you, we had a small difference of opinion. Your people were doing the best they could trying to save themselves, trying to talk to anybody that would listen to them while we were fighting on the depletion issue. I was trying to save you, but you didn't quite think so—there were at least some points of the amendment that I supported that you didn' think were in the Nation's interest. I believe you are going to find it necessary to come back to Washington again and take all your poor, hard-bitten wildcatters and try to talk to anybody that will listen to them. By now you ought to know that it is not enough to persuade the Senate Finance Committee that some unwise tax proposal aimed at you is not necessarily a good idea.

We just have to count on people coming and trying to buttonhole explain on the Senate floor what you said or what Mr. Robert Nathan said, there might only be a few Senators there at the time.

The people you are talking to are not the ones you need to talk to. You are like the preacher who stands up on the pulpit lecturing to the congregation how they ought to come to church on Sunday. The people he is talking to are not the people who need to hear that sermon. Only a few Senators show up at a hearing. You just have to pad down the halls and talk to people who absented themselves, and when the matter comes to a showdown in the Senate, if you look out there on that floor, all those people that need to hear the gospel absent themselves.

That is about the only way I know of trying to get some of them to at least hear what the problem is, as it appears to you and to your people. I am satisfied that there are very few Senators in the Senate that really have sworn to serve the devil. I think most of them would like to do the right thing, but unfortunately a lot of them don't see the light, they don't get the information they should have. I think you are going to have to work at it even more, trying to familiarize them with what your problem is.

Mr. Jones. I agree, Senator. We feel like that. Here in Washington—it is not Midland or Houston, and we feel the numbers we have to present now are more dramatic than they have been before.

Our energy situation has deteriorated as far as our domestic supplies are concerned, and we have been subjected to many punitive actions, such as price rollback, loss of depletion and these provisions of LAL and minimum tax, and things like that, which we feel are just not warranted at this time, and we hope we can sell our case to the individual Members of Congress.

The Chairman. Mr. Jones, we will place your complete statement in the record.

Thank you very much. I will study everything you presented here.

Usually I find myself in agreement with the IPA, and for many years we have tried to see to it that we do the Senate service rather than disservice.

Mr. Jones. Fine, thank you, sir.

The Chairman. Thank you very much.

[The prepared statement of Mr. Jones follows:]

STATEMENT BY A. V. JONES, JR., PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

I am A. V. Jones, Jr., a partner in Jones Company, Ltd., an independent oil and natural gas exploration and production firm at Albany, Texas. As President of the Independent Petroleum Association of America, I appear here today representing some 4,000 independent oil and natural gas producers from every producing area of the United States.

STATE AND REGIONAL ASSOCIATIONS OF INDEPENDENT OIL AND NATURAL GAS PRODUCERS

Joining in testimony today: Texas Independent Producers and Royalty Owners; Panhandle Producers and Royalty Owners Association (Texas); Kentucky Oil and Gas Association; Oklahoma Independent Petroleum Association; Eastern Kansas Oil and Gas Association; California Independent Producers Association; Ohio Oil and Gas Association; West Central Texas Oil and Gas Association; and North Texas Oil and Gas Association.

The opportunity provided to us to express our serious concern about some aspects of the tax bill (H.R. 10612) pending before this committee is very much appreciated. Before getting to those specific provisions, however, I think it highly important that the committee consider the state of our energy supply situation, what has been done about it, and what in our view must be done if we are to maintain the future energy-producing capability required by our society, our economy and the nation's security.

Our worsening energy supply situation can only be further aggravated should the Congress enact additional adverse changes in the tax treatment of oil and natural gas production. These two fuels supply three-fourths of our energy needs. There is no basis for anticipating that they will play a materially lesser role in the total energy mix in the next decade or so. In fact, even if we could achieve energy conservation to the most optimistic degree by limiting growth in consumption to two percent yearly, the combined demand for oil and gas (expressed in barrels equivalent) still would rise almost six million barrels per day, or 22 percent in the next ten years.

Given these facts, it is clear that we have no acceptable alternative except to expand the search for and production of domestic oil and natural gas.

In 1976, we must import in excess of 40 percent of our oil requirements just to meet day-to-day needs. Much of this growing dependency is attributable to the fact that we are now making up for both declining domestic crude oil production, and our growing shortage of natural gas, with increased imports of Middle East-North African oil. Our dependency on that area has increased more than 50 percent since the 1973 embargo. And we should not forget that the cutoff at that time, while it was the first to discomfort Americans because it caught us without adequate domestic supply for the first time, was the thirteenth major disruption in foreign oil supply since Premier Mossadegh shut down the Iranian oil industry in 1951.

To trustingly proceed under an assumption that it cannot happen again, and that we can deny or impair the incentives to restore the domestic industry to its maximum capabilities, is to run a risk we cannot afford. Yet this is a risk the Congress has deliberately assumed by its counterproductive actions of the past two years.

If the domestic industry is to attract the venture capital to accomplish the expanded effort that can and must be made to reduce our future dependence on OPEC oil, it must have the encouragement of sound and consistent governmental policies. Instead, it is confronted with one adverse proposal and action after another—such as the repeal of percentage depletion, the crude oil price rollback incorporated in the Energy Policy and Conservation Act of 1975, and the House-passed bill to extend the bankrupt concept of federal price controls on natural gas to intrastate consumers.

As a result of these and other pending actions such as the limitations on the expensing of intangible drilling costs incorporated in the legislation now before this committee, the domestic industry has never been confronted with greater uncertainty and discouragement as a result of punitive legislative actions by the Congress.

Against the background of frustrating uncertainty that I have attempted to describe, I would like now to discuss briefly the status of our petroleum supply situation, our worsening position as to dependence on foreign oil, some signs that

our efforts to improve our supply position are now lagging, and prospective future trends that will be vitally affected by government policies and actions which determine the economic climate for petroleum exploration, development and production.

The chart "U.S. Oil Production & Reserves" shows that the domestic industry has been unable to add reserves equivalent to annual production in every year since 1967. Our reserves in the lower 48 states have declined since 1968, and production has been on an uninterrupted decline since 1970. Projection of these trends indicates that by 1980, annual domestic production will have declined by about 1.25 billion barrels in the decade of the 1970's, and we will be adding reserves at only 1.5 billion barrels yearly. As a consequence, total reserves by 1980 will have dropped to only 23 billion barrels—compared with 31 billion in 1975.

Unless these trends are halted and reversed, dependence on foreign oil will reach almost 60 percent of U.S. requirements just five years from now.

Our declining strength as to domestic petroleum supplies is understandable when one reflects on the next chart, "U.S. Oil Wells Completed. As can be seen, except for only two years, oil well completions declined persistently from 1955 through 1973. Oil wells drilled in 1973, in fact, were less than a third of the number drilled in 1955. Depressed and inadequate drilling—caused by almost two decades of eroding economic incentives—resulted in the persisting decline pattern in domestic oil reserves. Some have, argued that a lack of drilling prospects, rather than economic incentives, caused the decline in activity. The facts, however, do not support this argument. The new oil reserves found for each oil well completed have, as shown on this chart, increased over the past twenty years.

Clearly, the progressively declining rate of drilling that began in the mid-1950's and continued through 1973, is the primary and overriding cause of our deteriorating reserve position. More important, the declining rate, the result of erosion in our domestic reserves, and the continuing drop in domestic oil production, have precipitated a dramatic increase in U.S. dependency on foreign oil.

It is doubtful that many Americans fully understand or appreciate the short time-span of our transition from self-sufficiency to dependency on others for essential oil supplies. This sharp and dangerous transition is illustrated in the chart, "U.S. Oil Demand & Producing Capacity." As can be seen, the first year in which the United States had to have some imports to meet its day-to-day needs was 1968, a scant eight years ago. In these eight years, we have increased our dependence on foreign oil by an average of almost five percentage points per year, with imports supplying about 40 percent of our requirements in 1975.

The question confronting our country is this: Are we going to make the policy and capital commitments to reduce this dangerous level of dependency, or will we continue on the present course until the United States becomes a permanent economic hostage of the OPEC cartel? All projections indicate that the anticipated restoration of economic activity will result in demand again rising above 17 million barrels daily in 1976. Although demand declined in each of the past two years due to recessionary influences and some conservation, the dependency gap was not reduced because production continued to decline under the momentum of 17 years of depressed exploration and drilling.

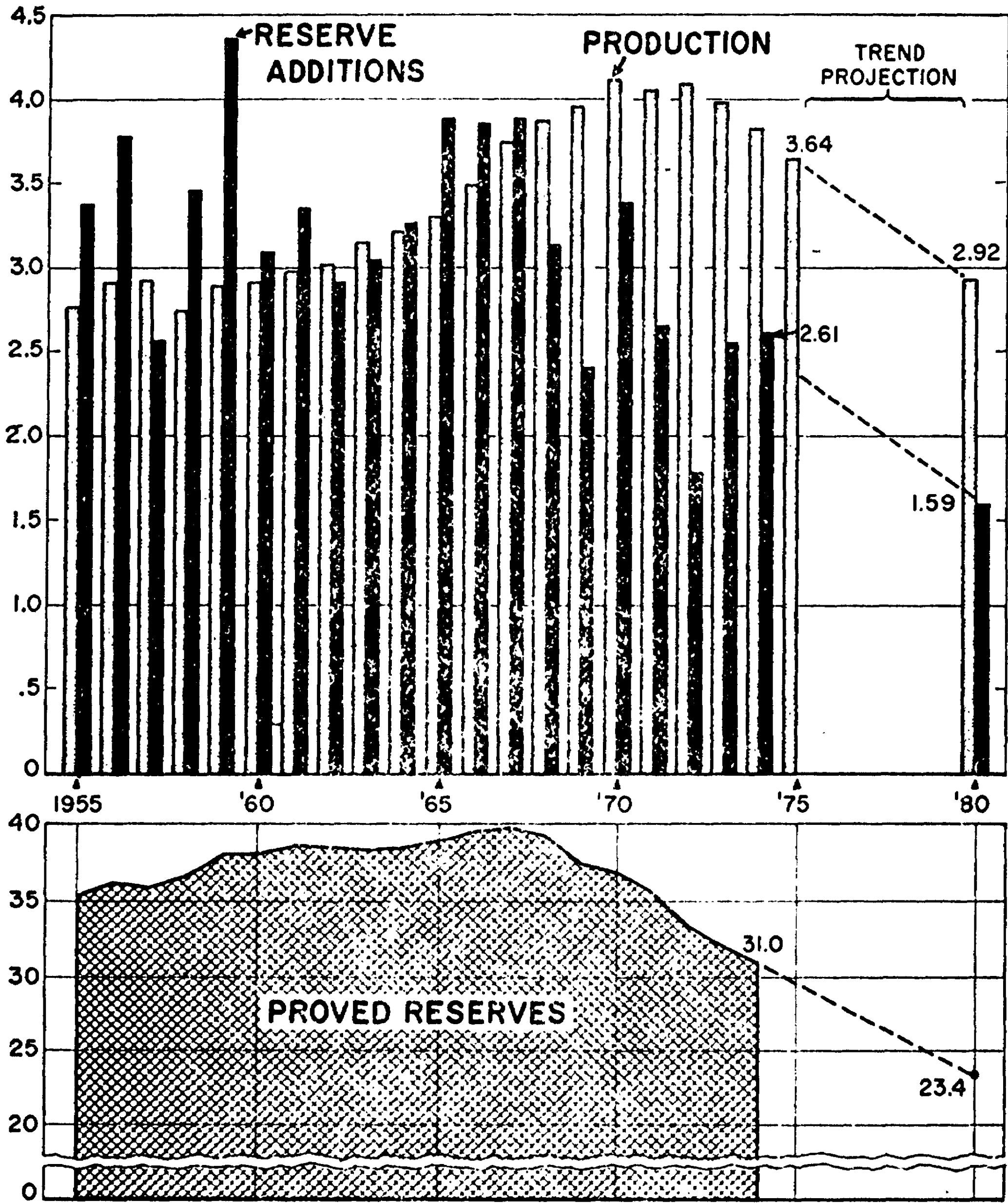
Unless domestic producing capability is expanded in consonance with a major conservation effort, dependence on foreign oil will reach almost 60 percent of requirements by 1980. A nation occupying and expecting to continue in a role of world leadership clearly cannot afford even our present dependence on others for critical energy supplies. It should be apparent that a prospective 60 percent dependency just five years from now would be intolerable and unacceptable.

Through its policies on tax treatment of petroleum exploration and development and in controlling prices of petroleum fuels (both oil and natural gas), the federal government controls the economic climate and incentives that will largely determine whether we reverse or further expand our dependency on foreign supplies. In the past two years, the Congress through punitive tax and price legislation has voted consistently for increased dependency. Not a single legislative act has been adopted designed to increase future domestic petroleum production by a single barrel of oil or cubic foot of natural gas, although the Senate has recognized the need to deregulate wellhead natural gas prices, for which it is to be commended.

U.S. OIL PRODUCTION & RESERVES

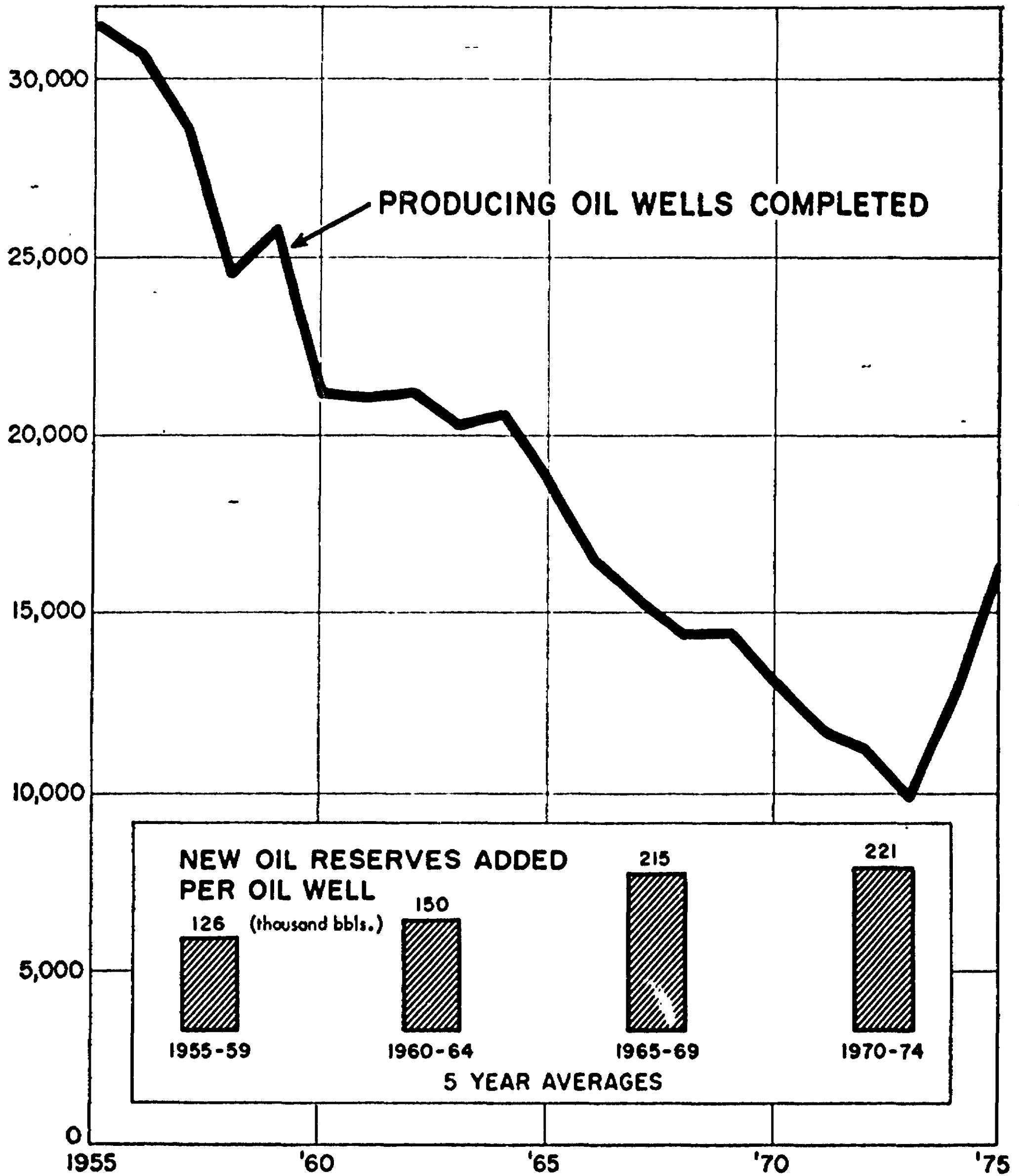
CRUDE OIL AND NATURAL GAS LIQUIDS

(billion barrels)

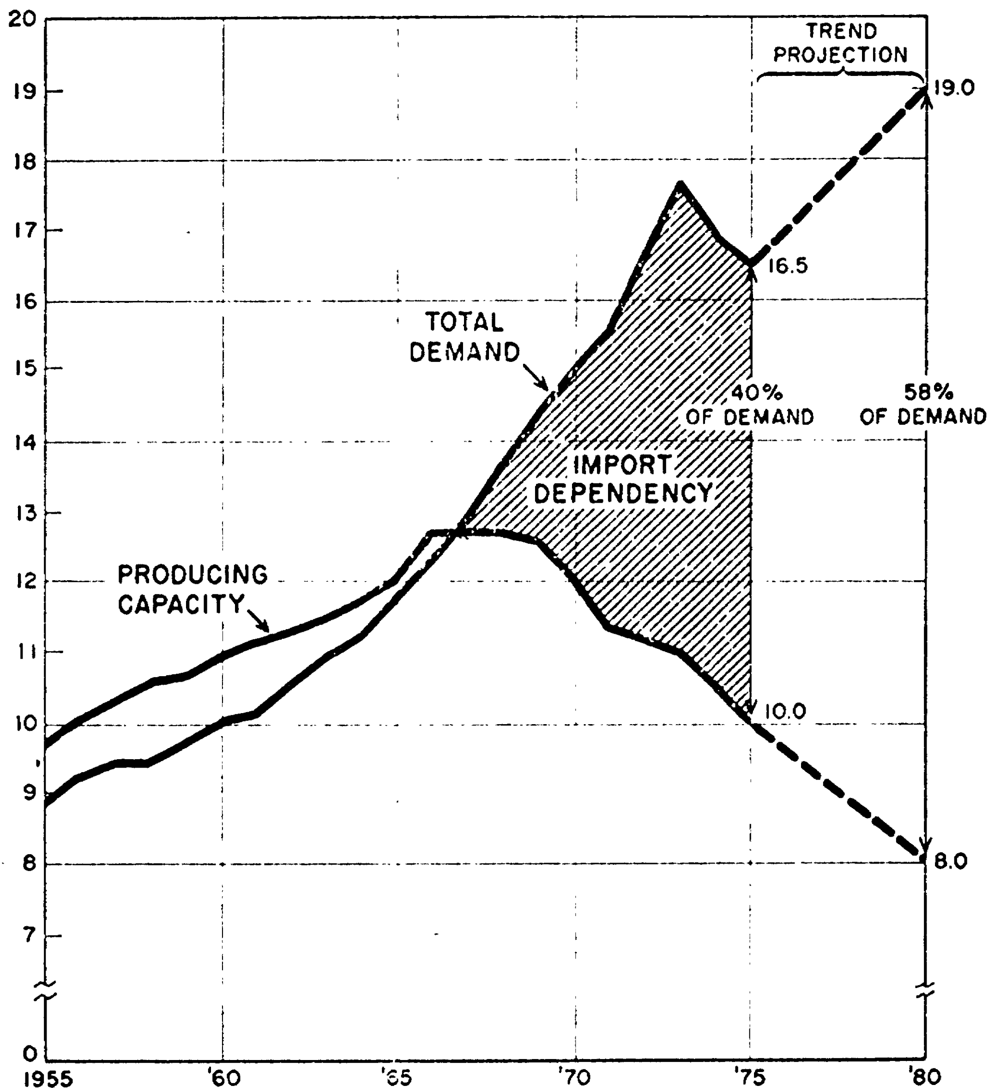


Note: Excludes Alaskan North Slope reserves not being produced.

IPAA Chart
March 1976



IPAA Chart
March 1976



The repeal of percentage depletion in March 1975, effectively removed more than $2 billion that otherwise would have been available for exploration and development. True, small producers were supposed to be exempt from the repeal of depletion. but this exemption was encumbered with so many vague restrictions that IRS has been unable to finalize definitive regulations. The result is that producers still do not know how they will be affected by the restrictions on the small producer depletion provision, and have no idea what their tax position will be for their 1975 tax year and subsequent years.

On top of the unfortunate repeal of depletion on oil and gas alone, among more than 100 items covered by this tax principle, Congress through the Energy Policy and Conservation Act of 1975 reduced by another $3 billion the 1976 revenues which would have been available to the domestic industry by rolling back the price of new and stripper well oil. By legislative action in 1975, therefore, Congress reduced by more than $5 billion potential exploration-drilling-production funds from the domestic industry.

The political fixation on denying the domestic industry the means to generate both internal and external funds to expand the search for the production of domestic petroleum fuels was further reflected in the recent adoption by the House of adverse legislation (H.R. 9464) to extend federal wellhead price regulation on natural gas. This legislation would apply to the gas sold in intrastate markets the same wornout regulatory concept that has served to dry up supplies of this fuel in the intrastate markets.

Aside from the practical economic effects of causing a flight of venture capital from petroleum exploration, these accumulating punitive actions by Congress have had an adverse impact on the psychology of the domestic oil and natural gas explore-producer. The message is coming through to many producers that a majority in Congress are not convinced that maximizing U.S. petroleum exploration and production is important, or that reducing U.S. dependency on foreign oil is a pressing priority. This climate of negativism is having a demoralizing effect among many who believe that the restoration of relative security as to energy supplies is a challenge of unprecedented costs and risks which ought to have the support of our government.

It is significant that the impact of these actions on industry revenues already is evidenced in a downturn in domestic industry activities that we can ill afford. Rotary rig activity, for example, has declined below year-earlier levels for the first time since 1972. This beginning trend is reflected in the chart "U.S. Rotary Rigs Running," which shows that the average rig count in the month of February 1976 was a declineas opposed to the significant increases in rig activity in February of the past two years.

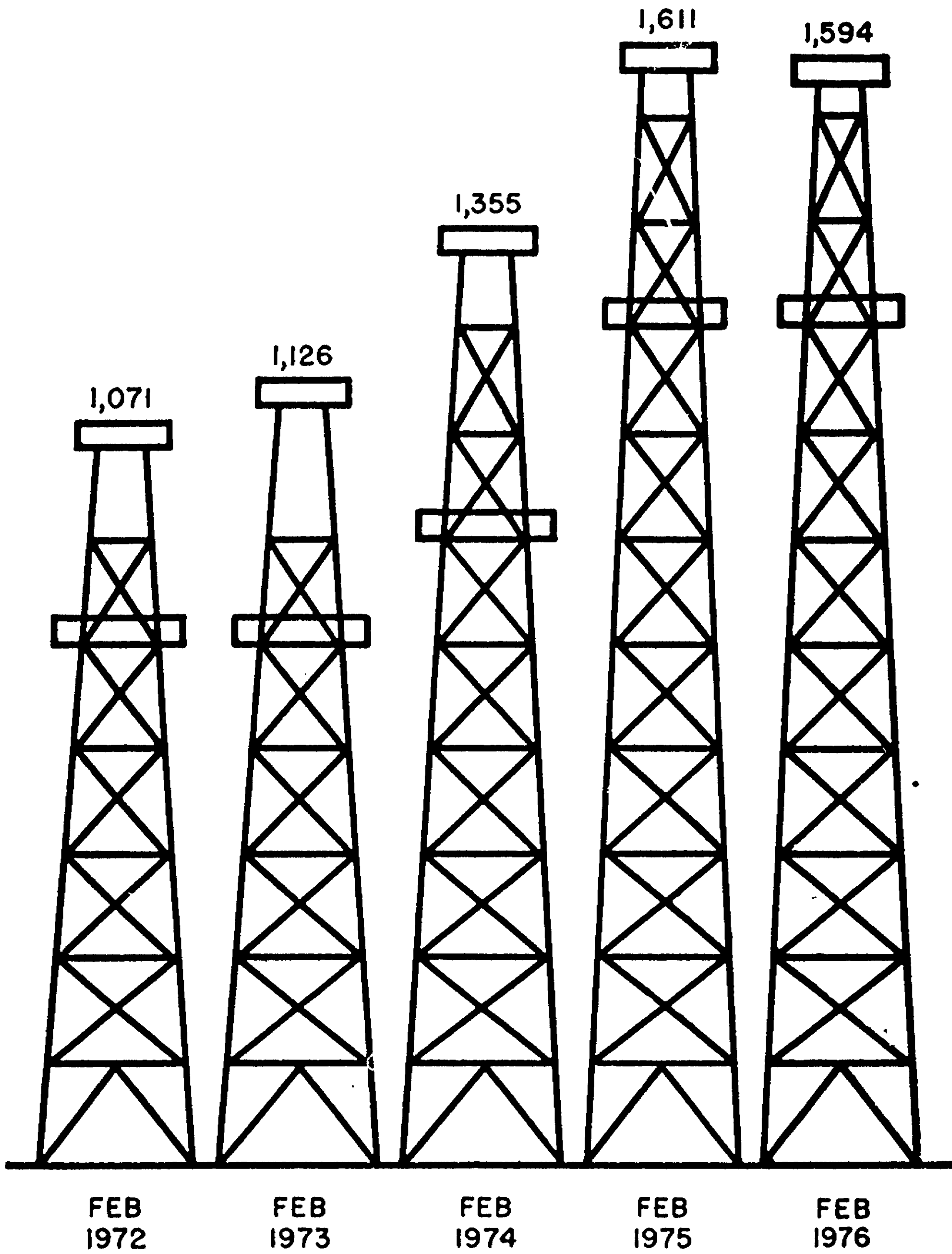
It should be hoped that this is a temporary abberation, but there are substantive reasons to believe that it is not. The primary reason is that there has been a disinct relationship between wellhead revenues and drilling expenditures for the past 20 years. Unless this relationship changes significantly which is unlikely, drilling expenditures will be limited in 1976 to approximately $5.8 billion under the "composite" pricing scheme imposed by Congress on domestic crude oil. This level of drilling expenditures would be a slight increase from 1975, but, due to inflation, would drill fewer wells. Under the incremental adjustments in controlled prices, the anticipated drilling expenditures in 1977 would rise by only a half billion to $6.3 billion, which would contain drilling at a virtually stable level in relation to 1975.

As illustrated on the chart, "Producing Oil Wells Completed," these limitations on drilling expenditures would not provide any meaningful increase in oil well completions in this two year period, as a result of the revenue impact of price controls. To keep the drilling resurgence which started in 1974 "on track," as can be seen, oil well completions should rise to 21,600 in 1976 and to 25,000 in 1977. To achieve this level of oil well completions, drilling expenditures would have to rise to $7.8 billion this year, and to $9.5 billion in 1977.

Much has been said about the capital requirements for domestic energy development. Study after study has been made by government, financial institutions, investment specialists, academic institutions, and the energy-producing industries themselves. Many reports by Congress have acknowledged and commented upon the unparalleled expenditures that will have to be made to increase energy production under environmental safeguards that work. The lowest range of estimates for oil and natural gas exploration, development and production anticipates expenditures through the 1980's of approximately two and one-half times the outlays of the 1960's. Our own estimates make clear that drilling expenditures must be more than doubled from the 1975 level, without adjustment for inflation.

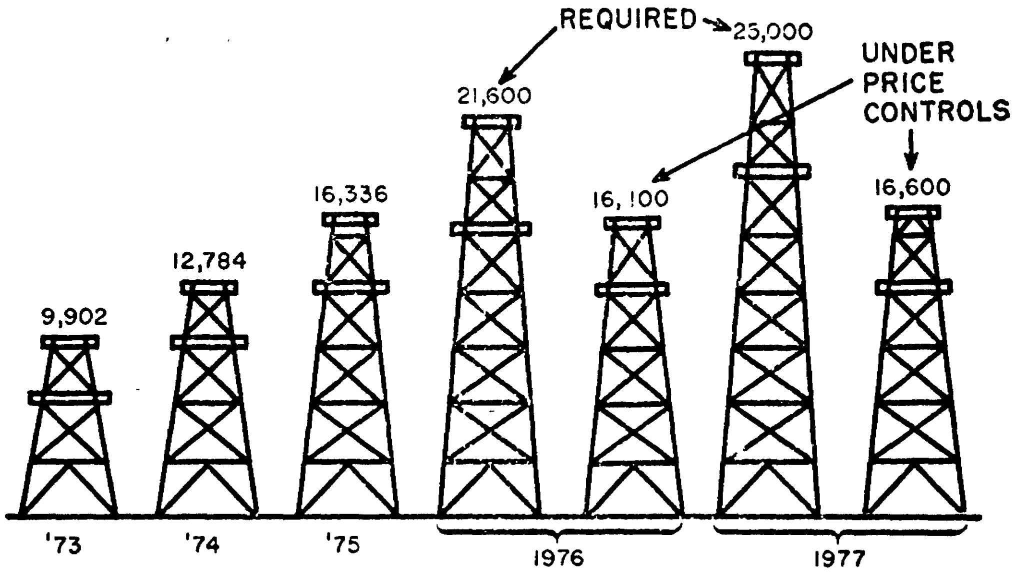
U.S. ROTARY RIGS RUNNING

FEBRUARY 1972-1976



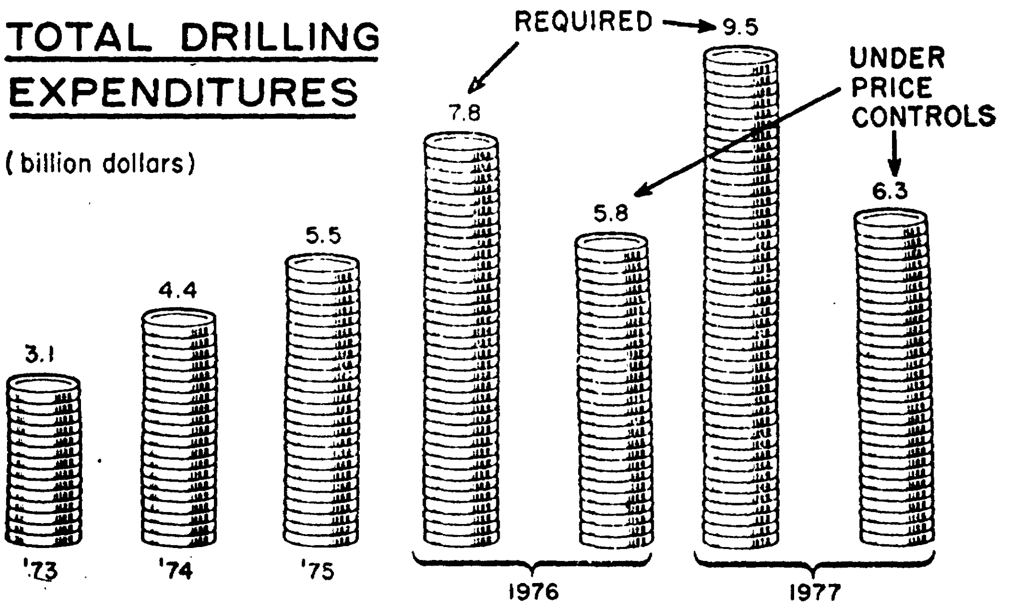
IPAA Chart
March 1976

PRODUCING OIL WELLS COMPLETED



TOTAL DRILLING EXPENDITURES

(billion dollars)



IPAA Chart
March 1976

In view of the need to generate capital resources of this dimension, it is submitted that Congress ought to be considering ways and means of making the high-risk enterprise of petroleum exploration at least as attractive as alternative investments. Instead, it is continuing to propose actions which would make petroleum ventures far less attractive—and the latest and currently pending example are the changes in the treatment of intangible drilling expenditures incorporated in the legislation (H.R. 10612) that is now under consideration by this committee.

Much of the adverse legislation that has come from Congress in the past several months was directed, according to its sponsors, at the integrated oil companies. Usually such legislation hurts the independent segment much worse, and the price rollback is the prime example. However, in the case of the IDC changes, there is no pretense that it is directed at the "big oil companies". It is directed at investors who are providing capital for drilling ventures by independent producers. The change would affect only independent producers who rely on such outside funds for exploration and development programs.

True, the changes proposed are supposed to adversely affect only development wells, but in a drilling program following discovery, these wells would represent the great bulk of the capital commitment in an exploration-development program. While the report of the House Ways and Means Committee estimates the first-year revenue impact at $207 million, this would not in our view be the most adverse result of this change. It would dry up much of the outside capital now being committed to domestic oil and gas exploration and development programs—because it would make these programs less attractive than other investment opportunities competing for such funds.

The activity primarily affected would be the multiplicity of effort to find and develop increased petroleum supplies by the 10,000 independent producers, primarily onshore in the lower 48 states. The chart "Role of Independents" summarizes some of the basic findings in a special study by the American Association of Petroleum Geologists covering U.S. drilling activity in the five years, 1969–73. This study analyzed drilling and the results of drilling by 16 large oil companies and by all others classed as independent producers. As shown, the independent segment accounted for 89 percent of domestic wildcat drilling, for 75 percent of discoveries, and for almost 54 percent of oil and gas reserves discovered.

The AAPG concluded from this study that while they operate in different cost and risk environments, independent producers and major companies contribute about equally to the finding and development of domestic petroleum resources. Federal policies which penalized either segment, therefore, would not serve the purpose of expanding our producing capabilities. The tax changes before this committee would be a distinct disincentive for the independent segment.

The proposed changes in the IDC treatment would impact on domestic drilling activity, which already is an unfortunate downturn, in the area where drilling is dominated by independent producers. It also is the area where oil and natural gas resources found can be made available to consumers with relative immediacy. For the short term of the next few years, the producing provinces of the lower 48 promise the quickest means of providing substantial additional petroleum supplies—in contrast, for example, to areas such as the Alaskan North Slope where the very large natural gas reserves that have been found will not be available to consumers for a number of years.

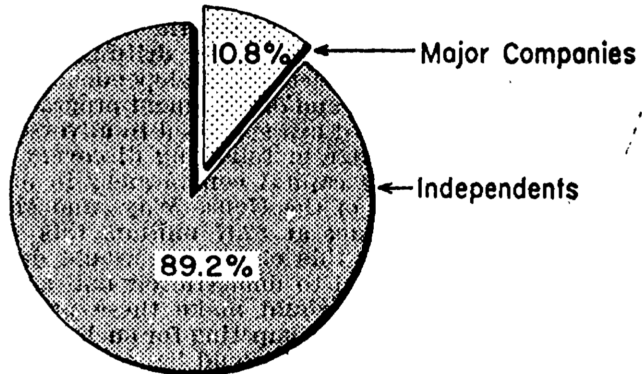
As previously pointed out, expenditures for drilling alone should be increased from $5.5 billion in 1975 to $7.8 billion this year and to $9.5 billion in 1977. Under price controls, however, drilling expenditures will fall short of the requirements by $2 to $3 billion in each of the two years. Only minimal increases over 1975 can be expected. Our studies confirm other findings that adoption of the proposed changes in petroleum tax provisions could result in a decrease of as much as 20 percent in drilling expenditures by non-corporate operators. This would further reduce the already inadequate drilling expenditures to no more, and perhaps less, than actual expenditures in 1975.

To obtain additional insights regarding the proposed tax changes, Norman Ture and Associates conducted a study at our request to determine the overall impact of the LAL proposal and the minimum tax proposal contained in the House-passed bill. Dr. Ture found that these proposals would have a negative impact on Federal revenues.

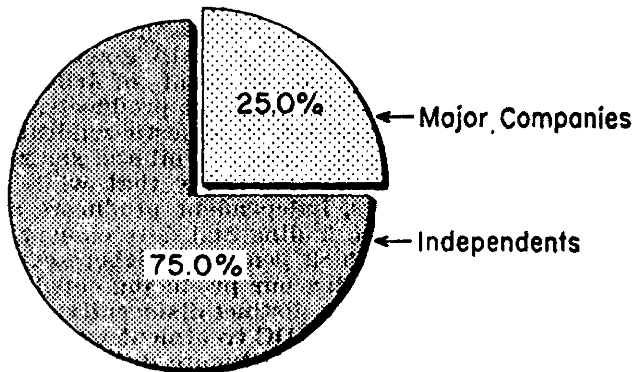
It would be unwise on two counts, therefore, for the Congress to impose higher tax rates on the petroleum industry: (1) drilling would be reduced at a time when there should be an all out effort: and (2) there would be a net loss in Federal revenues which would "fuel" inflation and unemployment.

ROLE OF INDEPENDENTS

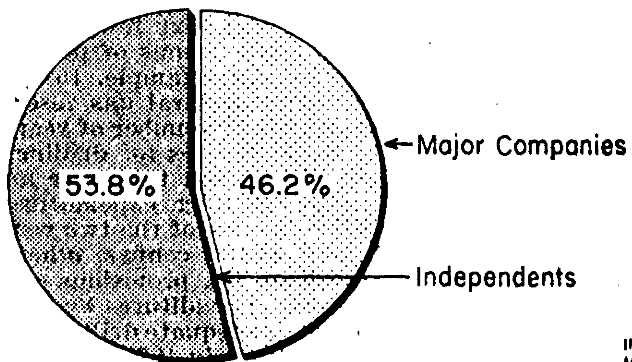
WILDCAT WELLS DRILLED



NEW FIELDS FOUND



OIL & GAS RESERVES DISCOVERED



Source: American Association of Petroleum Geologists, data covering years 1969-73

IPAA Chart March 1976

In view of the demonstrated need to redouble the total efforts of the domestic petroleum industry to find and make available all domestic petroleum resources, it is our conviction that Congress should be considering ways and means of encouraging greater investment in these activities, rather than changes which unquestionably would cause fewer dollars to be spent, less oil and gas to be found, and dependence on foreign oil to accelerate. In considering this matter, we urge the committee to keep in mind that increasing production of domestic oil and natural gas is of far greater importance to the nation and our economy than increasing revenue to the federal treasury.

RECOMMENDATIONS

We urge the Congress to consider the following proposals as the minimum action necessary at this time to remove the shackles from domestic oil and natural gas producers.

1. Terminate price controls.—Enact legislation at the earliest possible date to remove artificial government price controls from crude oil and natural gas. Recent experience clearly demonstrates that the domestic producing industry will respond in a very significant way to price incentives. It is imperative that the number of wells completed annually be increased substantially, and the quickest way to assure this is the immediate removal of counterproductive, illogical price controls which tend to encourage wasteful consumption and discourage increased production.

2. Retain present IDC provisions.—Reject completely the ill-conceived proposals contained in H.R. 10612 to change the present tax treatment of intangible drilling and development costs. The present treatment of IDC is necessary to partially overcome the inherent bias against such risky investment existing in the present tax structure. These proposals were offered initially under the misconception that the present tax provisions tend to encourage inefficient investment which makes no contribution toward increasing discovery and production of domestic petroleum reserves. The inaccuracy of this assumption is demonstrated by the direct correlation between total drilling expenditures, producing oil wells completed, and new additions to reserves. It must be borne in mind that no deduction for intangible drilling and development costs is permited unless there has been an actual outlay of such funds, and thus we are not dealing with a fictitious deduction.

3. Reject minimum tax expansion.—Reject any proposal to expand the minimum tax for individuals which includes provisions to decerase the effectiveness of current tax treatment of exploration and development expenditures. Oil and gas producers presently are subject to a tax system which effectively requires them to continuously reinvest their income in new exploration and drilling activities or pay substantial additional taxes. To impose any new so-called minimum tax provisions would force producers to withhold the investment of substantial additional sums from exploration and drilling activities in order to have the dollars with which to pay such taxes. The practical effect is to force producers to retain a higher proportion of their earnings in order to pay higher taxes—all at the cost of decreasing our effort to expand domestic oil and gas production.

4. Tax credit for exploration-development.—To encourage substantial new investment in exploration and development activities, adopt positive new tax incentives, such as an exploration and development investment tax credit similar in concept to the present investment tax credit for machinery and equipment. The same principle is equally applicable to encouraging additional investment in the drilling of oil wells.

5. Clarify 1975 act.—Revise the percentage depletion provisions of the Tax Reduction Act of 1975, which have confronted independent producers with considerable uncertainty, and generally discouraged much needed exploration and development activity. Specifically, we propose: Aa) That the "Retailer's Excluded" provision in the exemption for independent producers be coupled with the Small Refiner Exclusion. The effect would be to maintain the intent of the Act that most independent producers not engaged in refilning and marketing operations should retain eligibility for percentage depeltion to the limited degree permitted by other provisions of the Act. (*b*) Revise the Transfer of Property provision to liminate ambiguities and to make it clear this does not extend to nominal transfers of title which do not relate to an actual change in the beneficial ownership of property. This is especially critical since the Act was applied retroactively to transactions which were completed in all good faith in reliance upon long established and accepted practices within the industry. (*c*) Revise the provision which limits percentage depletion to 65 percent of taxable income. This provision constitutes a substantial disincentive to aggresive wildcatters who historically have been responsible for a substantial portion of new field discoveries. The provision requires wildcatters to reduce by approximately 23 percent the funds which otherwise would be expended for exploration and drilling

activity. It is recommended, therefore, that the method by which taxable income is determined be revised to take account of the "dry hole costs" which are expenditures that no wildcatter can void.

6. Defer depletion phasedown.—In order to offset the adverse effect of price controls, we recommend that there be a moratorium—at least for the duration of price controls—on the present annual reductions in the number of barrels of crude oil eligible for percentage depletion.

We urge this committee to initiate positive actions which will enable domestic oil and gas producers to get on about the business of finding and developing our vast potential reserves of crude oil and natural gas.

Thank you.

The CHAIRMAN. The committee will stand in recess until 10 o'clock tomorrow.

[Whereupon, at 4:15 p.m. the committee recessed, to reconvene at 10 a.m., Friday, March 26, 1976.]

TAX REFORM ACT OF 1976

FRIDAY, MARCH 26, 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 Abraham A. Ribicoff presiding.

Present: Senators Ribicoff, Packwood, Hansen, Curtis, and Dole.

Senator RIBICOFF. The committee will be in order.

Our first witness today is Mr. Ralph Weller, chairman of the Otis Elevator Co., on behalf of the Emergency Committee for American Trade.

Proceed, sir.

STATEMENT OF RALPH WELLER, CHAIRMAN, OTIS ELEVATOR CO., ON BEHALF OF EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. WELLER. Thank you, Chairman Ribicoff, for having me here to testify on behalf of the Emergency Committee for American Trade.

I am Ralph Weller, chairman and chief executive officer of the Otis Elevator Co., one of the members of ECAT, an organization of business leaders in support of sound policies for expanding international commerce and investment.

Mr. Chairman, we have submitted a statement and with your permission I will deviate from reading the statement to make some comments.

Senator RIBICOFF. Without objection the entire statement will go in the record as if read.

Mr. WELLER. Senator, our basic recommendations are twofold: One, retain the foreign tax credit; and two, retain the so-called tax deferral provisions of the Internal Revenue Code. We have several reasons for making these recommendations.

One: United States-foreign direct investment contributes greatly to the American economy. In 1974, for example, the net return to the United States from foreign investment was $14.6 billion. Overseas direct investments are an indispensable generator of U.S. exports supplied by the output of the American workers.

Two: We feel the present system of taxing income earned overseas is fair and neutral. I think we should stress that "neutrality provision."

We are competing overseas—and if I may speak just from my own personal experience in international trade, Mr. Chairman—we compete with giants overseas. My company competes with companies like Siemens, Mitsubishi, Hitachi, and others that are many times our size and that have a fair degree of expertise, management experience, and technological assets.

It is not an easy job to develop foreign markets. If we are not treated on a neutral basis, our job will be just that much tougher.

We feel that the foreign tax credit avoids double taxation while insuring that foreign source income pays the higher of the United States or the foreign tax rate. I am not an accountant nor an investment counselor nor an economist, so I will not bore you with the details of the tax bills. I think there are many other expert witnesses that you will hear that can talk to these issues.

Proposals to change the foreign tax credit to a deduction would result in punitive tax rates and substantial withdrawal of U.S. business from abroad. Certainly the withdrawal would not be voluntary. If we were forced to pay excessive tax rates over our foreign competition, it would, in effect, put us out of business in a lot of areas.

I might say that when Otis decided we could best serve our shareholders by taking our products to new overseas markets, rather than trying to diversify our activities into other products, we spent money overseas, but we did not lose one bit of elevator business in the United States.

Major cutbacks in the use of the credit and the so-called deferral provisions would seriously impair from one-quarter to one-half of the revenues of many of the largest industrial companies in the United States, leading to drastic consequences for U.S. production and employment.

The so-called deferral provision is very important to us, Mr. Chairman, and if I may, I would like to give you an example from our own experience of its importance. We introduced the elevator to Japan in the early 1930's. During that period of time we had 100 percent of the Japanese market. The Otis management at that time looked on the Japanese adventure, if you would like to call it that, as an investment. Accordingly we brought back to the United States all the profits we made, such as the deferral provisions would force us to do. We brought them back as return on investment.

We made a lot of money on that investment, but from 100 percent of the market in the early 1930's, our market dwindled down to 4 percent of the market in 1974. Why? Because we did not reinvest part of those profits to expand our business and to develop our market over there. We took the choice of bringing all the earnings home, which we would be forced to do were so-called tax deferral eliminated.

While we were doing that, our Japanese competitors—Mitsubishi, Hitachi, Toshiba, and other companies that you are all familiar with—were spending money developing their market, and they took that market away from us.

I may give you a more specific example in this area. Otis invented and developed the escalator as far back as 1898. The escalator market

in the Japanese islands is larger than the market in the United States of America. We make escalators in the United States. We make escalators in Western Europe. We have not been able to sell an escalator in Japan in 2 years, where we do not make them. We have not been able to export one.

So we feel very seriously that part of our income should be left to develop business and part should be brought back in dividends. That has been our policy over the last 10 years. In the last 10 years we have brought back approximately 50 percent of our foreign earnings in dividends.

The last point I would like to make is that proposals to tax unremitted foreign earnings are analogous to requiring individual shareholders of U.S. corporations to pay personal income taxes on corporate profits not paid out in dividends to the shareholders.

The competitive position of U.S. subsidiaries would be damaged should deferral be eliminated with foreign firms picking up lost U.S. business.

We in ECAT do not believe that everything is perfect in the field of international investment. It is a complex, many-faceted field. Competition in it is tough. Please don't make it any tougher.

Thank you, Senator.

Senator RIBICOFF. Thank you very much. I just have a couple of questions.

Do you have a list of the members for whom you speak?

Mr. WELLER. I don't have one with me. We could provide that to the committee though.

Senator RIBICOFF. I wish you would. I assume they are major American companies.

Mr. WELLER. As I say, they represent 65 companies involved in foreign trade and investment, sir.

[The list referred to follows:]

JANUARY, 1976.

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Mr. William A. Marquard, President, American-Standard, 40 West 40th Street, New York, N.Y. 10018.

Mr. Rodney C. Gott, Chairman, AMF Inc., World Headquarters, White Plains, N.Y. 10604.

Mr. David W. Mitchell, President and Chief Executive Officer, Avon Products, Inc., 9 West 57th Street, New York, N.Y. 10019.

Mr. A. W. Clausen, President, Bank of America, N.T. & S.A., Bank of America Center, San Francisco, Calif. 94120.

Mr. W. Michael Blumenthal, Chairman and President and Chief, Executive Officer, The Bendix Corp., Southfield, Mich. 48075.

Mr. T. A. Wilson, Chairman and Chief Executive Officer, The Boeing Co., Seattle, Wash. 98124.

Mr. James F. Bere, Chairman and Chief Executive Officer, Borg-Warner Corp., 200 South Michigan Avenue, Chicago, Ill. 60604.

Mr. Richard L. Gelb, President and Chief Executive Officer, Bristol-Myers Co., 345 Park Avenue, New York, N.Y. 10022.

Mr. Ray W. Macdonald, Chairman, Burroughs Corp., Second Avenue at Burroughs, Detroit, Mich. 48232.

Mr. Harold A. Shaub, President, Campbell Soup Co., Camden, N.J. 08101.

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Mr. Lynn Townsend, Chrysler Corp., 341 Massachusetts Avenue, Detroit, Mich. 48231.

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Mr. J. I. Miller, Chairman, Cummins Engine Co., Inc., 301 Washington Street, Columbus, Ind. 47201.

Mr. Justin Dart, President, Dart Industries Inc., P.O. Box 3157, Terminal Annex, Los Angeles, Calif. 90051.

Mr. William A. Hewitt, Chairman, Deere & Co., Moline, Ill. 61265.

Mr. A. Thomas Taylor, Chairman, Deltec International Ltd., 135 South LaSalle Street, Suite 3702, Chicago, Ill. 60603.

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Mr. J. Stanford Smith, Chairman and Chief Executive Officer, International Paper Co., 220 East 42nd Street, New York, N.Y. 10017.

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Mr. Anthony L. Conrad, President and Chief Executive Officer, RCA Corp., 30 Rockefeller Plaza, New York, N.Y. 10020.

Mr. Colin Stokes, Chairman, R. J. Reynolds Industries, Inc., Winston Salem, N.C. 27102.

Mr. Vincent L. Gregory, Jr., President, Rohm & Haas Co., Independence Mall West, Philadelphia, Pa. 19105.

Mr. Paul C. Baldwin, Vice Chairman of the Board, Scott Paper Co., Scott Plaza, Philadelphia, Pa. 19113.

Mr. Joseph B. Flavin, Chairman and Chief Executive Officer, The Singer Co., 30 Rockefeller Plaza, New York, N.Y. 10020.

Mr. J. Paul Lyet, Chairman and Chief Executive Officer, Sperry Rand Corp., 1290 Avenue of the Americas. New York, N.Y. 10019.

Mr. Richard M. Furlaud, Chairman of the Board & Chief Executive Officer, Squibb Corp., 40 West 57th Street, New York, N.Y. 10019.

Mr. Patrick E. Haggerty, Chairman, Texas Instruments Inc., 13500 North Central Expressway, Dallas, Tex. 75231.

Mr. Raymond H. Herzog, Chairman, President and Chief Executive Officer, 3M Co., 3M Center, Saint Paul, Minn. 55101.

Mr. James A. Linen, Chairman of the Executive Committee, Time Inc., Time & Life Building, Rockefeller Center, New York, N.Y. 10020.

Dr. Ruben F. Mettler, President, TRW, Inc., 23555 Euclid Avenue, Cleveland, Ohio 44117.

Mr. Harry J. Gray, President, United Technologies Corp., Main and Pearl Streets, Hartford, Conn. 06101.

Mr. George H. Weyerhaeuser, President and Chief Executive Officer, Weyerhaeuser Co., Tacoma, Wash. 98401.

Mr. Lester A. Burcham, Chairman of the Board, F. W. Woolworth Co., Woolworth Building, 233 Broadway, New York, N.Y. 10007.

Mr. C. Peter McColough, Chairman and Chief Executive Officer, Xerox Corp., Stamford, Conn. 06904.

Mr. William H. Flynn, Chairman, Zapata Corp., 2000 Southwest Tower, Houston, Tex. 77002.

Senator RIBICOFF. What would your thinking be about denying foreign tax credits, deferral or DISC benefits to American companies that engage and cooperate with the Arabs in their boycott?

Mr. WELLER. In the boycott, sir?

Well, it is a complex issue that I am really not prepared to speak to. I know for one that we do not engage in that. And I can speak personally on it. It is not going to hurt me personally.

Senator RIBICOFF. If you don't engage in it and you comply with the policy of this country, do you think that your competitors who do engage in it are entitled to an advantage over you in getting business?

Mr. WELLER. Well, I don't think that my competitors are able to compete against me on the basis of the boycott at the present time.

Most of my competitors in the Mideast are either Japanese or Western European companies.

Senator RIBICOFF. But assume that there would be two American companies selling the same product and true competitors in every sense of the word and one engages in the boycott and the other does not and consequently the American company that does not engage in the boycott loses business just for that reason.

Should we through our tax laws be giving a benefit to the companies that do cooperate with the boycott?

Mr. WELLER. Well, I am also not a lawyer, Senator, but it would be my impression just offhand that it would be illegal to set up some kind of a trust arrangement where you are going to pick on somebody else. Our company has had no trouble dealing with both Israel and the Arab nations through the years and we are going to continue to do that.

Senator RIBICOFF. But you don't want to make—you don't want to take a position as to that?

Mr. WELLER. I am afraid I am not qualified to take a position on that, Senator.

Senator RIBICOFF. Now, on the problem of taxing unremitted foreign earnings, how long do you think an American company should be allowed to keep its earnings abroad without remitting them back to the United States?

Mr. WELLER. Well, it is a many-faceted question, Senator. We have restrictions also placed on us by foreign governments concerning the repatriations of earnings. We also have restrictions placed on us by our partners who also own part of these companies and sometimes are a majority shareholder of these companies. Then we have restrictions of the marketplace that say that there are times when you have to invest to upgrade your product, you have to invest in brick and mortar so you can make more product or lose a share of a growing market, which is the reason we went there in the first place.

So trying to pick some magic number and saying how much or when, would put a serious restriction on a normal commercial decision. Obviously we have invested money overseas to make money and we are going to bring back that money when good commercial judgment says it should be brought back.

As I pointed out, our record is good. In the last 10-year period, if I may refer to these notes here, in the last 10-year period we made $29 million as a corporation and $153 million of that $29 million was made overseas. That is 53 percent, sir.

Of that 53 percent—or $153 million—we brought back $75 million in dividends, invested $58 million in plant and equipment, and used $20 million for working capital for expanding business.

We brought back just about 50 percent of our overseas profits, as you can see.

Senator RIBICOFF. I would like a list through the years when this was earned and when it was brought back. Do you have that available?

Mr. WELLER. I can make it available to the committee, yes.
Senator RIBICOFF. That would be appreciated.
[The document referred to follows:]

OTIS ELEVATOR CO.—10-YEAR INTERNATIONAL INCOME AND CASH INFLOW

[Dollar amounts in millions]

	Total income	International income	International subsidiaries dividends received	Technical assistance fees received
1975	40.5	34.8	13.0	6.7
1974	43.5	29.3	11.0	8.4
1973	40.3	24.1	15.0	8.5
1972	28.2	10.4	4.7	6.0
1971	24.8	6.8	3.9	5.0
1970	23.7	8.3	4.0	3.8
1969	23.0	11.3	6.2	3.1
1968	22.0	11.2	6.6	2.9
1967	20.0	7.8	4.8	3.3
1966	25.1	9.1	5.4	2.6
Total	291.1	153.1	[1] 74.6	[2] 50.3

[1] Cash dividend inflow from foreign subsidiaries.
[2] Cash inflow for technical assistance provided to foreign subsidiaries, which is in addition to international subsidiaries' dividends received.

Note: As a result of above, the company generated a net cash inflow of foreign source income of approximately $125,000-000.

Senator RIBICOFF. Gentlemen, you are here on a day where there will be a number of votes and we will vote as fast as we can and return. I am through with my questions. I will go over to vote.

Do you want to ask questions and come back?

Senator PACKWOOD. I will stay as long as I can, Abe, and if nobody is back, I will leave in 5 minutes.

Senator RIBICOFF. You gentlemen will have to be patient and we will come back on our own shuttle service.

Senator PACKWOOD. I agree with you on the statement about the foreign tax credit. I am not sure about the deferral. I want to understand the theory, the reason for it.

In your statement you analogize it to taxes on dividends to shareholders that would be as yet undeclared. It seems to me if you have a profit—you are operating Otis Elevator, not the various divisions, we have taxed Otis on any profits, period.

Why defer the tax on profits made overseas, and to this argument about the foreign withholding tax and the tax they will put on if we try to repatriate problems, absent that, what is your theory of deferring the tax on the profit just because it happens to be made in Venezuela or Germany rather than here?

Mr. WELLER. Well, I might start getting into corporate structure and if I am not clear, please make me do it again.

Our corporation owns some subsidiaries in foreign countries outright and some in varying percentages down to a minority position.

Otis (New Jersey), which is the corporation being taxed by the United States Internal Revenue Service, does not have overseas in-

come until it is sent to us. And we would be asked to be paying taxes on income earned in another sovereign nation, which is already being taxed there, which is subject to some regulations which you recognize over there, but which also is subject to some very fine commercial decisions which are saying that you can't bring it back without destroying the business.

I don't think that the purpose of taxation is to place a stranglehold on the ability of the corporation to use the funds within that third country that we are talking about.

Senator PACKWOOD. What you are saying, therefore, that even with a 100-percent-owned subsidiary—I don't know if you have any of these, do you?

Mr. WELLER. Yes, sir, we do.

Senator PACKWOOD. That that really is a separate entity from Otis (New Jersey).

Mr. WELLER. Yes, sir.

Senator PACKWOOD. You can do whatever you want in the country in which you operate within their laws——

Mr. WELLER. That subsidiary is subject to their laws, their taxation, and their market conditions, which is something we should be looking at.

Senator PACKWOOD. But absent additional penalties or, as you call it, a holding tax they put on profit repatriated to this country—absent that, where is the theory of why your 100-percent-owned subsidiary should not be taxed on its profits made in Venezuela the same as Otis (New Jersey) would be taxed on profits in the country?

You say it hasn't been paid back or it is another company, it really isn't another company in the normal sense because you can pierce the corporate veil. It is a 100-percent-owned Otis (New Jersey) company.

Mr. WELLER. You can, Senator, but as I tried to point out in my example of using our Japanese experience, when we actually had a corporate policy which followed what you are leading to, we dropped from 100 percent of the market to 4 percent of the market, because it was just bad business practices by taxation which we feel would be punitive in these cases.

Senator PACKWOOD. I want to help you on this if I can, but I don't want to get into the situation where the argument will be raised where American companies are using their deferred profits overseas in order to build up their businesses overseas, which may then help them make more profits here, but refuse to repatriate the profits to escape taxation.

Mr. WELLER. I think we can stand on our record there. I think studies will show that the amount of income repatriated has been considerable. As I say, I can quote to you our own particular experience of about a 50-percent return, and that is essentially our policy, to try to bring back 50 percent of the money every year knowing that we have to plough money back into the business.

Senator PACKWOOD. I had better go vote. I have only 7 minutes to get there now.

Mr. WELLER. Thank you, Senator.

[Whereupon, a brief recess was taken.]

Senator RIBICOFF. Thank you very much, Mr. Weller. I talked to Senator Hansen who said he did not have any questions. I understand that Senator Packwood has completed his questioning. Thank you for your courtesy.

Mr. WELLER. Mr. Chairman, if I might, Senator Packwood was on one area, and could I add one bit to my answer for just a few seconds?

Senator RIBICOFF. For the record? Fine, go ahead.

Mr. WELLER. Thank you, sir.

I did not touch in my answer on the aspects of international neutrality on the deferral issue. We were talking specifically about my company and I think it is extremely important that we put on the record the fact that if the United States treats deferrals in a different manner than other nations treat deferral, you are going to put us at a very serious disadvantage in competing again with our foreign competitors.

Before concluding, I would appreciate it if a brief statement on the DISC could be included as part of the record. It is not a statement on behalf of ECAT but rather of our corporate position on DISC.

Thank you very much, Senator.

[The statement on DISC and the prepared statement of Mr. Weller follows:]

STATEMENT OF RALPH A. WELLER, CHAIRMAN OF THE BOARD, OTIS ELEVATOR COMPANY, AND MEMBER OF THE BOARD OF DIRECTORS, UNITED TECHNOLOGIES CORPORATION

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

This statement is submitted for the record with the hope that it will be included in any consideration of changes to the current DISC legislation.

United Technologies Corporation (formerly United Aircraft Corporation) is a broadly based, multi-market corporation designing and producing high-technology products for industrial, commercial and governmental markets worldwide. Sales last year were $3.87 billion. The corporation late last year acquired controlling interest in Otis Elevator Company, the world's largest manufacturer of elevators and escalators.

Since DISC was instituted, the export sale of United Technologies Corporation have increased by 71 percent (or 33 percent in "constant economy" dollars) and 5,000 new UTC jobs have been created by these sales. In addition, there are about 5,000 jobs at our vendors which result directly from these sales, not to mention the supporting services and trade jobs which are generally estimated at 1.7 or more for each prime job.

The loss of tax income to the government resulting from the DISC deferrals has been more than offset by the taxes actually paid on the additional export sales (since the deferral generally amounts to only 50 percent of the regular tax on half of the profits on the exported products, a significant increase in exports/profit result in a net increase in taxes paid). In addition, the extra wages of our workers and profits of our vendors were fully taxed so that the favorable "leverage" on DISC deferrals is extremely high.

In addition to the jobs created by these sales, the favorable impact on the balance of payments should be recognized.

While it's impossible to definitely prove that all or a specific part of the UTC 71 percent export sales increase resulted from DISC, there can be no question about the fact that the increase would be substantially less had DISC not been available. In instances, the price differential between U.S. and foreign manufacture has been well within the tax deferral benefit provided by DISC and the existence of DISC has made it more desirable and possible to expend the extra effort and expense necessary to make export sales.

We therefore respectfully suggest that DISC be continued in its present form.

What is the DISC program?

DISC stands for "Domestic International Sales Corporation". Congress created DISC to stimulate exports. Under this program U.S. manufacturers may defer a portion of the taxes on export profits; generally, 50 percent of the regular tax on one half of the profits. These deferred taxes must be invested in export-related assets.

Why was the DISC program initiated?

To assist U.S. manufacturers to compete in world markets against foreign firms which are, in general, subsidized by their government. As a result, manufacturing/jobs would be retained in the U.S. and favorable balance of payments fostered.

Has DISC worked?

It has helped. Consider for United Technologies:

	(Pre-DISC) 1971	1975	Increase	Percent increase
Exports	$525,000,000	$900,000,000	$375,000,000	71
Exports (in 1971 dollars)	$525,000,000	$700,000,000	$175,000,000	33
Related UTC jobs	16,000	21,000	5,000	31

These additional UTC exports have created many thousands of vendor and supporting jobs. We estimate approximately one vendor job for each UTC job and the services/trade jobs are generally estimated at 1.7 or more for each prime job.

Can you really show that DISC has been responsible for this gain?

Each sale is made, or lost, as the result of numerous interrelated factors, no one of which can be given exclusive credit for the outcome. The price differential between U.S. manufacture and foreign manufacture in many instances has been well within the tax deferral benefit provided by DISC. DISC, therefore, has made it more desirable and possible to expend the extra effort and expense required to make export sales, thereby contributing to the increase in these sales and the resulting extra jobs.

But what about the loss of tax income to the U.S.?

Because of increased export sales/profits, United Technologies actually paid more taxes on 1975 exports than on 1971 exports. The taxes on the increased sales have therefore more than offset the tax deferral. In addition, the extra wages of our workers and profits of our vendors were fully taxed so that the favorable "leverage" on the DISC deferrals is extremely high.

Since the balance of payments is now favorable and unemployment has declined why not discontinue DISC?

Although improved, unemployment is certainly not at a satisfactory level, especially in Connecticut. Discontinuance of DISC would have a negative impact on the favorable trend and reverse some of the gains that have been made.

What would you recommend?

It would be unfortunate to change a program which is working, which has increased U.S. jobs and improved balance of payments as its objectives. Therefore, we recommend that DISC be continued in its present form.

STATEMENT ON BEHALF OF ECAT BY RALPH A. WELLER, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, OTIS ELEVATOR CO.

SUMMARY

Basic recommendation

Retain foreign tax credit and tax "deferral" provisions of Internal Revenue Code.

Basic reasons for recommendation

1. U.S. foreign direct investment contributes greatly to the American economy. In 1974, for example, the net return to the U.S. from foreign direct investment was $14.6 billion. Overseas direct investments are an indispensable generator of U.S. exports that are supplied by the output of American workers.

2. Present system of taxing income earned overseas is fair and neutral.

3. The foreign tax credit avoids double taxation while ensuring that foreign source income pays the higher of the U.S. or the foreign tax rate.

4. Proposals to change the foreign tax credit to a deduction would result in punitive tax rates and substantial withdrawal of U.S. business from abroad.

5. Major cutbacks in the use of the credit and "deferral" provisions would seriously impair from one-quarter to one-half of the revenues of many of the largest industrial companies in the United States, leading to drastic consequences for U.S. production and employment.

6. Proposals to tax unremitted foreign earnings are analogous to requiring individuals shareholders of U.S. corporations to pay personal income taxes on corporate profits not paid out in dividends to the shareholders. The competitive position of U.S. subsidiaries would be damaged should "deferral" be eliminated with foreign firms picking up lost U.S. business.

STATEMENT

Thank you, Chairman Long and members of the Committee on Finance, for having me here today to testify on behalf of the Emergency Committee for American Trade. I am Ralph A. Weller, Chairman and Chief Executive Officer of the Otis Elevator Company, and one of the 65 members of ECAT, an organization of business leaders in support of sound policies for expanding international commerce and investment.

My comments today are limited to the foreign tax credit and so-called foreign tax "deferral" provisions of the tax code. We firmly believe these provisions to be fair and sensible and in harmony with the systems of other countries. With the present provisions, foreign investment is possible.

American foreign direct investment today provides an indispensable source of earnings to be put to use creating jobs in the United States. It is also an indispensable generator of exports to be supplied by the output of American workers.

In 1974 alone, for example, the net return from foreign direct investment was $14.6 billion. In the past decade over $48 billion has been returned—again on a net basis—to the United States in the form of earnings from overseas direct investment. These billions of dollars are used exactly as profits made in the United States. They pay salaries, dividends and other expenses, and are invested in job-creating facilities here at home.

THE FOREIGN TAX CREDIT

Quite simply, the foreign tax credit provides that taxes paid foreign governments can be offset against the U.S. income tax on the income earned abroad. The foreign tax credit system does not permit foreign taxes to be credited against U.S. taxes imposed on income derived within the United States. It allows the credit only against income earned overseas. U.S. law and regulation determine what is U. S. source income and what is foreign source income.

The foreign tax credit is designed to avoid double taxation while ensuring that income earned abroad by U.S. firms shall be subject to the higher of either the United States or foreign tax rate. If the latter rate is the same or higher than the U.S. rate, then nothing is owed the U.S. Treasury. If the foreign tax rate is lower, then the U. S. Treasury is owed the difference between the foreign and the U.S. rate of 49 percent. In this manner, double taxation is avoided and the higher of the two tax rates is charged thus removing taxes as an incentive for either foreign or domestic investment.

Enactment of proposals before the Congress to convert the credit into a deduction would be to use the power to tax in the fashion our founding fathers feared—as the power to destroy. What follows is an illustration of how a hypothetical U.S. corporation doing business in Country A would fare if the law were changed as proposed:

Under current tax credit provision

Income in country A before any tax	$100
Country A tax (rate of 50 percent)*	50
U.S. tax (rate of 48 percent) before credit	48
U.S. credit for foreign tax paid	(48)
Net U.S. tax	0
Total U.S. and country A tax after credit	50

Under elimination of the credit and the allowance of a deduction for taxes paid

Income in country A before any tax	$100
Country A tax (rate of 50 percent)	50
U.S. deduction for country A tax	50
Income from country A subject to U.S. tax ($100–50)	50
Net U.S. tax (rate of 48 percent × 50)	24
Total U.S. and country A tax	74

This shows that under the current foreign tax credit provision, the total tax on $100 of profits would be $50 and the effective tax rate would be 50 percent. Under legislative proposals that would abolish the the foreign tax credit and substitute a deduction, the total tax would be $74 and the effective tax rate 74 percent. At tax rates of about 75 percent, there undoubtedly would be substantial U.S. business withdrawal from aborad simply because Americans would be unable to compete with their overseas competitors who would be paying much lower tax rates, since their governments follow the system we are threatening to abandon.

Leaving foreign markets to the business enterprises of other nations would have disastrous consequences to the U.S. balance of payments and to the economic health of our country. Many billions of dollars of current exports from U.S. parents to their overseas subsidiaries would be lost as eventually would the many billions of dollars of profits annually returned to the United States by overseas subsidiaries. Our economy would be poorer and jobs would disappear.

When considering the foreign tax proposals before your Committee, please keep in mind that from one-quarter to one-half of the revenues of many of the companies on Fortune's list of the 500 largest industrial companies are derived from foreign operations. To subject them to tax rates of 75 percent on that portion of their income would mean massive layoffs and chaos for the American economy.

It is also important to bear in mind when considering issues like the tax issue before your Committee that foreign businessmen are fully capable of taking over our overseas businesses. They have the knowledge, the skills and the desire to expand their markets. They are formidable competitors and they would welcome the competitive advantages that changes in the U.S. foreign tax credit and "deferral" systems of the kind before this Committee would hand them.

FOREIGN TAX "DEFFERAL"

The other major proposal of great general concern to ECAT members would tax all income earned abroad by a company's foreign subsidairy on a current basis, whether the profits were distributed to the U.S. corporate shareholders or not. This would be analogous to requiring individual shareholders of American corporations to pay personal income taxes on profits that had been earned by the corporation but not paid out in dividends to the shareholders.

As a practical matter, tax "deferral" has meaning in those instances where the effective foreign tax rate is less than the 48 percent U.S. rate. Where the foreign rate is the same or higher than the U.S. rate there is no U.S. tax. Most

U.S. foreign investment is in industrialized countries where tax rates are similar to our own. Thus, repeal of "deferral" would hit hardest at investment in less developed countries where the tax rates tend to be less than 48 percent.

Proponents of taxing unremitted foreign earnings argue that this would bring increased revenue to the U.S. Treasury. This, however, is not necessarily so since most countries levy, in addition to income and other taxes, a special tax on profits sent abroad. This tax on profit remittances leaving the country is referred to as a "withholding" tax and it averages about 25 to 30 percent, but is usually held to lower rates in those countries with which the U.S. has tax treaties.

In general, no country today taxes unremitted earnings of foreign affiliates of their corporations. Should the United States unilaterally institute current taxation of unremitted overseas subsidary income, many countries might take the view that the U.S. is intervening in their internal affairs by trying to direct that their corporations—which U.S. subsidiaries in their countries are—send their profits back to the United States as soon as they are earned each year. Such action would be bitterly resented and could lead to retaliation in the form of much higher profit remittance or "withholding" taxes. This, coupled with the foreign government's own income tax rate, could bring the total tax levy on the subsidiaries' profits up to or above the U.S. 48 percent rate, depending, of course, on the relative rate structures. Assuming existence of the foreign tax credit, the U.S. would gain little or no additional revenue whereas the foreign government would have collected more and the American subsidiary, through payment of higher taxes, would be placed at a serious competitive disadvantage vis-a-vis its foreign competitors who would be paying lower rates.

Again, an illustration might help make the effect of this clear. Assume a country has a 36 percent income tax rate and a statutory 30 percent "withholding" tax rate that has been reduced by treaty to 15 percent. In the case of $100 of foreign profits and a dividend distribution of $40 from the overseas subsidiary to the U.S. parent, the following illustration shows what would hapen if the U.S. tax were accelerated by eliminating so-called "deferral":

Under profit remittance of $40 and withholding tax of 15 percent

Taxable income	$100
Tentative U.S. tax at 48 percent	48
Credit for foreign income tax at 36 percent rate and "withholding" tax at 15 percent rate (15 percent of $40=$6) ($36+$6)	(42)
U.S. tax	6

Under profit remittance of $40 and withholding tax of 30 percent

Taxable income	$100
Tentative U.S. tax at 48 percent	48
Credit for foreign income tax at 36 percent rate and "withholding" tax at 30 percent rate (30 percent of $40=$23) ($36+$12)	(48)
U.S. tax	0

In this illustration, the U.S. government and the American subsidiary are the losers. The overseas subsidiary has paid a higher tax to a foreign government. And, the U.S. government has lost revenue that it eventually would have collected from the parent. As a result, the U.S. subsidiary is in competitive trouble, since its local competitors are subject to lower tax rates.

Rather than pay the higher profit remittance taxes, some corporations might choose to pay the U.S. tax out of domestic earnings. This, however, would reduce the capital sorely needed for domestic investment in job-generating facilities.

As this brief discussion on so-called "deferral" clearly illustrates, a change in one area of U.S. taxation can initiate a series of related actions in other countries that are detrimental to U.S. business abroad. It has taken decades of effort to establish profitable American subsidiaries overseas. Basic changes in the foreign tax credit and "deferral" provisions will damage these subsidiaries and will be harmful to the U.S. economy and U.S. workers. American profits and jobs

will suffer as will job-generating exports. A dampening effect on the economy and employment is something no one in America wants.

We in ECAT do not believe that everything is perfect in the field of international investment. It is a complex and many-faceted field. Competition in it is tough. Please don't make it any tougher.

Senator RIBICOFF. Mr. Robert M. Norris.

Are there a number of people accompanying you, sir?

STATEMENT OF ROBERT M. NORRIS, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC., ACCOMPANIED BY RAYMOND A. SCHRODER, CHAIRMAN, TAX COMMITTEE, NATIONAL FOREIGN TRADE COUNCIL, INC., AND WESLEY N. FACH, VICE PRESIDENT, TAX-LEGAL DIVISION, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. NORRIS. Yes, there are, sir.

Senator RIBICOFF. Raymond Schroder and Wesley Fach, all right.

Mr. NORRIS. Mr. Chairman, my colleagues and I appreciate this opportunity to present our views with respect to the bill under consideration this morning. Our full documentation on H.R. 10612 has been submitted and I offer it for incorporation in the record.

Senator RIBICOFF. Without objection, the entire statement and supplementary materials that go with it will be in the record.

Mr. NORRIS. I am mindful that desire of the committee is to keep the hearings as brief as possible and I should like first to begin by saying that basically I would like to talk about some basic economic considerations in connection with these bills.

We have advocated over the years, I think in great measure, the policy that we have advocated has been supported by this committee, and that is that the U.S. economy overall is strengthened by an economic policy, both domestic and foreign, which calls for continued expansion of international trade and investment, particularly on a basis that is realistic, fair, and reciprocal. Consequently, any legislation that would impede such expansion in our view should not be enacted.

Our concerns about the economic implications are indeed grave if there should be any significant change in the system of taxation of foreign-source income. These concerns are not new, as I am sure you are aware. And in this connection, in 1975 we published our study on the subject of "U.S. Taxation of Foreign Earnings—Economic Implications."

I would ask that this study be incorporated in and made a part of the record of these hearings.

Senator RIBICOFF. Without objection.[1]

Mr. NORRIS. Continuing on the economic side, Mr. Chairman, our view is that foreign direct investments are essential for maintaining expanding sales in foreign markets.

Not only do they contribute to the overall expansion of U.S. exports, the earnings of such investments are a major contribution to our balance-of-payments recipts.

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[1] See p. 925.

There is a lot of data on the inflow on interest, dividends and earnings on foreign direct investments. I would like to merely point out a couple of figures for the record.

The data shows that there has been a 4½ times increase from $4 billion for the year 1965 to $18.2 billion for the year 1974.

Fees and royalties remitted by foreign affiliates tripled from $1.2 to $3.2 billion for the same period.

Some balance-of-payments receipts from these sources over the past 10-year period 1965 to 1974 was $87.4 billion, or more than twice the $41.3 billion for new foreign direct investments abroad during the same period.

Not only has the net balance of direct investments become within recent years the principal plus factor in our balance of payments, but it has also more than offset the trade deficits experienced in the years 1971, 1972 and 1974.

With regard to employment, I think you will recall there was a Department of Commerce survey which showed for the period 1966 to 1970, that the U.S. employment of 298 multinational corporations expanded 1½ times faster than did total U.S. domestic employment for all U.S. private industries. It was—there was further comprehensive Department of Commerce data provided on 19 manufacturing industries that included the highest rate of expanding investment abroad and showed they tended to have the most rapid growth in domestic output and employment. Those with the slowest growth tended to experience the least expansion in home output and employment.

We maintain, have maintained and continue to maintain that foreign investment would not increase—curbing it would increase jobs at home. As you know, and we have said this many times before this committee, foreign markets cannot always be supplied on competitive terms through exports. Foreign investment is necessary to enter markets that would otherwise be forfeited—or foreclosed. It is necessary to preserve market positions which would otherwise be lost because of competition from other foreign investors.

The choice is often not one between U.S. and foreign operations, but between foreign operations or no access to, at all, foreign markets.

The realistic question is not whether foreign investment is to occur, because it will in any event, but whether the advantages will accrue to the United States or other countries.

Much of what I have said, Mr. Chairman, really leads me to stress very strongly that the increase in U.S. taxation of foreign-source income by restricting the foreign tax credit or by other means would negatively impact the competitive position of American business in the world marketplace. It would seriously curtail positive contributions which foreign investments have traditionally made to the U.S. balance of payments and indeed to our economic growth.

With regard to our full documentation on the provisions of H.R. 10612, our concern really is that the cumulative effect of those provisions that we oppose in that bill could so penalize business as to weaken its ability to compete abroad and even in certain instances companies would have to dispose of their investment.

Mr. Chairman, again in the interest of time I would like to close my remarks by commenting briefly only on three provisions of H.R. 10612.

First, I would like to talk about the tax deferral under the DISC provisions. As we all know, the concept of this emphasizes that the job of maximizing exports and maintaining a favorable trade balance lies primarily with private enterprise. And further, that the concept that this effort should be supported by a policy of our Government in programs which demonstrate that export expansion is a continuing objective of our Government.

The law also perceived that the DISC would serve to facilitate domestic plant expansion and increase research and promotion activities and to improve our country's capability to export goods to meet competition from abroad.

I would note for the record, Mr. Chairman, and gentlemen, that since 1961 when the DISC provisions were first enacted into law for financing of export-related receivables, they have provided a source of funds to finance long-term development programs which programs might otherwise not have been undertaken because of budgetary or other financial restrictions, particularly during periods where business was facing serious liquidity problems.

The point I want to comment on next is the proposed repeal of section 911 of the Internal Revenue Code. As you know, repeal of this annual exclusion of up to $25,000 would increase the cost of employment of individuals for overseas duty and the utilization of their services and experience which are necessary for the proper management and other control over foreign operations of U.S. business.

It would also negatively impact on the competitive positions of U.S. business vis-a-vis foreign competition, particularly since other competing countries do not tax citizens who have established a residence abroad. I think there is a corollary negative impact which could be a substantial reduction in employment of U.S. personnel for such overseas service.

Last, for the record we would like to note our support of section 1041 of the bill as reported out by the House Ways and Means Committee but which was subsequently deleted on the House floor because the 30 percent withholding tax, with certain exceptions, imposed upon the gross amount of dividends and interest paid foreign investors can seriously impact on the ability of U.S. companies to raise funds in the international capital market.

Since these hearings, Mr. Chairman, I believe contemplate that other matters might be considered, we would respectfully request permission to submit further documentation if there are such other matters considered.

Senator RIBICOFF. Without objection, Mr. Norris, that will be OK.

How many American corporations are represented by your organization?

Mr. NORRIS. Some 600, sir, from all parts of the country.

Senator RIBICOFF. I assume from among your members there were those who complied with the Arab boycott and those that don't comply.

Should they or should they not be treated differently?

Mr. NORRIS. I would like to comment with regard to the boycott question, Mr. Chairman.

I think it is our position that we would oppose any form of boycott. Boycotts are indeed matters which are very sensitive, very emotional.

They are frustrating indeed. On that basis we would oppose boycotts as a general principle.

My problem of dealing with the boycott question is the use of the tax laws to deal with it. As I said before this committee at the time the Jackson amendment was up with regard to the emigration of Soviet Jews to Israel, my concern was whether that should be, per se, a part of trade legislation.

I believe a question such as that and the current question of boycott, should be more properly dealt with in light of the diplomatic arena and the political field. I just happen to be confident that between the Congress and the executive branch of the Government exerting their energies in these areas that that can be properly dealt with in the political area.

Senator RIBICOFF. In that way nothing will ever really be done. You have now a position where you have two competitors, two major corporations, and I was intrigued reading the New York Times the other day, where they listed some of the companies that would not comply with the boycott. They represent some of the major corporations of this country, especially in the export field.

So you have company A that will not comply with the boycott; its competitor will. So its competitor has a decided edge in large portions of the world to do business.

Why should competitor A who complies with the American policy be penalized, as to competitor B who reaps tax advantages and reaps business profits because he complies with the boycott?

Mr. NORRIS. I heard you ask this question earlier and I am familiar with your point. My problem is, with regard to this, that I don't think you should use the tax laws to get at the problem. Moreover, I think that the administrative problems involved in any attempt to administer a tax law which would penalize——

Senator RIBICOFF. That is the easiest one of all to get at. It is a lot easier than antitrust or going to court criminally that takes years. You are going to have to file the tax returns and when you see the compliance with the boycott you lose tax advantage on the business you do abroad with those countries.

Mr. NORRIS. I understand that. Ultimately the matter has to be settled on the diplomatic basis, however. I think again that—my personal opinion is that to use the tax laws to achieve the objective of dealing with the boycott problem is not the right approach. I think it could be a precedent where tax laws could be similarly used for other, not similar, but kinds of problems providing the same kinds of frustrations.

Senator RIBICOFF. I would say this entire tax bill is full of decisions and provisions that are making policy in every phase of our Nation's economic and social activity and political activity, domestically and internationally. That is why you people are here. We are making policy right here.

Mr. NORRIS. I understand that.

Senator RIBICOFF. And you are coming in for a policy, you have a very big policy that you are all testifying to today. It is a question that you approach. I gather the thrust of all your testimony is to establish a neutrality between U.S. multinationals and foreign multinationals.

You don't want to be in a bad competitive position with foreign multinationals.

There is another point of view which is being pressed, the tax neutrality concerning foreign operations of the U.S. companies and concerning domestic operations of U.S. companies. Now, there would be two different types of laws written depending on which philosophy is taken. So you are really talking about policy here in this whole tax law.

Mr. NORRIS. I understand that. I am very much aware of the point that you are making. I am expressing a personal view, sir.

Senator RIBICOFF. Yes.

Mr. NORRIS. And I think this is really such a political problem that I believe it could be better handled and dealt with in the political-diplomatic arena.

Senator RIBICOFF. I think Senator Packwood would be next.

Senator PACKWOOD. In the last part of your statement you made reference to Domestic International Sales Corp., indicating you would like to keep the provisions in there now.

Would you be willing to trade off Domestic International Sales Corp., eliminate it altogether for a 2-percent reduction in the corporate tax rate?

Mr. NORRIS. I have not really—I don't know that we have given this any study. I think it is a matter that is worthy of study and exploration but I would hesitate to venture an opinion without studying it.

Senator PACKWOOD. The tax loss is about the same. You could reduce corporate taxes 2 percent at the cost of eliminating Domestic International Sales Corp. I was curious from an American business standpoint, from the overall generation of more business, be it export or otherwise, would American corporations be better off with a 46-percent tax rate and no Domestic International Sales Corp.?

Mr. NORRIS. I think that really I would have to, to answer this effectively, survey the feeling among our constituents to answer it honestly. I understand the money aspect of it would relatively be the same on the basis of what you say.

Whether an overall 2-percent tax reduction in the rate would accomplish the same objectives as the deferral under DISC or not I am not sure, sitting here, Senator, whether it would or not. I would have to really test this out and would like to get some judgmental values from our members.

Senator PACKWOOD. I would appreciate it if you would.

[The information referred to follows:]

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., April 14, 1976.

Hon. RUSSELL B. LONG,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is the response of the National Foreign Trade Council for incorporation in the record of the hearings of your Committee on March 26, 1976 on the tax provisions of H.R. 10612 to the following question of Senator Bob Packwood:

"Would you be willing to trade off DISC, eliminate it altogether for a two-percent reduction in the corporate tax rate?"

which was further clarified in the discussion by Senator Packwood as follows:

"I was curious from an American-business standpoint, from the overall generation of more business, be it export or otherwise, would American corporations be better off with a 46-percent tax rate and no DISC?"

It is therefore apparent that the purpose of such a proposal to reduce the U.S. corporate tax rate by two percentage points would be to bring about an overall generation of more sales for all business and would not be related only to export sales. The purpose of DISC, however—within the limitation of the provisions of the legislation—was directed towards the promotion and increase of export sales by U.S. companies.

As you and the members of your Committee know, the Council has supported the concept of DISC since its inception and has emphasized that the task of maximizing exports and maintaining a favorable trade balance lies primarily with private enterprise. Within this concept, we have continued to advocate that these efforts should be supported both by a policy of our Government and programs thereunder, which would demonstrate that export expansion is a continuing objective of our Government.

In the March 26 testimony, and in earlier testimony, we have emphasized that in attempting to evaluate the effectiveness of DISC as a stimulus for exports, there has been difficulty in obtaining data which would positively quantify the extent to which the DISC has increased exports. We have also emphasized that conversely there is no available data demonstrating that DISC has not increased exports. Some data is being developed, as for example in the August 7, 1975 letter from S. Stanley Katz, then Acting Deputy Assistant Secretary for International Economic Policy and Research of the U.S. Department of Commerce to The Honorable Guy Vander Jagt, which was offered by me for incorporation in the record at the March 26 hearing.

As you also know, it has been our position that there is a need for this data before a decision is reached on the discontinuance of DISC.

If a two percentage points reduction in the U.S. corporate tax rate were to be substituted for DISC, it would seem to us equally necessary to attempt to evaluate whether such a tax rate reduction would result in increasing U.S. exports and the degree, if any, compared with the use of DISC. Since Senator Packwood's question would involve the application of the tax rate reduction overall and not just to exports, it conceivably might be more difficult to develop data to determine whether such a tax rate reduction would have a negative or positive impact on increasing exports.

Senator Packwood queried in his further clarification of the question whether or not American business would be better off with a 46 percent tax rate and no DISC from the standpoint of the overall generation of more business, be it export or otherwise.

Our response, therefore, to Senator Packwood's question is that the proposal for an overall tax rate reduction of two percentage points should be considered and studied independently of the existing DISC provisions, particularly when there is not yet sufficient data to judge fully the effectiveness of DISC, and since the tax rate reduction would envisage overall generation of more business for American companies, which could also serve the objective of generating greater capital formation.

We respectfully request that this letter be incorporated in the record of hearings as being the Council's response to Senator Packwood's question.

For their convenience, a copy of this letter is being sent to each member of your Committee.

Yours very truly,

ROBERT M. NORRIS,
President.

Senator PACKWOOD. I have asked this of several companies that have been in my office, including those who export. Most of them when they think about it, and they only think about it for a minute or two, come down on the side of, if they could have it, of getting rid of Domestic International Sales Corp. if they were guaranteed the 2-percent reduction. They don't want to see the money go to some Federal spending program, but if they were guaranteed the quid pro quo they would accept the 46 percent.

Mr. NORRIS. I think one of the problems, if I understand your question correctly, if you have a 2-percent reduction in the rate, would you relate that only to the 2-percent reduction in terms of export sales?

Senator PACKWOOD. Oh, no; general sales.

Mr. NORRIS. It would be general. Then I suppose the basic consideration to think about would be whether that would be accomplishing the concept of Domestic International Sales Corp. as it was perceived when enacted in 1971; namely, to spur exports.

Domestic International Sales Corp., it seems to me, the deferral under Domestic International Sales Corp. is more directly related to exports.

Senator PACKWOOD. Well, it may be. I have been asking a lot of the corporations that come in the question: "Do you have the proof that. but for Domestic International Sales Corp., you wouldn't have developed exports? Give me the proof that if Domestic International Sales Corp. is eliminated you won't export as much. Give me the proof that there are now small corporations that would not be exporting at all but for Domestic International Sales Corp." I have yet to get the hard evidence. I realize it is hard to prove, but for, and what if.

Mr. NORRIS. I think we had a discussion on this at one earlier hearing. I merely would point out that as I recall Domestic International Sales Corp. was formed in 1971 and I think since Domestic International Sales Corp. there have been something over 7,000 Domestic International Sales Corp. formed, which seems to be an indication in itself that Domestic International Sales Corp. served one purpose at least, that is to have resulted in more companies becoming export-oriented to the extent that they formed Domestic International Sales Corp. to do it. That is No. 1.

Senator PACKWOOD. Most of those Domestic International Sales Corporations were formed by corporations who are already exporting.

Mr. NORRIS. And some who have not been exporting.

Senator PACKWOOD. Yes.

Mr. NORRIS. As I think I said earlier before this committee, there is really no available hard data that you can point to which says that Domestic International Sales Corp. has been responsible for the increase in exports, and I say conversely there is no hard data that shows it has not been. The difficulty is the availability of data. I would mention, Senator, that there was a letter which was written to Congressman Vander Jagt in August of 1975, from Stanley Katz of the Department of Commerce, who at that time was Acting Deputy Assistant Secretary for International Economic Policy and Research, which I think is interesting in terms of some of the figures that he sets forth in this communication to Congressman Vander Jagt. I might offer this for the record if you would like.

Senator PACKWOOD. I would like to have it, yes.

Mr. NORRIS. And the committee could take it into consideration when dealing with the Domestic International Sales Corporation problem.

I would, with your permission, Mr. Chairman, offer this for incorporation in the record.

[The letter referred to is as follows:]

U.S. DEPARTMENT OF COMMERCE,
Washington, D.C., August 8, 1975.

Hon. GUY VANDER JAGT,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN VANDER JAGT: Secretary Morton has asked me to thank you for your letter of July 23, expressing your interest in retaining the Domestic

International Sales Corporation (DISC) incentive for U.S. exports. The DISC appears to have been one of several important inducements to the strong expansion of the U.S. exports in recent years. This incentive of up to fifty percent tax deferral on export profits tended to spur exporters to greater efforts in selling U.S.-made goods abroad. In some cases, they decided to serve foreign markets by building plants in the United States to export rather than invest in overseas facilities.

The latest Treasury report shows that the average growth rate of DISC related exports for those DISCs with full tax years ending between December 1972 and June 1973 was 33 percent compared to a year earlier, while all U.S. exports, adjusted as far as possible to correspond to the composition and time period of the DISC exports, increased only about 23 percent. Commerce staff estimates based on these percentages indicate that the DISC incentive probably contributed $2.6 billion of extra exports during this period. For calendar year 1972 the DISC induced growth is estimated to be somewhat lower, i.e., $2.3 billion. This export growth can be compared with an estimated current revenue loss to the Treasury of $350 million in 1972. This comparison implies almost a 7 to 1 benefit-to-cost ratio. If the same ratio is applied for 1974, the export growth in 1974 attributable to DISC was close to $7 billion, while the revenue loss due to deferred taxes was $1.05 billion, according to Treasury estimates. Since pronounced changes in export patterns in response to the DISC incentive are bound to be less in the initial year of operation than later, it is likely that the benefit-to-cost ratio was more favorable in 1974 than in 1972. Therefore, the 1974 increase in exports attributable to DISC could have been as high as $9 billion. This $7–$9 billion range for DISC induced exports in 1974 contributed about 7–9 percent to the total U.S. merchandise exports for that year. In 1974 total merchandise exports increased $27 billion from $70 billion to $97 billion. Accordingly, these estimates take account of the fact that a major part of this increase—about $18–$20 billion was due to factors other than the DISC, i.e., inflation, the lower exchange rate for the dollar, a world shortage of agricultural staples, etc.

The GNP effect of the DISC induced export increase can be estimated from the econometric model of the United States economy 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, and about $700 million in increased Federal tax revenues. 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 1974 was likely to have been $21–$27 billion, which in turn would have induced increased tax revenues of some $5–$6 billion. This indirect revenue gain is several times more than the estimated $1.05 billion in current revenue loss in 1974 due to the direct and immediate effect of the DISC tax deferral.

The employment effect in 1974 of the export increase attributable to DISC can be calculated on the basis of BLS estimates of the average relationship of merchandise exports and jobs. The additional $7 to $9 billion of exports attributable to DISC is likely to have created anywhere from 280,000 to 360,000 export related jobs in 1974. Furthermore if one relates DISC induced GNP expansion to employment, the economic stimulus of the DISC related export increase is apt to have resulted in more than one million U.S. jobs in 1974.

It is, however, necessary to point out that caution must be exercised in the evaluation of 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 growth 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 be correct at certain times, and could vary from model to model as well. Finally, the job effects of export growth, as measured by the Bureau of Labor Statistics is based on average relationships from input-output tables. The job effect of an increase in exports may not be the same as the average relationship, and the relationship itself might change in time. In conclusion, these actual and potential shortcomings in the available data base could have an effect on the above estimates.

We hope that you will find these estimates helpful. Please let us know if you need further information or explanation.

Sincerely,

S. STANLEY KATZ,
Acting Deputy Assistant Secretary for International Economic Policy and Research.

Senator PACKWOOD. I would appreciate it if you would give me a response, assuming you could guarantee the 2-percent general reduction.

Mr. NORRIS. We will attempt to develop that for you and submit it for the record.[1]

Senator PACKWOOD. Thank you. I have no further questions.

Senator RIBICOFF. Senator Hansen.

Senator HANSEN. Mr. Norris, do you believe the elimination of DISC would reduce jobs in the United States as included in the House bill?

To refresh your memory—not that I am being presumptuous in assuming I might need to do that—DISC treatment would be eliminated for products sold for use as military equipment and for agricultural products not in surplus in the United States. In addition, DISC benefits would be available only for increase in exports over a base period. As I understand it you have to keep building all the time or you lose the benefits.

Mr. NORRIS. Yes.

Senator HANSEN. Second, companies whose total DISC benefits are less than $100,000 a year would not be subject to the new base period.

The third point I would call to your attention is that $20,000 exclusion or in certain instances the $25,000 exclusion for income earned abroad by U.S. citizens living or residing abroad would under the House bill be phased out over a 4-year period by lowering the exclusion by $5,000 or $6,250 per year. What would the effect be on employment in your opinion?

Mr. NORRIS. Here again I think we are dealing with a difficult matter and I am not saying that to duck an answer to your question. But basically I think so much of your answer to this kind of question would indeed depend upon the extent to which you have available meaningful data upon which you can say DISC has really resulted to what extent in exports, or has not.

Now, if the data, when it is developed, is well founded and significant and should show, for example, that DISC indeed has resulted in a significant expansion of our export sales, the answer would be that it would probably be better to keep it as it is rather than the new proposals under the bill, which would have variable applications because it would result, I think, in a decrease in employment to some extent.

I think we have got to get back to that basic question, Senator, and I think this is the real problem when we are talking about DISC always. I would hope we could get some more meaningful data. As we all know, there were other economic factors which came into play during the period of 1972 to date which influenced our ability to export, devaluation, for example, that sort of thing.

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[1] See p. 914.

Senator HANSEN. Would it be fair to infer that while it is difficult to quantify in terms of jobs, there is no doubt in your mind that these provisions would have an adverse effect?

Mr. NORRIS. I think they would have an adverse effect from the present provisions of DICS, yes, sir.

Senator HANSEN. Now you make the statement with respect to the $25,000 exclusion on earned income from those individuals who were employed abroad but are American citizens, that one of the reasons that you think we ought not to change that present provision is—I am referring to page 5 of your testimony in the first full paragraph—you say "particularly since other competing countries do not tax citizens who have established a residence abroad."

Is it fair to say that no other country, given a similar situation, taxes its citizens? Or are there some who do and some who do not?

Mr. NORRIS. I think there are some who do. What I am trying to convey without getting into the detail, Senator, is that our principal competitors abroad do not tax the——

Senator HANSEN. Could you identify those?

Mr. NORRIS. In the case of the United Kingdom, Germany, Netherlands, France and Japan.

Senator HANSEN. All right.

Thank you, Mr. Chairman.

Senator RIBICOFF. Senator Curtis.

Senator CURTIS. Mr. Norris, the committee has a large, voluminous bill sent over from the House, but we will not be the final decision-makers on this because many of these issues will be determined on the floor of the Senate. There is a vigorous drive to go further——

Mr. NORRIS. To what, sir?

Senator CURTIS. To go farther than the House has gone, even in an antibusiness direction. These people are entitled to their opinion, of course. The distinguished Senator from Massachusetts, Mr. Kennedy, appears to be leading the drive for some of these tax changes. He appeared before this committee a few days ago. I want to read a couple of paragraphs from his remarks and I would like to have the people from the business world tell us what you think about it:

> 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 here.

Continuing the quote:

> The Senate should also repeal the DISC tax benefit. This subsidy is a Treasury-spun 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 extensive study concluded that DISC had 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.

And then these provisions are again mentioned in his tables which he says would enhance the Treasury of the United States $1.5 billion in 1977, but over $2 billion by 1981.

Do you favor the Kennedy program?

Mr. NORRIS. I do not, sir.

Senator CURTIS. Do you have any comment about it?

Mr. NORRIS. I have some comment and I will attempt to make it brief.

With regard to the basic question of deferral, as has been pointed out many times in testimony before this committee, I think that the performance and the track record of American business with regard to remission of earnings abroad is pretty good.

After all, American business basically is in business to make a profit. It is also in business to protect the interests of its shareholders. I think as a matter of business policy very few corporations would take the hard position not to remit dividends to the benefit of the company and indeed for the benefit of its shareholders. That is basic.

The problem with regard to deferral is very much similar to the question of what would happen if you would repeal the foreign tax credit from a competitive standpoint. Let me—it may be an oversimplified example here of what I am trying to say, but if you have $100 of income, foreign-earned income, in a country where the tax rate is approximately the same as ours and let me ues 50 percent for a round figure.

So the tax on that $100 gross income earned abroad would be $50 in the foreign country.

The tax on that $100 gross income from foreign sources back here would still be 50 percent or $50. So if you allow the foreign tax credit, foreign tax paid would wash out the foreign tax and the total net tax burden would be $50.

Now, let's assume for the moment that you were to take another approach to the foreign tax credit and say, "Let's have it a deduction," which some suggest, "instead of a credit." You take your $100 of gross source income abroad where there is a 50-percent rate, you pay a $50 tax there. When you get that $100 subject to U.S. tax, you have $100, and you can get a deduction on that, and it means it would be a $25-dollar tax liability here, so that the total tax paid there would be $75 compared with $50.

Now, I use this as an illustration because the same competitive situations would put such as an American company to a competitive disadvantage in trying to deal in the overseas markets.

When you take the deferral, you have very much the same problem. You have a need for retention of earnings until remitted, first because no other foreign competitor imposes a tax on foreign-source earnings before they are remitted. Indeed, many foreign countries never tax foreign-source income at all. Consequently, the fact that we would tax so-called deferred income—incidentally, I think that is a bad term to call it "deferred income." It's really an "anticipatory tax of foreign earned income" rather than the deferral. But if we were to tax, and this is purely earned income, we would indeed place American business at a distinct disadvantage insofar as our foreign competitors are concerned who don't tax it and in any instance do not tax it before it is remitted.

Senator CURTIS. Our time is up, but I just briefly would ask you, if as you say the removal of these provisions would end these activities abroad, then there wouldn't be a gain to the Treasury if all this business activity stopped; is that right?

Mr. NORRIS. I think the track record and the benefits derived from foreign investment to the U.S. balance of payments will show that

the most traditional "plus" contributor to our balance of payments has been income including royalties and fees from foreign investment and this was particularly so during the bad periods of 1971-72 when we had some rather significant trade imbalances.

Senator CURTIS. Thank you, Mr. Chairman.

Senator RIBICOFF. Thank you very much, Mr. Norris.

[The prepared statement of Mr. Norris and a study referred to previously, follows. Oral testimony continues on p. 933.]

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC. ON TAX REFORM PROPOSALS RELATING TO FOREIGN INCOME

SUMMARY

The present method of taxing foreign source income, particularly the allowance of a foreign tax credit and taxation of foreign source income only when realized, has been essential to meet foreign competition abroad on equal terms.

Most of the proposals for taxation of foreign source income itemized for consideration by the Committee, as set forth in H.R. 10612, would, in varying degrees, penalize foreign investment and impair the ability of U.S. companies to compete abroad as well as impair their present position and future potential in the world marketplace.

We stress the importance of foreign direct investment to the U.S. economy, to U.S. employment, to U.S. exports and the U.S. balance of payments.

We recommend that no legislative changes be enacted that would significantly alter the present U.S. system of taxing income derived from foreign trade and investment. This is particularly important in the light of current and foreseeable capital formation requirements.

TOPICS FOR TAX REFORM—FOREIGN INCOME PER COUNTRY LIMITATION IN COMPUTING FOREIGN TAX CREDIT

Longstanding U.S. policy has recognized the primary right of a foreign country to tax income arising therein and has sought to promote tax neutrality through the foreign tax credit mechanism.

The flexibility now provided by the election to calculate a U.S. taxpayer's limitation on allowable foreign tax credits on either a per-country or overall basis is necessary to permit U.S. business to compete internationally with foreign companies. Loss of this flexibility would serve to aggravate their competitive disadvantage. This would be true particularly of less broad-based firms where a considerable part of their foreign operations consisted of risk ventures and firms wishing to expand their present operations in other areas but with serious risk of losses. Unless a taxpayer has the option of electing the per-country limitation method under these circumstances, the potential economic consequences, as contrasted with those of his foreign competitors who would not be burdened by the same tax consequences, could be a decision to forego the risk of any such venture, thus adversely affecting U.S. trade. This would affect primarily proposed ventures in less developed countries contrary to longstanding U.S. policy to assist in the development of such countries.

While Congress imposed certain punitive restrictions on the use of the per-country limitation in the Tax Reduction Act of 1975 in the case of oil-related income, any such restrictions should not be extended to other categories of income.

GROSSING UP DIVIDENDS FROM LESS DEVELOPED COUNTRY CORPORATIONS FOR PURPOSES OF DETERMINING U.S. INCOME AND FOREIGN TAX CREDIT AND TREATMENT OF EARNINGS OF LESS DEVELOPED COUNTRY CORPORATIONS WHERE THERE IS A DISPOSITION OF STOCK REPRESENTING THESE EARNINGS

H.R. 10612 would (a) repeal the present provision of Section 1248 under which gain realized upon disposition of shares of a less developed country corporation under certain circumstances is taxed as a capital gain rather than ordinary income and (b) amend the provisions of Section 902 to require gross-up of dividends received from less developed country corporations.

These provisions were enacted into law in the Tax Reform Act of 1962 only after careful consideration of their potential benefit to the economic development of less developed countries and to U.S. trade with such countries. The Council submits that the considerations supporting the conclusions reached in 1962 are even more valid today. Furthermore, these provisions should be retained to better enable U.S. business to continue to participate in these developing economies on a more competitive basis with non-U.S. businesses. Other countries, such as Japan, have negotiated agreements with several less developed countries which provide for substantially more favorable home country tax treatment of income from investments in less developed countries than is accorded income from investments by U.S. businesses. The ability of U.S. business to compete worldwide with foreign-owned businesses should not be further impeded by changes to present law which has been relied upon in making long-range plans to meet foreign competition. Continued participation in the development of less developed countries which, in general, represent large economic growth potentials for U.S. trade, without further disadvantages is beneficial to U.S. trade and investment, including the export of U.S.-manufactured products and equipment, and would contribute to better international relations between the U.S. and such countries.

APPLICATION OF THE FOREIGN TAX CREDIT IN THE CASE OF CAPITAL GAINS INCOME

H.R. 10612 provides that any capital gain from personal property (other than stock) sold outside of the country in which a company does most of its business would not be treated as foreign source income, for purposes of the foreign tax credit limitation, if no substantial foreign tax was paid on that income. In the case of stocks, however, the gain from disposition will not be treated as foreign source income, whether or not any substantial foreign tax is paid thereon, unless disposed of in the country from which such corporation derived most of its gross income. These proposals seem in fundamental conflict with the source rules in the Internal Revenue Code which have been tested for many years and found to be satisfactory, and to be contrary to the provisions of a substantial number of tax treaties entered into by the U.S. with foreign governments.

These proposals would change the present rule as to the source of any gain from the sale of a capital asset abroad so that such gain would be treated as U.S. source gain unless the specific exceptions applied, even though there was no measurable connection between the transaction and U.S. business operations.

It seems inappropriate to arbitrary treat as U.S. source income any gain realized upon disposition in the host country of shares of stock of a foreign corporation merely because less than 50% of the gross income from such foreign corporation was from sources within that country. The source of gross income of a foreign corporation is not determined by its country of incorporation. If dividends received from a foreign corporation would be treated as foreign source income, it seems reasonable to treat as foreign source income any gains realized on the disposition of such shares outside the United States, without regard to such corporation's sources of gross income.

In the case of a patent transaction under the proposal, the source of the income would depend upon whether the transaction were a sale (including an exclusive license) of a foreign patent or a license and, if a sale, whether substantial foreign tax was payable on the gain. This too seems illogical, particularly where it is not always under the control of the owner of the patent whether the transaction becomes a sale or a license, and under local foreign law some tax may be payable on the transaction even though not substantial as that term may be interpreted.

Moreover, it is difficult to reconcile the proposed treatment of foreign capital gains where no substantial foreign tax is paid thereon as U.S. source income with provisions of a number of income tax treaties between the U.S. and foreign countries. Ten of the present twenty-three treaties provide that capital gains realized by a resident of the United States in a foreign country are exempt from foreign tax, unless the property disposed of is real property or the gain is effectively connected with a permanent establishment of the U.S. company in the foreign country. Thus, the law embodied by such treaties requires that such foreign capital gains realized by U.S. persons be exempt from foreign tax while the proposed change in U.S. law could require as a result of such exemption that the gain be treated as an item of U.S. source income. This is an unwarranted in-

terference in the operation of tax treaties since it is generally understood by the treaty countries that the sources of the income is the country where the sale takes place. Unilateral action by the U.S. to change this principle of international tax law could result in foreign countries reviewing their position and imposing tax on capital gains where no tax is now payable.

Present regulations provide adequate safeguards against any abuse of present source rules.

The Council strongly urges that your Committee exclude such change in source rule in any bill submitted to the Senate for its consideration.

TREATMENT OF FOREIGN INCOME SUBSEQUENTLY EARNED WHERE FOREIGN LOSSES ARE AGAINST U.S.-SOURCE INCOME

Recapturing foreign losses by carrying them forward to offset subsequent foreign income for foreign tax credit limitation purposes is undesirable.

American business already has a disadvantage in competing internationally with nationals of countries which do not tax foreign source income (e.g., France and The Netherlands). Recapturing foreign losses will extend the disadvantage to competing with nationals of countries which grant foreign tax credit without recapturing foreign losses (e.g., United Kingdom, West Germany, Canada and Japan).

Moreover, a recapture mechanism will unfairly discriminate against industries which must operate abroad in order to maintain or develop a market for their products which otherwise would be closed to them.

It should also be noted that as a general rule the tax laws of foreign countries allow tax benefit for start-up losses through amortization and/or loss carryovers. These deductions reduce the foreign tax paid and therefore the amount of creditable tax during the pay-out period. In any event, a taxpayer will not benefit from additional U.S. tax deduction once an excess credit position is achieved because foreign taxes can never be applied against U.S. tax on income from domestic sources.

EXCLUSION FOR INCOME EARNED ABROAD BY U.S. CITIZENS LIVING OR RESIDING ABROAD

The Council urges the Committee not to adopt Section 1011 of H.R. 10612 which repeals Section 911 of the Internal Revenue Code. Section 911 of the Code now permits an annual exclusion of up to $25,000 of earned income for services performed while living or residing abroad. Repeal of this exclusion would either discourage the employment of U.S. personnel abroad or increase the cost of employment of such individuals whose services are necessary to maintain proper management and other control over foreign operations of U.S. businesses. Either alternative would adversely affect the competitive position of U.S. businesses vis-a-vis their foreign competitors.

In order to roughly equate the living standards of U.S. employees overseas with their counterparts in the U.S., American companies typically provide allowances of various types to cover unusual expenses incurred abroad. These generally take the form of cost-of-living allowances (including recognition of the fact that foreign countries rely heavily for revenue on indirect taxes not qualifying as foreign tax credits), housing allowances, and tuition expense payments. The after-tax effect on the "take home" pay of the employee, giving consideration to the present exclusion under Section 911, is a factor in the determination of these foreign service allowances. Therefore, the elimination of the present earned income exclusion under Section 911 would only add to the cost of present allowances granted such employees, thus adversely affecting the competitive position of U.S. businesses abroad. While the U.S. taxes its citizens on a worldwide basis, even though they reside abroad, most competitive countries, such as Germany, U.K., Japan and France do not. Therefore, any increase in cost of employing U.S. nationals abroad would impact adversely on the competitive status of U.S. companies vis-a-vis foreign competitors.

In this connection, it should be observed that a U.S. person accepting a foreign assignment generally is at a unique tax disadvantage with respect to one accepting a new assignment within the U.S. Ordinarily, an employee transferred abroad is not able to defer recognition of taxable gain on the sale of his principal residence in the U.S. since, as a practical matter, he will occupy rental quarters while on foreign assignment. Thus, upon his return to the U.S., his principal amount available for purchase of a residence will have been reduced by the tax paid on the recognized gain on sale of his residence prior to foreign assignment.

It also should be noted that small and medium-sized concerns often use self-employed U.S. citizens residing abroad to act as independent commission agents in effecting export sales. To the extent that repeal of the present exclusion under Section 911 would reduce the presence of such persons abroad, the expansion or maintenance of present levels of U.S. exports could be adversely affected.

WESTERN HEMISPHERE TRADE CORPORATIONS

The National Foreign Trade Council opposes elimination of the deduction allowed to Western Hemisphere Trade Corporations which was enacted in 1942 for the purpose of encouraging trade with Latin America and Canada. The provisions have worked well for over thirty years permitting United States corporations to compete effectively with both foreign local corporations and with third country foreign corporations doing business in the countries of the Western Hemisphere.

The activities of the Western Hemisphere Trade Corporations are a substantial factor in maintaining a favorable balance of trade with these countries. In addition, it does not appear timely to make any change in this provision as it would adversely effect the competitive position of U.S. business in relation to foreign competitors, who enjoy export incentives granted by their own countries, pending conclusion of trade negotiations with foreign governments to eliminate or reduce present barriers to free and competitive trade.

Accordingly, the existing provisions must be retained if we wish to continue to maintain and implement our international policies with respect to investment in and trade with the nations of South America.

TAX TREATMENT OF U.S. POSSESSION CORPORATIONS

The Council supports the concepts of taxation of possession corporations as set forth in Section 1051 of H.R. 10612.

TAX DEFERRAL UNDER DISC PROVISIONS (INCLUDING EXPORT TRADE CORPORATIONS)

The Council, in reiterating its support for the concept of DISC, emphasizes that the task of maximizing exports and maintaining a favorable trade balance lies primarily with private enterprise and that business efforts should be supported by government policy and programs which demonstrate that export expansion is a continuing objective of our government. The DISC clearly manifests this objective. The concept of DISC is that it should also serve to facilitate domestic plant expansion and increase research and promotion activities and in turn improve our country's capacity to export and meet competition abroad of foreign producers who enjoy export incentive benefits provided by their governments.

Since 1971, U.S. exports have increased from a level of $43 billion to $107 billion in 1975, a dramatic increase of approximately 150 percent. Although there are other factors which have had a bearing upon U.S. international trade, there can be no doubt that DISC has had a favorable impact on U.S. exports during its existence, as well as developing a base for future export sales, and in turn on U.S. jobs which has helped to soften the impact of a depressed domestic economy. The Commerce Department has estimated that $5.2 billion of exports in 1975 were attributable to DISC with an increase of 180,000 export related jobs without regard to other jobs from the increased stimulus to the gross national product and its multiplier effect.

DISC has materially assisted in the financing of export related receivables during a period of severe cash liquidity problems. Without the cash flows generated by DISCs, the level of exports could not have been sustained.

Furthermore, in this period DISC has provided a source of funds to finance long-term market development programs which might not otherwise have been undertaken because of budgetary or other financial restrictions, thereby broadening the base for future export sales.

APPLICATION OF THE 30 PERCENT WITHHOLDING TAX TO DIVIDEND AND INTEREST INCOME RECEIVED FROM THE U.S. BY FOREIGN PERSONS

The Council wishes to express its support of Section 1041 of H.R. 10612 as ordered reported by the House Ways and Means Committee (subsequently deleted on the House floor).

It would urge the Committee to reinstate Section 1041 as reported out by the House Ways and Means Committee but, however, in implementing that decision it not adopt a narrow or restricted definition of "portfolio investments". This proposal would encourage U.S. business to use foreign capital markets as a source of funds for future capital requirements, thus contributing to a favorable balance of payments. Any restrictive definition, however, would only serve to reduce the full potential use of such foreign capital markets.

The Council also endorses the statement by Assistant Treasury Secretary Charles M. Walker before the Senate Finance Subcommittee on International Finance and Resources on March 1, 1976 setting forth in detail the position of the Treasury Department and the Administration that existing withholding taxes on dividends and inteerst payments by U.S. persons to non-resident aliens and foreign corporations should be eliminated.

DIVIDEND TREATMENT OF U.S. SHAREHOLDERS WHERE FUNDS ARE INVESTED IN THE UNITED STATES BY FOREIGN CORPORATIONS

While the Council supports the amendment of Section 956 of the Internal Revenue Code set forth in Section 1021 of H.R. 10612, it would urge further consideration of the complete repeal of Section 956 as an additional inducement to improvement of the balance of payments position of the U.S. The principal effect of the current provision, aside from operating as a trap for the unwary, is to encourage foreign corporations to invest abroad. Thus, a corporation in search of temporary investments for working capital is induced to purchase foreign short-term obligations rather than those of United States companies. The Council believes that present case law adequately protects the government against utilization of funds of foreign subsidiaries by U.S. shareholders in the form of disguised dividends without payment of tax thereon.

ADVERSE IRS RULINGS FOR TAX-FREE EXCHANGES INVOLVING FOREIGN CORPORATIONS RELATED TO U.S. TAXPAYERS

The Council strongly supports the elimination of the advance ruling requirement of Section 367 of the Internal Revenue Code as set forth in Section 1042 of H.R. 10612.

U.S. TAXATION OF FOREIGN EARNINGS

ECONOMIC IMPLICATIONS

FOREWORD

A growing body of literature and documentation has dealt with foreign direct investment in considerable detail. In our view, there is a continuing need for information on and analysis of the subject, particularly in the light of recent developments in a world of increasing international economic interdependence.

In 1971 and 1972, the National Foreign Trade Council published its studies on "The Impact of U.S. Foreign Direct Investment on U.S. Employment and Trade" and "Economic Implications of Proposed Changes in the Taxation of U.S. Investments Abroad". This paper, drawing upon these and other studies, examines the present system for the taxation of foreign source income and the economic implications of certain tax proposals which would adversely affect U.S. investment abroad and the international operations of U.S. companies.

ROBERT M. NORRIS,
President, National Foreign Trade Council, Inc.

JULY 1975.

SUMMARY

Since 1972, there have been a number of proposals which would eliminate or so drastically reduce the amount of foreign tax credit allowable as to have substantially the same effect as the elimination of such credit, as well as proposals to tax the earnings of U.S. subsidiaries abroad, whether or not such earnings were remitted to the United States.

Apparent misunderstandings still prevail about the operation of the foreign tax credit and the effect of taxing earnings of foreign subsidiaries of U.S. corporations prior to their remission.

The U.S. foreign tax credit system has been reviewed many times in the past by Congress and has been found to be sound tax policy.

Repeal or limitation of this credit would negate the longstanding U.S. policy of promoting tax neutrality between foreign and domestic income.

Contrary to the implication of many published statements, the foreign tax credit can never be used to reduce the U.S. tax on domestic source income.

Comparison of the tax rates on income earned by wholly-owned manufacturing subsidiaries operating in countries with substantial U.S. investments shows that by and large the tax burden abroad is equal to or greater than the U.S. tax rate.

This comparison refutes the allegation that foreign investment is motivated by lower foreign taxes.

Elimination or substantial restriction of the credit would result in double taxation of U.S. companies abroad thereby placing them at a competitive disadvantage with foreign-owned competitors to such an extent that American business ventures would, in all probability, be eliminated in foreign countries.

Any anticipatory taxation of income prior to realization by a U.S. taxpayer would not only result in a U.S. tax on income that may in fact never be realized, but would place U.S. business at a competitive disadvantage abroad and would adversely impact capital formation in the U.S.

The result of the reduction in foreign investment that would be caused by such burdensome taxation, when viewed in the light of the substantial value of such investments (in excess of 107 billion dollars in 1973), would be to reduce substantially U.S. employment and to affect adversely our balance of trade and balance of payments.

U.S. foreign direct investments are essential to maintain and expand sales of U.S. corporations in foreign markets and the earnings derived from such investments have become a major contribution to the U.S. balance of payments receipts.

Changes in U.S. tax laws which would result in discriminatory tax burdens on U.S. corporations operating abroad would result in decreased U.S. exports with adverse effects on U.S. employment, balance of trade and balance of payments.

Decrease in foreign investment would not result in an increase in U.S. investment primarily because foreign investments are undertaken not as an alternative to domestic investment but to supplement such investment.

INTRODUCTION

In the latter part of March this year, a proposed amendment to the Tax Reduction Act of 1975 would have taxed the earnings of U.S. subsidiaries abroad, whether or not such earnings were remitted to the United States. This amendment was passed with very little discussion or consideration by the Senate but was deleted by the Conference Committee, although other items having an adverse effect on the competitive status of U.S. companies abroad were included in the Tax Reduction Act as enacted.

This proposed amendment was also contained in the proposed Foreign Trade and Investment Act of 1972 (the Burke-Hartke bill), along with a proposal to eliminate the foreign tax credit. Since 1972, several bills have been submitted to Congress containing similar provisions.

Detailed studies[1] and testimony concerning these tax provisions of the Burke-Hartke bill established the fact that foreign direct investments entailed little or no tax advantage relative to U.S. investment in most major countries and, generally, taxes have not been the motivation for the establishment of foreign operations or the incorporation of foreign subsidiaries. Further, the studies showed that multinational manufacturing enterprises expanded their U.S. employment faster than U.S. manufacturing companies as a whole. The studies and testimony documented that the elimination of the foreign tax credit and the proposed taxation of foreign income prior to receipt would adversely effect:

U.S. competitive position abroad.
U.S. employment.
U.S. exports.
U.S. balance of trade and payments.

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[1] "The Impact of U.S. Foreign Direct Investment on U.S. Employment and Trade", National Foreign Trade Council, Inc., New York, November, 1971; "Economic Implications of Proposed Changes in the Taxation of U.S. Investments Abroad", National Foreign Trade Council, Inc., New York, June, 1972.

The reasoning and analysis set forth in opposition to the 1972 proposals, which were not enacted, are clearly valid today and in the present world economic situation would establish that the adoption of such proposals would be even more harmful to the United States. Accordingly, it is important that there be an evaluation at this time of any tax proposals, particularly in terms of their effect on the economy of the United States and the ability of U.S. enterprises to compete abroad.

In the interest of brevity, this paper concentrates solely on two proposals which would change the present U.S. system for taxation of income derived from foreign trade and investment. One would impose double taxation on the U.S. shareholder by restricting or eliminating the present system of allowing credits for foreign income taxes incurred on income derived from abroad up to the level of U.S. tax on such income, and the other would tax the income of foreign subsidiaries prior to realization by the U.S. shareholder.

FOREIGN TAX CREDIT

The Council is gravely concerned about the apparent misunderstandings that still prevail surrounding the operation of the foreign tax credit. The U.S. foreign tax credit system has been reviewed many times in the past by the Congress and has been found to be sound tax policy. Repeal or limitation of the foreign tax credit would negate the longstanding U.S. policy of promoting tax neutrality between foreign and domestic investment. Allowance of a credit for foreign taxes paid, limited to the U.S. tax on foreign source income, approaches international tax neutrality.

Contrary to the inferences in some published statements, the foreign tax credit, under existing limitations, can never be used to reduce the U.S. tax payable on income from domestic sources.

Because foreign tax systems cannot be expected to conform in exact detail with the rates and provisions of the U.S. law, one limitation permits any income tax paid to one foreign country to be applied as a credit against U.S. tax on any income derived from sources within that country, though the foreign country may tax items of income at a rate lower than the U.S. rate and other items at a rate higher than the U.S. rate. The other limitation permits income taxes paid to all foreign countries to be credited against U.S. tax on all foreign source income. A taxpayer may elect to use either limitation but may not switch from one to the other at will.

The authorization to combine foreign taxes at various rates in computing the credit provides the necessary flexibility for international business to maintain the tax neutrality intended by the foreign tax credit system. Under this system, the United States recognizes the primary right of foreign countries to tax income arising therein, and imposes a U.S. tax only to the extent it will bring the total rate up to the U.S. rate as a minimum.

Under these concepts, there is no reason or necessity to regulate the maximum rate at which foreign taxes will be recognized as creditable or to discriminate against any particular industry abroad. The existing limitations prevent the use of high foreign tax credits to reduce the U.S. tax on U.S.-source income.

Appended hereto (Table A) is a comparison of the current statutory tax rates on income earned by wholly-owned manufacturing subsidiaries operating in countries with substantial U.S. investments.

The comparisons in the table refute the notion that foreign investment is motivated by the desire to avoid high domestic taxes. U.S. direct investments in most of the countries shown bear roughly the same tax burden as do domestic investments. The average of total tax burdens on U.S.-owned foreign subsidiaries in the seven countries compared is approximately the same as the U.S. burden, counting both federal and average state income taxes. Even where the tax burden is lower—as for example in The Netherlands (49.3%), Italy (46.5%) and Canada (46.4%)—the differences relative to the U.S. rate are too small to constitute significant incentives for foreign investment.

The case for keeping the foreign tax credit is compelling. Foreign income tax rates, unlike state income tax rates, are generally as high as the U.S. rates. If these income taxes were treated as a deduction rather than a credit, American companies would no longer be able to compete in operations abroad. Through no fault of their own, companies who, in good faith, based their prior decisions on longstanding, generally accepted tax principles would suffer an impairment of earning power and a destruction of capital value. To illustrate this point, the

following tabulation (based on the same payout ratios used in Table A) shows the total percentage increase in the effective tax rate of a U.S. parent company operating a wholly-owned foreign subsidiary in each of the seven foreign countries if foreign tax credit and deferral of tax on remitted income are eliminated:

Local tax jurisdiction of subsidiary	If foreign tax credit and deferral of tax on unremitted income are eliminated	Under present laws	Percentage increase
Canada	72.1	46.4	55.4
France	74.7	51.3	45.6
Germany	76.0	53.8	41.3
Italy	72.2	46.5	55.3
Japan	75.6	53.0	42.6
Netherlands	73.6	49.3	49.3
United Kingdom	75.0	52.0	44.2

The result would be to elimiante American business ventures in foreign countries. This is recognized on both sides of the aisle in Congress. For example, the then Assistant Secretary of the Treasury for Tax Policy, Stanley S. Surrey, in testimony in the late 1960's at hearings before the Senate Foreign Relations Committee with respect to the proposed United States-Brazil income tax treaty, reiterated a fundamental and accepted premise: "American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease."

George P. Shultz, then Secretary of Treasury, stated in his testimony before the Ways and Means Committee on February 4, 1974: "the basic foreign tax credit must be understood as a tax loophole or positive incentive to foreign investment, but rather as part of a system designed to allocate primary taxing jurisdiction to the government within whose borders the income is earned. The system does not reduce the total tax bill of U.S. companies below the amount they would have paid to the U.S. if the income had been earned here. They are excused from paying U.S. tax on foreign income only to the extent that they have paid an equivalent tax on that income to a foreign government. We must accept the fact that other countries now impose taxes comparable to ours, so that the U.S. now collects little or no tax from operations conducted by its corporations in most major foreign countries."

TAXATION OF INCOME PRIOR TO REMISSION

Is the U.S. principle of taxing income regardless of source breached by taxing U.S. shareholders on the income of their foreign subsidiaries only when distributed to such shareholders? No. What is at issue here is not whether foreign source income should be taxed, but whether such taxation should occur before the income to which it applies is realized. Any proposal to tax income prior to realization is really an attempt to tax indirectly undistributed earnings of subsidiaries operating abroad which the United States cannot tax directly because they are foreign corporations outside the tax jurisdiction of the U.S. This would result in an acceleration of tax payments rather than an elimination of deferral.

Today there is no other country which taxes undistributed operating earnings of a foreign operating subsidiary. In fact, some countries never tax earnings of foreign subsidiaries regardless of whether such earnings are distributed or not.

Any tax on undistributed earnings of operating foreign subsidiaries would discriminate against U.S. shareholders of foreign corporations because shareholders of domestic companies would contniue to be taxed only on their dividend income, not on the undistributed earnings of the corporations in which they have an equity. This is consistent with sound tax principles. Under U.S. tax law, a corporation is treated as an entity separate from its shareholders, each taxed on its separate income. There would be no justification for the corporate tax if shareholders were taxed on undistributed corporate earnings, since such treatment would amount to defining shareholders themselves as the corporate entity, paralleling the treatment of partnerships. This reasoning applies to individual and corporate shareholders alike.

Nor can it be reasonably urged that the proposal for having undistributed earnings is needed to prevent tax abuse. Existing sections of the Internal Revenue Code dealing with foreign personal holding companies, tax haven situations and allocation of income and expense items are adequate to prevent abuses. Moreover, as pointed out earlier, when foreign tax rates are considered in the areas where U.S. foreign investments are concentrated, there is on balance no tax advantage because a foreign income tax equivalent to the U.S. income tax is being levied on the earnings of the foreign subsidiary when earned.

Thus, there is no justification for departing from the well-established principle of taxation and the universal practice of other countries that do tax foreign source income namely, that a parent company should be taxed on the earnings of its foreign subsidiaries only when dividends are received and not before.

In summary, any severe restriction on the use of the foreign tax credit, or the anticipatory taxation of income earned abroad prior to realization by the United States' shareholder, would so impair the ability of taxpayers with substantial foreign operations and investment to compete abroad that many such U.S. companies would at the very least be compelled to substantially reduce their investments and activities abroad. Indeed, in a number of cases, the overall burden might be so great that taxpayers would be compelled to discontinue foreign operations and investment entirely when the full tax impact materialized.

ECONOMIC IMPLICATIONS

The economic cost to our nation resulting from any substantial reduction in the foreign direct investments of U.S. nationals must be realistically appraised in terms of the substantial value of such investments, and their contributions to the U.S. economy.

Not only are U.S. foreign direct investments essential for maintaining and expanding of sales in foreign markets, and not only do they contribute positively to the overall expansion of U.S. exports, but the earnings derived from such investments have become a major contribution to U.S. balance of payments receipts.

In analyzing the data it is important to relate the magnitude of U.S. direct investments abroad to the results of the overseas operations of U.S. companies represented by such investments. At year-end 1973, the book value of U.S. direct investments abroad exceeded $107 billion [2] and the total sales of majority-owned U.S. foreign affiliates in 1972 totaled $221 billion.[3] Of these total sales about 7% represented exports from foreign affiliates to the United States, particularly in the fields of transportation and energy resources; 71% represented local sales in countries where the affiliates were located and 22% constituted exports from those locations to countries other than the United States.[4] These figures indicate the important position of the United States in the world marketplace. Such investments, to a large degree, assure for American business access to foreign markets both for export of products of U.S. manufacture and sales of products manufactured abroad. Moreover, a special survey of the U.S. Department of Commerce shows that U.S. exports of 298 multinational companies have expanded at a rate faster than have total U.S. exports. For instance, in the period 1966 through 1970, total U.S. exports rose by 44% whereas total exports for the 298 multinational companies surveyed rose by 55%. It is significant that in 1970 these same 298 multinational companies alone accounted for around 50% of total U.S. exports.[5] It is equally significant that over the years about 25% of U.S. exports have been made to foreign affiliates.[6]

The data on the inflow of interest, dividends and earnings on foreign direct investments to the United States show a 4½-time increase from $4.0 billion for the year 1965 to $18.2 billion for the year 1974.[7] Fees and royalties remitted by foriegn affiliates about tripled from $1.2 billion to $3.2 billion for the same period.

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[2] "U.S. Direct Investment Abroad in 1973", Survey of Current Business, August 1974, Department of Commerce.

[3] "Sales by Majority-Owned Foreign Affiliates of U.S. Companies, 1966–72", Survey of Current Business, August, 1974, Department of Commerce.

[4] Ibid.

[5] "Worldwide Sales of U.S. Multinational Companies", Survey of Current Business, January, 1973, Department of Commerce.

[6] "U.S. Direct Investments Abroad, 1966", Supplement to the Survey of Current Business, Final Data, 1975, Department of Commerce.

[7] "U.S. Balance of Payments Developments—First Quarter 1974", Survey of Current Business, June, 1974, Department of Commerce & "U.S. Balance of Payments Developments—Fourth Quarter & Year 1974", March, 1975, Department of Commerce.

The sum of the balance of payments receipts from these sources for the past 10 years (1965–1974) was $87.4 billion, or more than twice the $41.8 billion outflow for new direct investments abroad during the same period.[8] As shown in the table below, not only has the net balance on direct investments become within recent years the principal plus factor in the U.S. balance of payments, but it has also more than offset the trade deficits experienced in the years 1971, 1972 and 1974.

COMPARISON OF INVESTMENT INCOME WITH DIRECT INVESTMENTS AND TRADE BALANCE

[In billions of dollars]

	1970	1971	1972	1973	1974
Investment income including fees and royalties	7.2	8.5	9.3	12.3	21.4
Direct investment outflows	−4.4	−4.9	−3.5	−4.9	−6.8
Net balance on direct investment account	2.8	3.6	5.8	7.4	14.6
Trade balance	2.2	−2.7	−7.0	−.5	−5.9
Excess of direct investment account over trade balance	.6	6.3	12.8	6.9	20.5

Source: U.S. Department of Commerce, Survey of Current Business, June 1974 and March 1975.

FOREIGN INVESTMENT AND U.S. EMPLOYMENT

Far from exporting jobs, the evidence indicates that those American companies expanding their foreign investments actually have increased jobs at home at above average rates. From 1966 to 1970 total employment in the United States of 298 multinational corporations included in a U.S. Department of Commerce Survey expanded at a rate one and a half times faster than total domestic employment of all private industry in the same period.[9]

A detailed industry analysis by Professor Robert G. Hawkins[10] both confirms and further emphasizes the positive relationship between investment abroad and domestic expansion that has been noted in other surveys. Mr. Hawkins' examination of comprehensive Commerce Department data for 19 manufacturing industries led him to conclude that the industries with the highest rate of expanding investment abroad tended to have the most rapid growth in domestic output and employment. Conversely, the industries with the slowest investment growth abroad tended to experience the least expansion in home output and employment. Analysis of 39 sub-industries containing the largest foreign investments in manufacturing generally supported the results of the more aggregated comparisons. In Professor Hawkins' words:

"It appears the MNC operations abroad are more a product of relative dynamism of the industry and the firms involved—both domestically and overseas—than of the switching of the locus of production of a fixed level of output among countries."

Furthermore, the survey by the National Foreign Trade Council (NFTC, corroborated by the Tariff Commission,[11] refutes the contention that U.S. companies have shifted plants or high-level technology abroad to a significant degree for the purpose of supplying the U.S. market with the output of low-wage foreign labor. The sectors where the inroads of imports into the domestic market have been most rapid and extensive are not generally sectors where U.S. direct investments abroad loom large.

Evidence from the NFTC survey indicates that foreign investments giving rise to imports back to the United States are concentrated in a few industrial sectors, a few components or simple products and raw materials and not ones incorporating high technology. This was confirmed in a publication by the Commerce Department which noted that:

"The rapid growth of U.S. imports in recent years has not been due solely, or even mainly, to the multinational corporation. Most of the increase has come from sources other than the foreign affiliates of U.S. firms. German, Japanese,

[8] Ibid.

[9] "Special Survey of U.S. Multinational Companies, 1970", November 1972, Department of Commerce.

[10] "The Multinational Corporation—Studies in U.S. Foreign Direct Investment", U.S. Department of Commerce, Volume I, March 1972.

[11] "Economic Factors Affecting the Use of Items 807.00 and 806.30 of the Tariff Schedules of the United States", Tariff Commission Publication No. 339, September, 1970.

and other exports of automobiles, steel, textiles, footwear and electronic goods

have very successfully entered the American market without the benefit of ties with U.S. corporations[12]

Moreover, the U.S. Tariff Commission in a special report to the President stated:[13]

"Industries characterized by heavy overseas investment in productive facilities appear also to be those which not only contribute most heavily to U.S. exports but also have had the least impact on the upsurge of U.S. imports—with exactly reverse results appearing for those industries in which strong foreign investment activity is not characteristic."

Notwithstanding the clear evidence that foreign investment overall is not a cause of domestic unemployment—quite the contrary—certain critics allege that curbing such investment can lead to job expansion at home. In their view, the demonstrable expansion of domestic employment by firms investing abroad illustrates merely that the firms concerned are enjoying rising demand for their products in several areas of the world, and not that their foreign investment is a direct cause of higher employment at home. On the unrealistic premise that production abroad is a substitute for exports as a means of supplying export markets, these critics conclude that no matter how rapidly U.S. foreign investors expanded their exports from the United States, their export performance would be better still if foreign investment were discouraged, and larger exports would mean greater domestic production and this in turn would mean more jobs.

But this conclusion is invalid because its major premise is unrealistic. Curbing foreign investment would not increase jobs at home.[14] Foreign markets could not be supplied on competitive terms through exports. Foreign investment is necessary to enter markets that would otherwise be foreclosed, and to preserve market positions that would otherwise be lost because of competition from other foreign investors enjoying the benefit of lower production costs. It is essential that such investments be made to overcome obstacles such as trade barriers, transportation costs, perishability of products, local content requirements, and government procurement practices.

The choice for the U.S. firm is most often not between U.S. or foreign operations, but between foreign operations or no access at all into foreign markets. The realistic question is not whether foreign investment is to occur, because it will in any event, but whether its advantages will accrue to the United States or to other countries.

FOREIGN INVESTMENT—DOES IT PREEMPT DOMESTIC INVESTMENT?

Certain critics also call for tax measures to restrict foreign investment on the grounds that to a significant degree domestic and foreign investments are mutually exclusive and that foreign investment materially reduces the amount of domestic investment that would occur in its absence. Available evidence does not support this allegation. The earlier NFTC survey indicated that foreign direct investment tends to expand U.S. exports and thereby stimulates both domestic investment and employment in the United States, even though this may involve some shifts in the structure of employment in this country. All but one of the respondents to an earlier survey by the Emergency Committee for American Trade (ECAT)[15] stated that their foreign investment programs were independent of their domestic programs, and therefore had no adverse impact on domestic investment expenditures. Basic to this exercise of independence is the availability of foreign funds to finance investments abroad.

The NFTC study in 1972, drawing on a comprehensive report on sources of funds for U.S.-owned foreign affiliates[16] showed that in manufacturing, capital from the United States accounted, on the average, for only 12.6% of total invest-

[12] See Note (10) Supra.

[13] "Competitiveness of U.S. Industries", Report to the President, U.S. Tariff Commission, Publication No. 473, Washington, D.C., April, 1972.

[14] A recent econometric study by the National Association of Manufacturers estimates that if legislation were enacted eliminating "tax deferral" on foreign source income, employment in the United States over a five-year period would decrease by 680,000; if the foreign tax credit provisions were repealed, employment over the same period would decrease by 1,240,000; and if both "deferral" and foreign tax credits were eliminated, this would result in a 2,720,000 decrease in employment over the same period. (Source: "Tax Impact Project Report", National Association of Manufacturers, Washington, D.C., June, 1975.)

[15] "The Role of the Multinational Corporation in the United States and World Economies", ECAT, Washington, D.C., February, 1972.

[16] "Source and Uses of Funds of Foreign Affiliates of U.S. Firms, 1967–68", Survey of Current Business, November, 1970, Department of Commerce.

ment abroad in the most recent five years for which consistent data are available—1963–65 and 1967–68. To be sure, this low percentage of U.S. source funds partly reflects capital contributions by foreigners with whom, in many cases, American parent companies share ownership. And in the 1965–68 period, reliance on U.S. source funds was probably subnormal, because the government's balance of payments programs placed great stress on the overseas financing of foreign direct investment. Still, the average percentage of U.S. source funds in 1963–64, before these balance of payments programs were instituted, was 11.0%, lower even than the five-year average. Despite these qualifications, it remains a striking fact that only $1 from the United States was associated with each $8 of actual investment abroad by U.S.-controlled foreign affiliates during the period covered.

Furthermore, at most, only a small fraction of each dollar actually invested abroad could be lost to the home economy. And even this fraction would be lost only if the U.S. portion of the overseas investment dollar came at the expense of domestic investment. But there are good reasons for believing that little, if any, does. To be sure, at the level of the individual company, fund limitations could require a marginal choice between investing at home or abroad. This raises the possibility that preventing a firm from investing elsewhere might induce it to expand at home into projects that would not otherwise be profitable enough to warrant approval. But even at the individual company level, the result of restricting foreign investment might simply be lower total investment and not expanded investment at home. In any event, what is true for a company need not be true for the economy. Indeed, capital outflows tend to be offset by government policies aimed at maintaining domestic stability. These policies help to maintain a high level of investment at home, except during periods of monetary and fiscal stringency imposed to counter inflation. By their very nature, these compensatory policies tend to prevent foreign investment from displacing domestic.

In summary, foreign investments tend to supplement rather than supplant domestic investment, and their effect on the domestic economy is positive in the long run by actually increasing the amount of funds available for both investment and consumption at home. This positive effect is a consequence of the return flow of funds from U.S. investments. As already described, remittances of dividends, interest, branch earnings, fees and royalties have risen more rapidly than capital outflows from the United States, with the result that for the period 1970–74 U.S. investments abroad have returned annually around $2 of purchasing power for every American dollar currently sent out for foreign expansion.[17]

Nor is there any reason to suppose that reducing the profitability of foreign operations would produce larger domestic capital expenditures by U.S. industries. Any realistic historical review of the facts will demonstrate, as it has been earlier pointed out, that decisions to make foreign direct investments are not a matter of choice but of necessity. Such investments permit access to the marketplace which would otherwise be denied. Enlarging upon these investments not only preserves for the investor his position in the marketplace but helps to insure him a share in an expanding market. Reduction in the profitability of foreign operations would, therefore, destroy their viability and force their abandonment thereby ceding the markets to other foreign investors.

TABLE A.— A COMPARISON OF THE CURRENT STATUTORY TAX RATES (INCLUDING WITHHOLDING TAXES WHERE APPLICABLE) ON INCOME EARNED BY WHOLLY-OWNED MANUFACTURING SUBSIDIARIES OPERATING IN SELECTED COUNTRIES WITH SUBSTANTIAL U.S. INVESTMENT

PARENT COMPANY'S COUNTRY OF OPERATION AND INCORPORATION

[All amounts expressed in percentages]

Subsidiary's country of operation and incorporation	United States	Canada	France	Germany	Italy	Japan	Netherlands	United Kingdom
United States	51.0							
Canada	46.4	42.0	46.4	46.4	46.4	46.4	46.4	46.4
France	51.3	56.3	50.0	50.0	53.8	53.8	50.0	51.3
Germany	53.8	53.8	56.3	50.0	58.8	56.3	56.3	56.3
Italy	46.5	53.3	49.1	53.3	45.0	47.8	45.0	46.4
Japan	53.0	54.2	54.2	53.0	53.0	50.5	53.0	53.0
Netherlands	49.3	51.9	49.3	50.6	48.0	49.3	48.0	49.3
United Kingdom	52.0	52.0	52.0	52.0	52.0	52.0	52.0	52.0

[17] See Note 7 Supra.

The 51.0% rate for a U.S. corporation operating domestically takes into account the Federal income tax of 48% and average state income taxes of 5.8%. Likewise, the rates shown for other countries include local income tax effects.

Because withholding and home country taxes (in certain cases) depend on amounts remitted, it was necessary to consider the percentages of after-tax earnings distributed to the parent companies. The dividend for each country was deemed to be 50% of the after-tax net income.

Differences in the rates paid by the various nationalities reflect variations in tax-treaty dividend withholding rates between countries.

It has been assumed that the total income of the wholly-owned subsidiary was earned within the taxing jurisdiction in which it operates.

Senator RIBICOFF. Mr. William J. Nolan, please.

STATEMENT OF WILLIAM J. NOLAN, JR., CHAIRMAN, COMMITTEE ON TAXATION, UNITED STATES COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE, INC.

Mr. NOLAN. Thank you, Mr. Chairman, members of the committee. I am William J. Nolan, Jr., vice president, Amax, Inc., I am appearing today as chairman of the Committee on Taxation of the United States Council of the International Chamber of Commerce.

The U.S. council membership is comprised of most of the major business firms in the United States engaged in foreign trade and foreign operations. It represents American business interests within the international chamber, which in turn represents the international business community in approximately 60 countries. I have filed with the committee a comprehensive statement which I hope will be included in the record.

Senator RIBICOFF. Without objection the entire statement will go in the record as if read.

Mr. NOLAN. I would like to summarize very briefly a few of the points.

As we reviewed the wide range of topics which are to be considered by your committee during the course of these hearings, our organization in an effort to be most constructive opted to limit its comments to those measures before you which if adopted would have the most far-reaching implications upon the majority of our membership.

In this regard, the first topic I would like to comment on are those propsals before the Congress which would eliminate or restrict the foreign tax credit. It is apparently the view of the sponsors of these proposals that the credit is an unwarranted incentive for those U.S. businesses that invest abroad and in turn is a cause of unemployment and inflation in the United States. The objective of the proposals appears to be to discourage U.S. foreign investment and/or to force our U.S. companies to relocate their foreign operations here at home.

Although there may be disagreement as to the effects of foreign investment by U.S. corporations, the preponderance of the evidence supports the fact that foreign investment generally is not made in lieu of domestic investment. On the contrary, U.S. based multinational firms would prefer to manufacture in the United States and export to foreign countries so they might realize efficiences of scale to the maximum extent possible.

However, because of both tariff and nontariff barriers to U.S. exports, this objective cannot be fully realized except as a byproduct of foreign operations.

Furthermore, our foreign operations would be significantly affected if the foreign tax credit were to be repealed in that they would be placed at a severe competitive disadvantage as compared with foreign-based multinationals whose home countries do not impose similar tax burdens. Such action would eventually reduce U.S. manufactured exports in the form of completed units, components, replacement parts, plant, machinery, and equipment, et cetera.

More importantly, there would be no offsetting increase in domestic employment opportunities since limitation of foreign manufacturing operations of U.S. companies would not result in transfer of these operations to the United States.

Instead, the operations of foreign-based multinationals would be well positioned to take advantage of these foreign sales opportunities. If indeed the Congress determines that some corrective action is warranted as may be the case in dealing with the problems that low-priced imports have visited upon certain industries, we would propose that the appropriate action be aimed at these specific problem areas rather than in the repeal of existing income tax provisions that have much broader economic implications.

Along these same lines there are various legislative proposals before the Congress that would alter the method by which the current credit is calculated. More specifically, these proposals would require that, (1) the overall limitation be repealed, (2) the per-country limitation be repealed, or (3) the taxpayer be required to use the method which produces the lowest credit and, therefore, the highest U.S. tax on foreign source income.

The Council does not subscribe to these proposals on the grounds that we view them as attempts to chip away at the foreign tax credit with the ultimate objective being to eliminate the concept without providing any viable substitute for avoiding double taxation.

I think it worth emphasizing—because there does seem to be considerable misunderstanding of the effect of the foreign tax credit—that under present law, the credit is limited to foreign source income and does not reduce the U.S. tax imposed on U.S. source income.

The second proposed legislative change upon which I would like to comment has to do with the acceleration of taxes on undistributed income of foreign subsidiaries.

In our opinion, if this proposal is adopted it would result in a significantly higher tax burden on the foreign income of U.S. corporations. The arguments in favor of this proposition erroneously refer to the current law as granting a "deferral privilege" with respect to such income. We submit that there is no such thing as a deferral privilege; that under internationally accepted tax principles, income earned by a separate entity is not taxed to its shareholders until received by them. This has been a basic underlying tenant of the U.S. tax system since inception and it is reflected in the treatment of domestic shareholders of domestic corporations.

In its true perspective any legislation which ended the deferral on foreign subsidiaries' earnings would not be eliminating a privilege, but rather imposing a penalty.

Again, we believe that the enaction of any such punitive legislation would serve only to increase the competitive edge of international

corporations of other nations at the expense of our own. In developing our position on the proposed foreign tax credit rules, and on elimination of the deferral rules, we relied heavily on concepts of taxation which have proven through their usage over the past 50 years to be fair and reasonable principles and which surely would be compromised if the proposed revisions were to be adopted. To elaborate, the United States has historically taken the view that taxes on international business should be "neutral"; that is, they should be imposed in a way that business decisions are able to be made on their own merits and are not unduly influenced by tax considerations.

Second, we as a nation have long held that there should be equal treatment of taxpayers regardless of the source of their income.

Several intergovernmental organizations such as the Organization for Economic Cooperation and Development, the European Economic Community, and recently the United Nations have clearly recognized the importance of these principles and are devoting a substantial portion of their energies to developing techniques which would promote maximum advantages of world trade while insuring that the countries involved received their appropriate taxes.

They also recognize the hazards and inequities of multiple taxation and are striving toward the goals of economic neutrality and national treatment. The U.S. Government is a recognized leader in these efforts. Congressional committees and others should be cognizant of these activities and should, in our opinion, lend their full support to these endeavors.

Although we have strongly endorsed the concepts of economic neutrality and tax equality, we welcome certain provisions of the code which are adopted from time to time and which are seemingly contrary to our philosophy. These provisions which were considered to be in the Nation's best interest at the time they were adopted generally establish incentives or neutralize foreign incentives. This brings me to the third point and that is that we feel that it would be unwise at this point to repeal or further restrict either the DISC or the Western Hemisphere Trade Corp. provisions. We think that those provisions which have served for various periods of time and were adopted for a purpose should be given a longer chance to prove their value. That is all I have.

Senator RIBICOFF. Senator Packwood.

Senator PACKWOOD. I don't think I have any questions, Mr. Chairman.

Senator RIBICOFF. Senator Curtis.

Senator CURTIS. Mr. Nolan, you were here in the hearing room a bit ago when I asked the previous witness about the proposal advanced by Senator Kennedy.

Mr. NOLAN. Yes, I was.

Senator CURTIS. That is, to end the present tax deferral and do away with DISC.

Based upon your comment already made, I take it that you concur with Mr. Norris in his opposition?

Mr. NOLAN. I do indeed.

Senator CURTIS. Do you feel that if these actions were taken it would enhance the Treasury of the United States to anything like $2 billion by 1981?

Mr. NOLAN. I can't believe it. I can't answer with definite knowledge.

Senator CURTIS. You believe the activity would end without—the business activity would end without these provisions?

Mr. NOLAN. I think there would certainly be a curtailment of the foreign business activities.

Senator CURTIS. Isn't it also true that a foreign subsidiary does not receive the investment tax credit?

Mr. NOLAN. That is correct.

Senator CURTIS. Would you concur with this statement? It has been argued that there are tax incentives to be gained by incorporating overseas and we feel these so-called incentives would result in tax neutrality and provide additional revenues. The reverse is true, if the law were changed to end deferral to provide a tax deduction rather than a credit for that portion of foreign taxes which corresponds to U.S. State and local taxes, there would be temporary revenue gains, that these gains would be more than offset if the law were also changed to extend the investment tax credit and the asset depreciation range to investment abroad and to allow foreign tax credits in excess of the tentative U.S. tax.

Do you agree with that contention?

Mr. NOLAN. Well, there are a lot of different conclusions in there.

Senator CURTIS. Yes.

Mr. NOLAN. I think that if the—the single most important occurrence would be treating the credit as a deduction as I think you quoted first. I think that would so disturb the foreign operations of U.S. companies that you might be able to extend the investment tax credit and asset depreciation range and everything else and still not do any substantial good because if—even if those items are granted that would not stop the foreign government from taxing without regard to them. Most of our major competitors are taxing income just about as high as we are if not higher. So, if you took away the credit, you would still be paying the tax and anything extra that the United States gave would have no bearing on it.

Senator CURTIS. That's all.

Senator RIBICOFF. Senator Dole.

Senator DOLE. I have no questions, Mr. Chairman. I apologize for coming in late. I am in the process of reading the statement.

Senator PACKWOOD. Could I ask one that I forgot?

Senator RIBICOFF. Yes.

Senator PACKWOOD. Let me ask you the same question of trading of DISC for the 2-percent reduction in the corporate tax rate.

Mr. NOLAN. I could answer that very quickly since my company doen't have a DISC, but I think some of my membership do and they would not think that would be a very good trade. I think the thing to know is whose ox is being gored, Senator Packwood.

Senator PACKWOOD. As I indicated, the corporations involved heavily in export whom I have asked, most of them when they weigh it come down on the side of rather having the 46 percent tax rate if they are guaranteed of that in exchange for DISC. In your case, there is no problem at all.

Mr. NOLAN. No, no problem. I will take it if you guarantee it, please. [Laughter.]

Senator RIBICOFF. Senator Packwood had asked the previous witness, I believe, a very important question concerning the back-up, or the proof that DISC actually helps in the export business and creation of jobs. I think he raised the point that while people generalize there has been very little proof. I am impressed with that question.

Would you want to comment, or do you have available some factual material to answer Senator Packwood's previous question?

Mr. NOLAN. I do not, Senator Ribicoff. I would endeavor to try to find out if there is any. I don't know of any, as a matter of fact.

Senator RIBICOFF. That's a very good question. I mean I originally voted for DISC. I mean, I have questions in my mind at the present time. I have not made up my mind on this issue.

The question that Senator Packwood puts to the witness is a very proper and legitimate one and I share his concern.

Mr. NOLAN. I am really surprised that the Treasury doesn't have any information on that score, but I don't remember ever having seen any.

Senator RIBICOFF. Well, it isn't only the Treasury involved, you know, your membership, these large corporations, they have very good auditors. They ought to have a pretty good idea of whether this does or does not help in export business and creation of jobs. They ought to have proof of that.

Mr. NOLAN. I certainly would be more than happy to go back to our membership and see if I can't compile something on that score.

[At presstime, June 8, 1976, the material referred to had not been received for the record.]

Senator RIBICOFF. How many major corporations are members of the U.S. Council of International Chamber of Commerce?

Mr. NOLAN. About 225.

Senator RIBICOFF. I would make out of those 225 there are some companies that comply with the Arab boycott and there are some that do not?

And many of them compete with one another in the world market. Why should we treat the company that complies with the boycott the same as the company that doesn't comply with the boycott?

Mr. NOLAN. Well, I think there are two answers.

First off, I don't know of any that do. I am sure there are, but I personally disapprove of the boycott.

But leaving that aside, leaving personal opinion aside, it seems to me not only are the U.S. companies competing with themselves, but also with other foreign corporations.

Now, conceivably treating the corporations differently under the U.S. tax law would injure them, but favor the foreign corporations.

Senator RIBICOFF. In other words your opinion is that as long as some foreign company does something that is contrary to American policy and American public opinion, that American companies should do anything they want to do irrespective?

Mr. NOLAN. No, sir, I did not mean to imply that.

Senator RIBICOFF. That seems to be the impression I would gather.

Mr. NOLAN. Excuse me, I was pointing out we have to keep in mind international competition as well as U.S. competition.

Senator RIBICOFF. There is more than just doing business. I think the world is composed of many other factors. I was very intrigued to

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see a list of companies in the New York Times this past week, some of them major companies of America, who refuse to comply with the boycott and as I looked over those lists not a single one of them has a monopoly. Each one of those companies as I went down that list, really is in tough competition with other companies. Why should they be placed at a disadvantage to companies that comply with the boycott? That bothers me.

Mr. NOLAN. It bothers me also.

Senator RIBICOFF. I don't want to name the companies because I think it is unfair.

Mr. NOLAN. Well, no, they were named—the ones you mentioned were named in the newspaper.

Senator RIBICOFF. The others weren't and I didn't have the proof whether they were or were not complying. But the fact some were listed, it raises implications, but since I don't have the proof, I won't name the companies. But it becomes obvious that you have major corporations in the United States that as a matter of policy will not comply with the boycott and you have their competitors who are complying with the boycott. So, they are losing business, the other people get business. They are using the American tax laws to encourage them to continue the boycott. Now, why should they have the competitive advantage of the tax credits and DISC and tax deferrals which amounts to about $1 billion a year?

Mr. NOLAN. Well, Mr. Chairman, the main reason I would suggest it should not be handled in the tax law, but as a political matter. Now, I heard your prior comments that this would be the easiest way to handle the thing rather than some sort of special legislation. But it strikes me that the tax law—and granted your position that the tax law is constantly making policy outside the tax field—still, I feel it is a rather dangerous disturbing factor to go after particular areas under the tax laws.

Senator RIBICOFF. Sir, if we were not making policy in the tax laws everything you are talking about would be out the window. You are making policy with everything that everyone of you gentlemen are testifying to.

Mr. NOLAN. Yes, yes.

Senator RIBICOFF. And much of it, I agree with. I know of no better way of making economic and social policy than through the tax laws. Every provision in the tax laws makes policy in this country. Now, we have a major problem facing American business.

Senator DOLE. Mr. Chairman?

Senator RIBICOFF. Senator Dole.

Senator DOLE. Could I put in the record a statement by the Department of Commerce on DISC and what it means tax-wise and how much it increases the GNP? It is only an estimate, but it might give some answer to Senator Packwood.

Senator RIBICOFF. I think it is important and I think it is important that not only the Treasury and Commerce, but also private industry submit figures like that because it would be very persuasive on the decisions we make.

[The statement referred to and an analysis by Dr. Norman Ture, follows:]

Analysis of D.I.S.C. by the Department of Commerce

Due to the multiplier effect, the Commerce Department staff estimates indicate that $1 billion of increased exports results in an annual increase in GNP of $3 billion. Therefore, the estimated $7 to $9 billion increase in exports due to DISC incentives would result in a $21 to $27 billion increase in GNP.

Federal Tax revenues are about $230 million annually for each $1 billion of GNP. Thus, the $7–$9 billion increase in exports attritutable to DISC directly increased Federal revenues by $1.6 to $2.1 billion, without considering the much larger impact of Federal revenues from the multiplier effect to the GNP; i.e.: the 3-fold increase in GNP for each export dollar.

Analysis of DISC by Norman B. Ture

(1) Total U.S. merchandise exports in 1974 were $5.2 billion greater than they would have been in the absence of the DISC provision.

(2) Throughout the business sector, there were 442,000 more full-time equivalent jobs than there could have been in the absence of the DISC.

(3) Wages and salaries paid to employees in export production in 1974 were $0.6 billion greater than the amount that would otherwise have been paid. Adding the $3.6 billion of wages and salaries paid to the additional employees in supplying industries, the aggregate amount of employee compensation in excess or the amount which would have been paid in the absence of DISC is about $4.4 billion.

(4) The total increment of GNP in the business sector attributable to DISC was $28.5 billion.

(5) Aggregate capital outlays throughout the business sector are estimated to have been $23.3 billion more than they would have been without DISC.

On the basis of the Treasury's fiscal year estimates, the calendar year 1974 revenue loss attributable to DISC is estimated at about $1.0 billion. This is the "initial impact" revenue loss, based on the assumption that there were no changes in exports, production, employment and income in response to the DISC provisions. These responses, as estimated above, generated about $2.2 billion in Federal tax revenues above amounts of revenues that otherwise would have been obtained. The next revenue effect, therefore, is a gain of about $1.2 billion.

Summary of economic effects of DISC: All exports industries [Dollar amounts in billions of 1974 dollars]

Increases in—	
1. Employment, total (effective jobs)	442
2. Employee compensation, total	$4.4
3. Net change in Federal tax revenues	1.2
Initial impact	—1.0
Increase attributable to increase in output and income	2.2
4. Business sector GNP, total	28.5
5. Value of exports	5.2
6. Capital outlays due to DISC	22.3

Senator Ribicoff. Does anyone else have any questions of this witness because there is a vote on and we could answer the vote now.

Again, our apologies, gentlemen. We are finished, Mr. Nolan, questioning you.

[The prepared statement of Mr. Nolan follows:]

Statement of William J. Nolan, Jr., Chairman of the Committee on Taxation of the United States Council of the International Chamber of Commerce

I am William J. Nolan, Jr., Vice President of AMAX Inc., and am appearing today as Chairman of the Committee on Taxation of the United States Council of the International Chamber of Commerce. The U.S. Council membership is

comprised of most of the major business firms in the United States engaged in foreign trade and foreign operations. It represents American business interests within the International Chamber, which in turn represents the international business community in approximately 60 countries. As some of you may recall, our Committee on Taxation has had the privilege of presenting its views on tax matters to your Committee on prior occasions.

General background

Hopefully, we have long since passed the point where we should dispute the advantages to us of world trade and investment. Economic interdependence is a reality. In short, the United States must have access to foreign technological developments and commodities and raw materials located abroad. The United States must finance these foreign purchases through what it produces efficiently—whether soybeans, aircraft, or sophisticated computers. Obviously, it is frequently necessary to invest abroad as part of the complicated system of production and trade. Raw materials may only be found—or only remain in quantity— in countries where capital is short or nonexistent.

The worldwide shipment of many items is precluded because of transportation costs or physical impossibility. Protectionist or nationalistic fervor demands local manufacture or imposes punitive tariffs and duties on foreign production. The new economic order currently being debated and implemented will ensure that the developing world will get more and more of total world production.

The studies in this area have been less than conclusive and must be further researched and attuned to changing conditions. It is of no help to suggest, for example, that if punitive taxes were imposed on foreign investments, there would be equivalent investment in the United States. Our productive facilities depend on tin—zinc—iron ore—neckel, etc., not available in sufficient quantity in the United States. So long as we drink coffee or tea, eat bananas and coconuts, read newspapers, use aluminum cans, ride on rubber tires and consume countless other everyday items, we must finance their growth or production directly or indirectly. U.S. companies investing abroad for these purposes are not improperly diverting capital or labor but are generally contributing to the economic well-being of this country.

Intergovernmental organizations such as the OECD, the EEC and recently, the U.N. are devoting a substantial portion of their energies to developing techniques which would promote maximum advantages of world trade while ensuring that the countries involved receive their appropriate taxes. They also recognize the hazards and inequities of multiple taxation and are striving toward the goals of economic neutrality and national treatment.

The United States Government is a recognized leader in these efforts. Congressional Committees and others should be cognizant of these activities and avoid unilateral action which would only penalize U.S. citizens and give competitive advantages to foreigners. In the meantime, we should support the efforts of these organizations as they attempt to curtail special tax provisions under legislation of certain countries. *In general, tax holidays, tax sparing and similar incentives to international business should be limited in time and application to recognized economic objectives such as assistance to underdeveloped countries on a temporary basis.*

It is generally accepted that taxes on international business should be "neutral," that is, they should be imposed in a way that business decisions are made on their own merits, and not because of tax considerations. And it is also generally accepted that the cornerstone of tax neutrality is the elimination of international double taxation.

The major industrial nations of the world eliminate double taxation either by following the "territorial" concept of taxation or by granting a credit for taxes paid by domestic taxpayers to foreign jurisdictions.

Under the "territorial" approach income from commercial activity is taxed only by the country in which it is generated. France and the Netherlands are among those who follow this concept. From a theoretical standpoint, the territorial concept best meets the tests of non-discrimination and neutrality. It could be subject to abuse, however, as encouragement would be given to the establishment of tax-haven operations in countries soliciting businesses solely on the basis of tax savings. This could well foster the spread of stricter controls on capital and technology flows and limitations on transfer prices for good and services.

Under the foreign tax credit system, on the other hand, a country taxes the worldwide income of citizens and domestic corporations, but allows a credit for

taxes paid foreign countries. The United States, Japan and the United Kingdom among others, use this system. Both systems recognize that the host nation is entitled to priority in taxing domestic commercial activity; for it is the host nation which supplies the financial, social and economic stability which permit profitable commercial activity. The tax credit system, in addition, permits the investor nation to tax foreign profits to the extent its tax rate exceeds that of the host nation.

FOREIGN TAX CREDIT

There are several proposals before the Congress which would eliminate or restrict the foreign tax credit. These are apparently based on the assumption that the credit is an unwarranted incentive to foreign investment by U.S. business and in turn in a cause of unemployment and inflation in the U.S. Accordingly, the aim of the proposals is the discouragement of U.S. foreign investment and/or the forced withdrawal of U.S. interests from abroad by imposing on U.S. owned business a cost which would render it unable to compete with foreign owned business.

Repeal of the credit for foreign taxes paid on foreign source income would be disastrous to U.S. business interests abroad. The Council, believing that such contraction of U.S. business interest overseas would be contrary to sound U.S. economic policy, accordingly opposes all such proposed legislation which would have the effect of causing double taxation. The Council is of the opinion that the foreign tax credit is not an incentive but rather is a necessary mechanism for the implementation of both our long-standing policy of international taxation and the many bilateral agreements for the avoidance of double taxation. We know of no developed country which has taken a position adversely affecting its nationals' overseas investments as dramatic and severe as would be the introduction of double taxation through the elimination of the foreign tax credit system. Obviously, the forced withdrawal of U.S. foreign investment will not solve U.S. employment and inflation problems and in fact may well contribute to both.

In electing the credit method of avoiding international double taxation, the United States has long recognized that foreign income tax laws might very well differ in rate and method of computation from those of the United States. Accordingly, in arriving at the allowable credit, U.S. taxing concepts have been applied even if the foreign country does not necessarily follow such concepts in imposing its income taxes. That is, in taxing woldwide income, the same rules for determining income subject to tax have generally applied whether the business operations were conducted in the United States or abroad. This approach by the U.S. ensures that income taxes will be paid in an amount at least equal to the U.S. income tax that would have been paid had such foreign income been earned in the U.S.

Further, in order to preclude the credit for foreign taxes from exceeding the U.S. income tax on foreign source income, the law applies one of two limitations (either the per country or the overall) to obtain this objective. These provisions limit the amount of the credit to the amount of the U.S. tax on such foreign source income so as to ensure that full U.S. tax is imposed on U.S. source income. The general result is that the burden of income taxes on foreign source income is the higher of either the foreign or U.S. tax rate. The Council supports the retention of the present credit provisions and believes that any substantive changes would be ill advised.

The U.S. foreign tax credit is, therefore, far from being an incentive. The credit achieves the objective of tax equity and neutrality. By avoiding double taxation, it effects equality by permitting U.S. owned business to operate in overseas locations with a generally no more burdensome tax cost than its foreign owned competitor. At the same time, it effects equity by subjecting foreign source income to no higher a U.S. tax burden than U.S. source income. Finally, it effects neutrality by insuring that foreign source income bears no lower combined U.S. and foreign tax burden than that imposed on U.S. source income.

Unemployment not due to U.S. foreign investment

Although economists may disagree on the effects of foreign investment by U.S. corporations, the preponderance of evidence supports the fact that foreign investment generally is not made in lieu of domestic investment and that employment in plants abroad, therefore, does not result in a loss of employment in the United States. There is no question that production will flow from plants abroad; the question is who will own such plants. It is quite obvious that if U.S.

interests cannot compete abroad as a result of a severe and punitive U.S. tax burden on such foreign operations, the ownership of such plants will fall to others. This, of course, would not mean that comparable reinvestment in the United States will result.

U.S. operations abroad help increase our exports of capital goods and intermediate products. The proceeds of these export sales and profits from foreign branch and subsidiary operations, together with fees and royalties from overseas sources, have a most favorable impact on our balance of payments. Moreover, this inflow, whether retained or distributed as dividends, provides additional U.S. governmental revenues and stimulates the U.S. economy. More importantly, the need for U.S. produced goods by our business operations abroad creates more U.S. jobs than would otherwise be the case. Inasmuch as more than 90% of the output of U.S. owned foreign operations is absorbed in foreign markets, which could not otherwise be competitively supplied by export sales from U.S. plants, the use of American products, et cetera, results in higher U.S. employment.

More domestic jobs are created in supporting foreign operations than are lost as a result of importing a small percentage (less than 10%) of the output of American plants abroad. We believe that the Tariff Commission Report of January 1973 to the Senate Finance Committee fully supports this thesis. In any event, recent developments in the Third World will require greater local production and it is obviously in our national interest that U.S. business share in this growth.

Repeal of tax credit not answer to import problem

It is recognized that low priced imports have created problems in certain industries and require immediate attention. Although the magnitude of such problems may be quite severe in localized areas, corrective action should be aimed at these localized problems (as was done in the Trade Act of 1974) rather than taking the form of repealing existing income tax provisions that have broad, sweeping application. It would be particularly tragic in that these proposals might well increase the severity of the existing problems at the expense of abandoning fair and reasonable principles in usage over the past 50 years. The Council believes the overall net result would be to worsen our economic ills by increasing unemployment, lowering productivity, continuing the inflationary spiral and forcing U.S. withdrawal from foreign markets.

ACCELERATION OF TAXATION OF UNDISTRIBUTED INCOME OF FOREIGN SUBSIDIARIES

Unfortunately, there is a large body of opinion in legislative and economic circles today that undistributed income earned abroad by U.S. controlled foreign subsidiaries should be taxed to the U.S. shareholder as earned rather than, as under the current rules, when distributed (except for the existing Subpart F provisions which currently tax to U.S. shareholders certain categories of so-called tax haven income as earned by a controlled foreign subsidiary).

The arguments in favor of this proposition erroneously refer to the current law as granting a "deferral privilege" with respect to such income. We submit that there is no such thing as a deferral "privilege:" that under internationally accepted tax principles income earned by a separate juridicial entity is not taxed to its shareholders until received by them. This has also been a basic underlying tenet of the U.S. tax system since inception and is reflected in the treatment of domestic shareholders of domestic corporations. As has been noted by a leading authority in the economics of taxation, "the phrase 'deferral of tax' as used in this connection is as unjustified as it would be to criticize the estate tax because it 'defers' the tax until death."

A controlled foreign subsidiary of a U.S. corporation is legally a separate juridicial person, created under laws of another sovereign nation. Such a subsidiary is required to conform to the rules and regulations (including taxation) of the country under whose laws it was created as well as those countries in which it conducts its business activities. It has no responsibilities or obligations, taxwise or otherwise, under the laws of the United States or any of the several states, unless it is doing business within the U.S. wherein its obligations are clearly spelled out in existing federal and state legislation. In this connection, it is the foreign country in which the subsidiary is domiciled and/or operating, not the U.S., which provides the basic governmental services expected by the citizenry

(including juridicial persons) of any sovereign state. Although the U.S. parent corporation of a controlled foreign corporation has many obligations under our rules of law and our customs, such obligations arise by reason of its separate existence as a U.S. corpration.

This distinction between the legal entities is obscured by those arguing against deferral and its recognition serves to explode the myth of a deferral privilege. In its true perspective, any legislation which ended deferral on foreign subsidiaries' earnings would not be eliminating a privilege but rather imposing a penalty.

Other countries of the world recognize and abide by the concept of separation of corporations and their shareholders. To the best of our knowledge, no country has ever instituted a policy which subjects to tax its resident taxpayers on the earnings of controlled foreign subsidiaries. In fact, as previously discussed, a number of countries have adopted territorial tax systems under which earnings of foreign subsidiaries are never subjected to home country taxation in recognition of the principle that a host country should have the first and primary right to tax income earned within its boundaries.

The extension of U.S. taxing jurisdiction as advocated to foreign income of foreign corporations may well invite some form of retaliatory action by other foreign countries. For one thing, such unilateral action on the part of the U.S. would serve to run counter to the philosophy embodied in our network of double taxation treaties. What shape such retaliatory acts may take is speculative at best, but the seeds therefor will be sown if the U.S. proceeds to legislate in this direction.

As has been noted in the introductory portion of this submission, any punitive legislation enacted by the Congress which imposed significantly higher tax burdens on foreign income of U.S. corporations would only serve to increase the competitive edge of international corporations of other nations vis-a-vis our own. The application of a concept which breaches the corporate veil of controlled foreign subsidiaries, in conjunction with other of the provisions advocated, could have such a deleterious effect on U.S. owned foreign business to lead to a complete retrenchment therefrom, with the ultimate effect of inviting foreign owned business to compete directly with U.S. business in the U.S. marketplace. To the extent any abuses exist, current legislation (Section 482, etc.) is sufficient to deal with the matter.

It should be noted that the ending of deferral would generate little overall additional tax revenue to the U.S. Government by reason of the combined effect of corporate tax rates in other countries comparable to ours and withholding taxes. Moreover, in countries offering lower tax rates and/or other tax incentives where potential U.S. revenue might arise in specific situations in the absence of deferral, it seems clear that these countries would deny the benefit of these tax incentives to subsidiaries of U.S. corporations in order to capture the tax that would otherwise flow into the U.S. Treasury. In fact, this position has been considered by the U.N. Ad Hoc Committee of Experts as a solution to the problem of otherwise improperly shifting revenues to the capital exporting country from the host country.

If, as a result of the end of deferral and the lack of legislative action by host country governments, the U.S. tax obligation of a U.S. corporation were to increase, one of two adverse effects is likely. First, the U.S. corporation might decide to apply its own domestic cash resources to the satisfaction of the additional tax liability so created, with the obvious result of diminishing the U.S. corporation's funds available for domestic investment. Out of this might ensue a reduction in employment opportunities for U.S. workers. Alternatively, the U.S. corporation might decide to draw on the cash resources of the foreign subsidiary whose income is giving rise to the additional tax liability, with the result of diverting funds from the foreign subsidiary so as to impair its ability to compete locally. This could result in a decreased demand by the foreign subsidiary for U.S. produced components and parts with an adverse impact on the U.S. job market.

Other Matters

There are special provisions in the U.S. Code which appear to conflict with the basic concept of neutrality in the taxation of foreign income. These provisions were adopted to establish incentives, or neutralize foreign incentives, considered desirable as national policy objects at that time. With the current world economic situation, we do not believe that it is desirable at this time for the U.S.

to take unilateral action, as proposed in H.R. 10612, to eliminate or reduce the benefits from these special provisions.

(1) Domestic international sales corporations (DISC) and Western Hemisphere trade corporations (WHTC)

On the assumption that the encouragement of exports is a desirable policy goal for the U.S., as mentioned above, we do not believe that it is appropriate at this time to take unilateral action either to repeal or further to restrict the DISC and WHTC provisions, and accordingly, we strongly urge that these provisions be at the very least retained in their present form.

With particular respect to DISC, we believe that data available thus far indicates that these provisions have had a favorable impact on U.S. exports, although the precise magnitude is difficult to measure because of other nontax factors which contribute to the growth in export activity. Furthermore, the argument that the DISC incentive is too costly in direct revenue loss to the U.S. Treasury fails to take into account the secondary revenue effect attributable to the U.S. tax paid on the increase in corporate and personal incomes generated through increased export activities, including the manufacturing for export. It should further be noted that the use of an incremental approach, as embodied in H.R. 10612, would serve to penalize those taxpayers who were substantial exporters during whatever base period is selected.

(2) Earned income exclusion

We recommend retention of the Section 911 earned income exclusion and therefore do not endorse the House bill provision which repeals Section 911 on a phase-out basis. If it is still in the interest of the U.S. to encourage its citizens to go abroad to promote U.S. business (which we believe it is), then the tax law should recognize the extraordinary costs and expenses (including taxes) of a U.S. citizen working and/or residing abroad.

Other provisions contained in H.R. 10612 propose constructive changes which the U.S. Council has in the past advocated.

(1) Possessions corporations

In concept, we endorse the special provisions of the Code which exempt U.S. corporations from U.S. tax with respect to income generated from business activities in the U.S. possessions and Puerto Rico. Code Section 931 has done an adequate job in this regard; but it has demonstrated a glaring weakness in its perhaps unintended penalty against repatriation to the U.S. of possessions earnings in excess of those needed for reinvestment. We believe that new Section 936, as embodied in H.R. 10612, remedies this deficiency and therefore receives our strong endorsement.

(2) Advance ruling requirement

We endorse the provision of H.R. 10612 which substantially liberalized the existing Section 367 advance ruling requirement. This has long been a top priority amendment advocated by the U.S. Council and, as the provision is a step in the needed overhaul of Section 367, should be enacted as soon as possible.

(3) Investment in U.S. property

We are substantially in agreement with the provision of H.R. 10612 which restricts the application of Section 956 on taxation of U.S. shareholders of controlled foreign corporations investing in U.S. property. The concept behind Section 956 has long served no useful policy purpose (in fact, it has been detrimental to the U.S. balance of payment position), and has merely functioned as a trap for the unwary. We would suggest that the House provision be further restricted to treat *only* investments in U.S. property, thereby eliminating from its ambit leases with related parties.

Senator RIBICOFF. The next witness will be Mr. Horne, and if you will be patient, we will be back within 5 minutes.

Senator DOLE. I would be willing to stay and he can start.

Senator RIBICOFF. All right, Mr. Horne, will you come and testify then and Senator Dole will stay.

Senator DOLE. This is one of the few times Republicans have the majority. You may proceed.

STATEMENT OF WILLIAM M. HORNE, JR., CHAIRMAN, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION; ACCOMPANIED BY THOMAS A. MELFE, CHAIRMAN, TAXATION COMMITTEE OF THE TRUST DIVISION, AMERICAN BANKERS ASSOCIATION

Mr. HORNE. Thank you, Senator. I am William Horne, Chairman of the Taxation Committee of the American Bankers Association and I have with me Mr. Thomas Melfe, who is Chairman of the Taxation Committee of the Trust Division of the American Bankers Association. I will speak on the general provisions affecting banks and Mr. Melfe will testify as to estate and trust provisions.

We appreciate this opportunity to appear before you today and we will try to contain our testimony to the highlights of the statement which we have submitted for the record.

Senator DOLE. Your entire statement will be made a part of the record. You may summarize, there is a time limit imposed and the bell will ring.

Mr. HORNE. We would like to discuss first the proposal for a taxable State or municipal bond, the option provision which has been proposed in the House. We think that that legislation could be effectively combined with the bill before you. This proposal has been supported by the administration and has been studied by the Treasury Department for a number of years.

We think it is an idea whose time has come. It would provide more effective assistance to the hard-pressed State and local governments in their public borrowing. We would support the optional taxable municipal and State bond proposal and hope that it can be considered by your committee.

Our second proposal would be a permanent exemption for withholding for interest on foreign-owned deposits in U.S. banks. This is a provision which now is contained in section 1041 of the House bill. This exemption was a permanent exemption from 1921 to 1966. In 1966 the exemption was made temporary and Congress has extended the temporary exemption from 1966 through the end of this year. We think it is time to make that exemption permanent and the House bill so provides. But I would like to emphasize the necessity for early action on this proposal.

The foreign-owned deposits in U.S. banks amount to, in the aggregate, about $7 billion. These are short-term deposits for periods of 3, 6, and up to a maximum of 12 months. There is a potential loss of existing deposits unless Congress acts relatively quickly.

We would hope that this action could be taken by the committee at an early date.

Senator DOLE. Your statement indicates that the exemption expires on December 31?

Mr. HORNE. December 31 of this year, yes.

Senator DOLE. Yes.

Mr. HORNE. We believe that passage of the permanent exemption provides no loss of revenue to the Treasury Department, as included in the House bill, and in fact if Congress does not take action it could have a serious impact on capital flows into the country with a corresponding ripple effect on the economy.

Another item we would like to affirmatively support in the House bill is section 1211 dealing with administrative summons by the IRS for bank records and the John Doe summons provisions.

While the IRS must not be impeded in its taxpayer investigations, we also know that there is a potential for abuse if legal restraints are not placed on overzealous or arbitrary IRS actions.

We believe the House bill represents a proper resolution of the conflict between the IRS need to investigate and the individual's right to privacy for his financial records.

The John Doe provisions in the House bill might be strengthened by requiring the Federal Court to review both the John Doe summons as to its relevancy and whether it adequately protects the rights of innocent taxpayers.

There is another provision in the House bill that the American Bankers Association feels should be carefully looked at by your committee and rejected. This is section 206 of the House bill which provides a limitation on deductions for nonbusiness interest. This provision would impose a $12,000 limitation on personal interest expense and would further limit the deductibility of investment interest expenses. This is a true sleeper in the House bill. It could have a substantial impact on the housing market and on the financing of small businesses.

On the foreign income provisions of the House bill, we would have little to add because they have been widely discussed by other witnesses before your committee. We would simply like to emphasize the ABA position that no changes would be made affecting foreign income. We would therefore oppose any changes which would penalize foreign investment because our experience has shown that these investments result in large inflows to the U.S. economy and have a beneficial effect on domestic employment.

One final provision we would like to address your committee's attention to, specifically, is section 1011 of the House bill dealing with taxation of Americans working abroad. We oppose the provisions which would repeal the present $20,000 to $25,000 earned income exclusion which U.S. citizens earn abroad.

Along with this proposed repeal, the House bill would grant a $20,000 exclusion to U.S. citizens working abroad for a charitable organization.

Also, under section 912 of present law, the U.S. Government, officers and employees can exclude a special living allowance which they get for overseas assignments. But under the House bill, a U.S. citizen working for a U.S. private company overseas would get neither the $20,000 exclusion allowed to employees of certain exempt organizations, nor the exclusionary overseas living allowance granted by U.S. Government employees. This appears to be a totally unwarranted discrimination and apparently a bias against the free enterprise system. We hope your committee will correct this inequity.

This concludes my remarks on the general provisions and Mr. Melfe will comment on estates and trusts.

Senator DOLE. I would say that the other members would be returning. Mr. Melfe can go ahead and summarize whatever he wishes to do.

I assume they will ask questions of each of the witnesses at that time. If I should have to leave, someone will be back in a few minutes.

Mr. HORNE. Thank you.

Mr. MELFE. Thank you, Senator. I am Thomas A. Melfe, chairman of the taxation committee of the trust division of the American Bankers Association which represents 4,000 banks with trust departments.

I am also executive vice president of the U.S. Trust Company of New York. I would like to spend a few minutes on these provision of H.R. 10612 which relate to trusts and estates. We have prepared a written statement and with your permission we would like to have it included as part of the record of these proceedings.

Senator DOLE. The entire statement will be made a part of the record.

Mr. MELFE. Mr. Chairman, there are a number of provisions in H.R. 10612 which are applicable to trusts but which create an inappropriate and serious result because of the unique tax structure of trusts. In the case of a typical trust which distributes all of its income currently, the trust is given a distribution deduction for amounts that are distributed to beneficiaries and the beneficiaries include those amounts in their gross income. Also an estate or trust may have a deduction for income paid or permanently set aside for a charity, and there is a special deduction under section 691 of the code to mitigate against double taxation when income is subjected to both State and income taxes.

I would like to briefly discuss provisions of H.R. 10612 which create problems——

Senator DOLE. Excuse me, are you reading from a summary attached to your statement?

Mr. MELFE. No.

The first is 301, the minimum tax. This was enacted in 1969 and applies to estates and trusts as well as to individuals. There have been proposals for change in the structure of this minimum tax. We feel that regardless of its ultimate form the minimum tax should allow to estates and trusts these unique deductions to which I referred so as to avoid double taxation and to be consistent with the conduit theory of estates and trusts under current law.

The bill does not do so and therefore it would lead to incorrect and unwarranted results.

For example, the excess itemized deduction provisions of H.R. 10612 would have 70 percent of those deductions, in excess of 70 percent of the taxpayer's adjusted gross income, considered as a tax preference and, in the case of a trust and estate, the bill does not exclude the distributions and other deductions that I referred to, with the result that a minimum tax can be imposed on an estate or a trust which has distributed its entire income to the beneficiary.

Also, the bill imposes a $12,000 limitation on the amount of personal interest which is deductible from gross income but it specifically provides that a trust shall have no deduction for such personal interest. We fail to see why a trust or an estate should be denied such a deduction.

Section 701 of H.R. 10612 relates to the throwback rule as applied to accumulation trusts. This rule has the effect of taxing to a beneficiary any accumulations that are paid to him in the manner that such income would be taxed to him if he had received it in the year that it was received by the trust.

Present law provides that a beneficiary receiving a throwback has the right to compute his tax under an exact method or a shortcut method. H.R. 10612 eliminates the exact method. We fail to understand the reasons for this and believe the options should be retained.

Section 701 of the bill would also eliminate a beneficiary's right, which he has under current law, to a tax refund to which he may become entitled under either the exact method or the shortcut method of computing the throwback income subject to taxation. We see no justification for the elimination of the tax refund benefit available under current law.

The bill also repeals a throwback treatment of capital gains. We agree with this because the present law is unduly complicated and virtually unworkable. However, elimination of the capital gain throwback has been coupled with a new section proposed, section 644, which treats as a short-term capital gain all unrealized appreciation of property transferred to a trust if a sale is made within 2 years after the transfer to the trust. This provision does not apply to outright gifts and we fail to see the reason for penalizing trusts in this regard and not outright transfers.

For that reason we believe section 644 should be eliminated as discriminatory and unnecessary.

Mr. Chairman, the ABA greatly appreciates this opportunity to present these views to you and your committee.

Senator RIBICOFF (presiding). Mr. Horne, you say you represent some 14,000 commercial banks in America?

Mr. HORNE. That is correct.

Senator RIBICOFF. How many commercial banks are there?

Mr. HORNE. I do not know the exact figures but I can supply it for the record. That is about the extent of most of the commercial banks in the United States.

Senator RIBICOFF. In other words, you represent the overall majority.

Mr. HORNE. 94 percent.

[The following information was subsequently supplied by Mr. Horne:]

There are 14,572 commercial banks, of which ABA represents 94 percent.

Senator RIBICOFF. You know the major role in the Arab boycott is being played by the banks of this country. When someone wants to do business with an Arab customer he needs a letter of credit from a bank, they are frequently refused a letter unless they participate in the boycott.

Now, some banks engage in this and some banks do not. Do you think that there should be a different treatment of banks from the tax standpoint that engage in the boycott and those that do not engage in the boycott?

Mr. HORNE. Mr. Chairman, would you permit me to make a personal reply to your question rather than representing the ABA on this

one because I really have no authority to speak for the ABA and its members on this point.

I would like to make a personal comment.

I have long admired your distinguished service in the Senate and particularly on the Senate Finance Committee. I find I usually agree with the position you take, but I do think in this case that the proposal to deny a foreign tax credit for U.S. companies that do support the boycott is not a good provision of the tax law. I say that for this reason; I think it is really too bad that in the status of our position as a country in the world today, that we cannot resolve issues such as the boycott between two countries in a way other than by applying penalties to our own citizens in hopes they will be able to put pressure on that way to get sovereign countries to change their position.

I think that for this reason—expressing only a personal view—I really believe that that type of legislation is not in the best interests of the country.

Senator RIBICOFF. We are not talking about business in other countries, we are talking about 3,000 American companies boycotting some 2,000 American companies, and not doing business or employment with people. I am very intrigued that around this room all you gentlemen who represent in one way or another the major business and banking companies of America are afraid to face up to this issue.

Many American companies are facing up to the issue because they are saying "No."

I do not know that any of them are going bankrupt or doing so badly. But if an American bank. an American company is going to take dictation from another country as to how and who they do business with I think we have fallen on very, very sad times on American ethics and of American business practices.

If you have bank A that will refuse to play along and bank B that does play along, bank B gets the business. Bank A is being hurt.

Now, if we have corporations who will not go along with the boycott and corporations that will, then the corporations that conform with American business principles and practices and philosophy and policy loses business and the other one gains business.

Why should we as a people give a benefit for a bank or a corporation that is going contrary to American practice and policy.

All I can tell you, gentlemen, you are going to face this question. We are going to vote on it in the Finance Committee and we are going to vote on it on the floor of the U.S. Senate.

And we are not going to duck it or avoid it. But what intrigues me is that none of you will face up to a basic policy. You say, "Let us not use the tax laws."

You are asking us to use the tax laws with every line in your testimony to establish a policy that is social, economic, or political, but yet you say do not use the tax laws for this policy.

I have no further questions.

I do not know if any of my colleagues are coming back to ask you questions.

Would you please, until the other members return, Mr. Horne, be willing to step aside to see if any of the others may have questions when they return from the vote.

Mr. HORNE. Certainly.

[The prepared statement of Messrs. Horne and Melfe follow. Oral testimony continues on p. 969.]

STATEMENT OF WILLIAM M. HORNE, JR., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

SUMMARY

I. The taxable municipal bond option

We support proposals to permit state and local governmental units, at their option, to issue Federally taxable obligations with a Federal subsidy of the taxable interest cost to the state or municipal issuer. The taxable option would:

(1) Broaden the market for state and local bonds,

(2) Stabilize that market during periods of monetary stringency,

(3) Provide more efficient assistance to state and local governments.

II. Permanent exemption from withholding for interest on foreign-owned deposits in U.S. banks

We support the permanent exemption from withholding for interest on bank deposits on non-resident aliens, not related to a trade or business, as provided by the House bill. U.S. banks hold approximately $7.0 billion in interest-bearing non-negotiable deposits. A continuation of the exemption, which expires on December 31 of this year, is essential for the following reasons in order to:

(1) Prevent the outflow of foreign-owned time and savings deposits, and related demand deposits.

(2) Avoid serious adverse effects on the U.S. economy, including an immediate dollar-for-dollar reduction in bank reserves with resulting distortions in the banking system.

A permanent exemption is necessary in order to remove continuing uncertainties in U.S. tax policy for attracting foreign funds for U.S. investment through the bank deposit mechanism.

III. Limitations on IRS Administrative Summonses For Bank Customer Records

(1) IRS Administrative Summons Generally: (*a*) We support the llimitations in the House bill on the authority of the IRS to issue administrative summons for taxpayer records held by banks and other third-party recordholders, viz: (i) The summons should suffiicently identify taxpayer's financial records, (ii) The IRS should be required to notify the taxpayer of the pending summons for his financial records, (iii) The taxpayer should be permitted to object to the summons and to stay compliance before the records are turned over to the IRS. (iv) The taxpayer should be given 14-days in which to notify the recordholder and the IRS not to comply with the summons, (v) In an IRS court proceeding to enforce the administrative summons, the taxpayer should be given the statutory right to intervene in order to assert his legal rights prior to enforcement.

(2) John Doe Summons. We support the provisions to limit the issuance of John Doe or "no-name" administrative summonses for taxpayer financial records in order to protect the rights to financial privacy of individuals who are not under tax investigation, with the following additional recommendations:

(*a*) Prior to the issuance of a John Doe summons, a Federal court should review the extent of the summons request in order to determine its relevancy to the tax investigation at hand, and,

(*b*) The Federal court should review the records obtained under the summons before they are submitted to the Internal Revenue Service in order to protect the rights of innocent taxpayers whose records are reviewed under the John Doe procedure.

IV. Limitation on deductions for nonbusiness interests expense

We oppose the proposed amendments to Section 163(d) which would provide substantial limitations on deductions for interest in nonbusiness indebtedness. These amendments would not achieve their intended objectives because: (1) They may permanently disallow the personal interest deduction for borrowers, and, (2) They would adversely affect the investment interest deduction for borrowings to finance vital sectors of the U.S. economy, particularly for financing of small businesses.

V. Foreign income

We oppose those provisions of the House bill which would tend to upset the existing neutrality of our tax laws regarding foreign income. We would oppose any changes in the tax structure which tend to penalize foreign investment because such proposals would: (1) discourage competition by American business in the international market place, (2) burden American shareholders with tax costs, adversely affecting their cash position and ability to make current investments, and (3) impose tremendous administrative burdens on taxpayers with foreign income.

VI. Taxation of Americans working abroad

We oppose the proposed amendment under Section 911 to end the limited exclusion of a part of income earned by Americans working in foreign countries. The termination of this exclusion would increase the high cost of employing U.S. personnel overseas, creating a detriment to effective international competition by American businesses.

STATEMENT

I am William M. Horne, Jr., Chairman of the Taxation Committee of the American Bankers Association. I wish to express my appreciation for this opportunity to testify on behalf of the American Bankers Association before the Committee on Finance on the subject of tax reform. The American Bankers Association is a national organization which represents approximately 14,000 commercial banks. My oral testimony before this Committee will cover the following topics of tax reform which are being considered in these hearings: (1) The Taxable Municipal Option, (2) The Permanent Exemption From Withholding For Interest On Foreign-Owned Deposits in U.S. Banks, (3) Limitation on IRS Administrative Summons for Bank Customer Records, (4) Limitation on Deductions For Non-Business Interest Expense, (5) Foreign Income, and (6) Taxation of Americans Working Abroad.

THE TAXABLE MUNICIPAL BOND OPTION

The American Bankers Association takes this opportunity to stress its support for the principles underlying proposals to permit state and local government units, at their option, to issue federally taxable obligations as contained, for example, in H.R. 11214 introduced by Congressman Reuss. The bill would require the Secretary of HUD to subsidize 40 percent of the taxable interest cost to the municipal issuer. Under necessary regulations to be determined by the Secretary, the subsidy payments would be automatic.

H.R. 11214 and other similar bills in the past have been designed to broaden the market for state and local bonds, to stabilize that market during periods of monetary stringency, and to provide more efficient assistance to state and local governments.

The American Bankers Association believes that with an appropriate subsidy percentage, the taxable option would expand the market for municipal bonds to include certain tax-exempt or lightly taxed institutions and other taxpayers that cannot now advantageously buy tax-exempt bonds. Broadening of the investor base would diminish the rate of volatility for all municipal borrowing, which is a large factor of uncertainty in the present municipal market environment.

It is likely that the taxable bond option would be used in the longer-term area because tax-exempt municipal yields rise relative to taxable yields, as the term to maturity increases. The taxable option would provide state and local issuers with needed flexibility to take advantage of lower tax-exempt yields in the shorter maturities and lessened after-subsidy costs in the longer maturity areas. A smaller supply of tax-exempt bonds may also tend to reduce costs.

Free market forces would continue to determine borrowing rates based on quality. Experienced intermediaries now handling the distribution of municipal bonds would continue to underwrite and distribute both taxable and tax-exempt bonds.

As for the government, a simple subsidy approach would not be difficult to administer, thus eliminating the need for a large new bureaucracy. Moreover, subsidized taxable municipal bonds may be a more efficient way of providing help to hard-pressed municipalities than the issuance of tax-exempt bonds. Much of the subsidy cost would be offset by taxes on the total interest paid on taxable bonds.

This is not to say that potential problems do not exist. The most important of these is the amount of the subsidy percentage. Too large a percentage would shift all—or most—municipal issuances into the taxable option. On the other hand, too small a percentage would be ignored by municipal issuers.

The American Bankers Association does not believe that the subsidy should be treated as a guarantee. Without constraints on excessive issuance, the entire taxable bond market would be weakened. It should be made clear that the subsidy would terminate with default.

The exact percentage of subsidy may require some change for optimum results over time. However, any change in the percentage should remain within the power of Congress. The testimony should guard against any limitation by an executive department on the amount municipalities may issue subject to subsidy during a given period. Otherwise, requirement of issuance approval could lead to charges of political maneuvering.

Uuon introducing H.R. 11241, Congressman Reuss stated: "With a 40 percent subsidy it is estimated about 16 percent of tax-exempt bonds would be replaced by taxable bonds."

The American Bankers Association cannot take issue wtih that estimate because no recent data are available for an adequate appraisal. However, recent studies have shown that 58½ percent of municipal obligations were more than ten years to maturity and 42 percent had maturities over fifteen years. Coupled with data on the widened yield spreads since mid-1974 between Aaa and Baa municipal bonds and on the increased ratios of municipal to corporate yields, we believe that perhaps 25 percent or more of municipal bonds would be offered in taxable form. If that estimate is correct, some $7½ billion of the $30½ billion of municipal bonds offered in 1975 would have been issued as taxables.

Conceivably, the amount could be substantially greater than 25 percent. Accordingly, it might be well to consider whether the initial subsidy percentage should be set at some lower rate, say the 33⅓ percent originally proposed by Senator Proxmire in 1972. If that percentage proves to be too low after a trial period of perhaps two years, a legislative change should be made based on the experience that would then be available. However, any change should be legislated rather than be determined administratively.

The legislation should also ensure the avoidance of self dealing as in the case of a municipality borrowing from its own pension funds. In general, a market test should be required. For example, dealings between a state financing bank and the municipalities to which it lends should be monitored. There also should be rules to avoid arbitrage wherein a municipality could borrow on a taxable basis and then buy a Treasury or Federal Agency issue and pocket the subsidy. The arbitrage provisions of the Internal Revenue Code now apply only to tax-exempts.

One final point. The American Bankers Association would like to underscore the concern expressed by some that the issuance of optional taxable municipals might be the first step toward complete elimination of the tax-exempt status for municipalities. We would urge that the Congress reaffirm that this is not its intent. Further, it should be made explicit that the agency charged with the administration of the program should not seek to bring about this result through its regulatory policies.

Permanent Exemption from Withholding for Interests on Foreign-Owned Deposits in U.S. Banks

Under Section 861(c) of the Internal Revenue Code, interest on bank deposits of nonresident aliens, unrelated to a trade or business in the U.S., is exempt from the 30 percent withholding tax. The exemption expires on December 31, 1976, unless legislation is enacted to extend it. Under Section 1041 of H.R. 10612, the exemption would be made permanent. The American Bankers Association strongly urges the Senate to adopt this provision.

Historically, the interest on these foreign-owned deposits has been exempt from U.S. tax for more than half a century. For 45 years (1921 to 1966) the exemption was permanent. Beginning in 1966, the Congress made the exemption temporary by imposing a definite termination date at the time of each extension. Since 1966, the Congress has reviewed the exemption several times, and after careful consideration of the impact of permitting it to expire, has renewed the exemption.

A prolonged delay in the enactment of the legislation allowing the exemption to continue would result in a rapid outflow of foreign-owned deposits from the banking system. An outflow of time and savings deposits would also be accompanied by the loss of demand deposits owned by the same individuals. The total of interest-bearing, non-negotiable deposits of banks has grown rapidly during the past two years. From December 1973 to December 1975, these funds increased from $2.9 billion to more than $7.0 billion.

Failure to enact legislation on the bank deposit exemption would have a serious effect on the U.S. economy. With the approach of the expiration date most, if not all, of these deposits would be drained from our banking system to find refuge in other strong currency countries that permanently exempt interest earned by foreigners from withholding or other taxes.

Repatriation or transfer to other countries of a significant part of the funds now on deposit in U.S. banks would have a strong adverse impact on our foreign exchange position and balance of payments.

Withdrawals of these deposits from the banking system would result in an immediate dollar-for-dollar reduction in bank reserves. While the reserve loss could be replaced through Federal Reserve open market operations or reduction in reserve requirements, distortions within the banking system would arise. The distribution of the replacement reserves throughout the country would inevitably be quite different from the distribution of the deposits withdrawn. This development would require inter-bank transfers of funds through the money market with an unwarranted impact on money market interest rates. Reserves lost which would not be fully replaced by the Federal Reserve, or frictions involved in the inter-regional movements of maldistributed replacement reserves could have a multiplied drag effect on the economy. Loans that would otherwise be made would not be made. The potential incomes and taxes such loans would have generated, would be lost.

Advocates of tax withholding, particularly on deposit interest, must certainly be aware that such deposits represent liquid funds that can readily flow from country to country seeking the highest rates of return after tax. Since the bulk of this money would undoubtedly be moved out of the country with the imposition of withholding, the tax gain would be negligible in comparison with the adverse effects generated.

In the annex to his statement before the Subcommittee on International Finance and Resources of the Senate Finance Committee on March 1, 1976, Assistant Secretary of the Treasury Charles M. Walker listed 9 Western European Countries plus Canada, Australia and Japan that wholly or largely exempt interest on foreign held deposits from withholding or other taxes.

Appearing before the Senate Finance Committee on major tax revisions, Secretary of the Treasury William E. Simon made the following statement about witholding taxes on foreign long-term (nondeposit) investment in this country: "Increased investment by foreigners in the United States is desirable any time. 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. The statutory elimination of withholding will greatly increase market efficiency for investments in the United States."

Secretary Simon and Assistant Secretary Walker were aware, of course, that the House had already passed the permanent exemption of bank deposit interest from withholding. They strongly requested the Senate and the House to also extend the exemption to long-term investments. Their recommendations as to the benefits to our economy of encouraging long-term capital to remain or flow to this country apply equally to foreign-owned bank deposits.

It should be pointed out that as has been the case since 1966, the need to return to Congress every other year to obtain an extension of the exemption from withholding for interest on these bank deposits has had a tendency to produce uncertainties among foreign owners of U.S. bank deposits as to whether these deposits should be renewed or even acquired in the first instance. A permanent exemption would remove this uncertainty in U.S. tax policy for attracting foreign investment through the bank deposit mechanism.

Accordingly, the American Bankers Association urges Senate approval of the permanent withholding exemption of interest on foreign-held bank deposits as provided by Section 1041 of H.R. 10612.

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Limitations on IRS Administrative Summons to Obtain Bank Customer Records

Section 1211 of the House bill would enact a new Section 7609 of the Internal Revenue Code which contains special procedures to be used in connection with administrative summons for third party financial books and records in taxpayer investigations. This new section limits the IRS' administrative summons authority under Section 7602.

The American Bankers Association strongly endorses these provisions of the House bill and takes this opportunity to recommend certain additional provisions which will safeguard the privacy of an individual's financial records in the possession of a bank or other third party recordholder.

The American Bankers Association and its member banks are greatly concerned about the basic concept of privacy or confidentiality of bank customer records. This problem was highlighted in the recent Supreme Court case, *U.S.* v. *Bisceglia*, which involved the issuance of a "John Doe" summons to examine the bank records of a large number of bank customers in order to identify an unknown individual who had made a deposit or cash exchange of old bills.

The Federal courts have held that records of an individual's financial transactions with a bank are entitled to the fundamental right of privacy guaranteed under the Constitution, and that such records may only be obtained by the Government through lawful process. *See U.S.* v. *Miller*, 500 F.2d 751 (1974). However, under existing judicial decisions, the concept of financial privacy does not in fact provide a bank customer with the right to challenge an IRS administrative summons to a bank for his financial records in connection with a Federal tax investigation. This is because a valid administrative summons is a "lawful process" under which the IRS may obtain an individual's banking records.

For a number of years, the American Bankers Association has received voluminous complaints from its member banks concerning problems that banks have encountered in responding to IRS summonses for customer records. Many of these summonses have involved apparent abuses or questionable practices by IRS field agents. Additionally, these IRS record requests, which have greatly increased in volume within the last decade, impose heavy financial burdens on banks.

One of the most frequent problems that banks encounter in responding to IRS summons for customer records is that the summons is overly broad, i.e., it requests "all records" of financial transactions of the named taxpayer over a period of years. In such cases, the summons does not designate specific records sought or sufficiently identify the types of banking transactions of the customer which are under investigation. A summons of this type imposes time-consuming and costly record identification and retrieval burdens on the bank, particularly in the case of a typical bank with a multiple branch system which does not maintain a centralized records system. More importantly, overly broad summonses may violate the concept of financial privacy.

From a public policy point of view, banks often object to the role in which they find themselves in tax investigations of their customers. Under existing law, the IRS is not required to notify the bank customer that an administrative summons for his financial records has been issued. Unless the bank notifies the customer of the receipt of the summons, the customer is probably unaware that his records are being examined by the IRS. Many banks have received strong complaints from their customers for responding to IRS summons. In a number of recent cases, banks have been sued in the Federal courts to enjoin this procedure.

Although banks recognize their duty under the law to provide the IRS with customer records under a valid administrative summons involving a civil tax investigation, banks frequently encounter circumstances in IRS investigations which cause them to question the validity of a summons and thereafter to challenge it in order to protect the customer's rights. For example, frequently the investigation is conducted by an IRS "special agent". The use of a special agent may indicate that a criminal investigation of the customer is underway. In some recent cases brought to the attention of the American Bankers Association, the special agent has acknowledged that the investigation is criminal in nature. Under existing case law, an administrative summons will not issue if the taxpayer is under a criminal investigation (or if there has been a recommendation for criminal prosecution). Obviously, there is a close dividing line between a civil investigation and a criminal investigation in many IRS taxpayer examinations.

However, banks are confronted with the dilemna of not wishing to act as conduits of information which will result in a criminal prosecution of a bank customer without the customer's right to challenge the authority of the IRS to obtain such records for this purpose.

An additional problem involves efforts of IRS agents to look at the records of customers who are not named in the summons. For example, this may occur when the IRS seeks to bring its own personnel onto the bank premises to examine customer records. It is to be emphasized that the majority of banks refuse to permit the IRS to use this procedure but instead use bank personnel to conduct the records search and retrieval. Moreover, the body of the administrative summons may request the records of other individuals who have had transactions with the named taxpayer under investigation. At issue, of course, in all of these situations—including the John Doe summons—is the privacy of the financial records of individuals who are not the named subjects of a tax investigation.

The American Bankers Association recommends the following changes in the Internal Revenue Code, most of which are contained in Section 1211 of H.R. 10612.

(1) The administrative summons should sufficiently identify the records of the taxpayer which are sought by the IRS to enable the third party recordholder to locate such records, and to protect the rights of other other individuals who are not under investigation.

(2) A taxpayer whose records are sought in a tax investigation through the issuance of an administrative summons—or any other person whose financial records are identified in the body of the administrative summons—should be notified by the IRS in person or by certified mail of the administrative summons prior to its issuance to the third party recordholder.

(3) The customer or other individual entitled to notice of the administrative summons should be advised in writing by the Internal Revenue Service of his right to stay compliance.

(4) The customer or other person entitled to notice should be given a period of 14 days in which to notify the person summoned (the third party recordholder) and the Internal Revenue Service not to comply with the summons.

(5) The bill should expressly provide that the financial institution or other third party recordholder may challenge an administrative summons on grounds currently available under Federal court decisions (e.g., the summons is defective on its face, the summons was improperly served, the summons has been issued in connection with a criminal investigation, the summons imposes an unreasonable burden upon the third party recordholder, etc.). H.R. 10612 is silent on the right of the third party recordholder to challenge an administrative summons.

(6) The customer or other person entitled to notice should be given the clear right to intervene in any proceeding by the IRS to enforce the administrative summons in the Federal courts. Both the right to stay compliance and the right to intervene in a Federal court proceeding should be set forth in terms which may be easily understood and under the simpliest possible methods for invoking these procedures.

(7) Section 1211 specifically provides that a John Doe or "no name" summons may be served only after a Federal court proceeding in which the Government establishes that there is "reasonable cause" to believe that a transaction has occurred which involves an unreported or incorrectly reported tax liability. Although this provides safeguards which go beyond those provided under the Supreme Court's decision in *U.S.* v. *Bisceglia,* we urge this Committee to consider two additional provisions involving John Doe summonses which are essential to protect the financial privacy of the records of individuals who are not under tax investigation, to wit:

(*a*) The court should review the John Doe summons in order to determine, in the first instance, the relevancy and materiality of the records sought to the tax investigation which is being made before the summons is served on the third party recordholder; and

(*b*) The court should review the records obtained from the third party recordholder before such records are submitted to the Internal Revenue Service in order to provide the maximum possible protection to the financial privacy of innocent bank customers whose records are reviewed under the John Doe summons procedure.

This additional review procedure would ensure that the rights of innocent bank customers would not be jeopardized by the John Doe summons procedure

and would lessen the opportunity of IRS agents to engage in "fishing expeditions".

We respectfully request that the following two items be entered into the Committee's Record in connection with the administrative summons issue:

(1) newspaper articles and editorials commenting on the United States Supreme Court's decision in *U.S.* v. *Bisceglia*,* and

(2) the American Bankers Association's publication entitled, "A Banker's Guide to IRS Procedures For Examinations of Customer Records and Levies on Customer Accounts",* issued to approximately 20,000 ABA member banks and member branches in 1974.

LIMITATION ON THE DEDUCTION FOR NON-BUSINESS INTEREST EXPENSE

The banking industry strongly opposes the proposed amendment to Section 163(d) of the Code (Section 206 of H.R. 10612), which would impose substantial limitations on deductions for interest on non-business indebtedness.

The Report of the Committee on Ways and Means sets forth two general reasons for the proposed change in Section 163(d):

(1) That interest on borrowings should not be deductible where the loan proceeds are spent for items of a luxury nature to provide a standard of living which is clearly out of the ordinary, i.e., the benefits of the personal interest deduction should go to the lower and middle-income taxpayers; and

(2) That a taxpayer should not be permitted to shelter or reduce income from the taxpayer's professional or other income-producing activities by incurring related deductions.

The objectives outlined by the House Committee in support of these amendments are of operationable volidity. In any case, the amendments go much too far. They can result in a permanent disallowance for the personal interest deduction and the spill-over effect could also result in permanent disallowance of investment interest deduction for borrowings to finance vital sectors of the Nation's economy.

As Secretary Simon noted in his testimony, due to the rapidly growing cost of housing and high current rates of interest, the deduction for interest on the home mortgage may be affected by the $12,000 personal interest limitation. As inflation continues to drive up the costs of housing, college education, medical care, automobiles and other non-luxury consumer goods, the aggregate personal interest expense of middle-income and even lower-income taxpayers to finance these non-luxury items will soon exceed the $12,000 allowance and will be lost to that extent.

In any event, personal interest expense will currently substantially absorb the $12,000 allowance available under the House bill to offset investment interest expense in excess of investment income and net capital gain. Therefore, the immediate and perhaps major impact of this provision will be on the investment interest deduction.

The current interest limitation in Section 163(d) does not affect a taxpayer unless he incurs investment interest expense of $25,000 in excess of investment income and capital gains, in which case only half of the excess interest is subject to current disallowance. It should be noted that many taxpayers in the higher economic brackets receive substantial amounts of investment income in the form of interest and dividends.

Therefore, the major impact of the current disallowance of excess for such diverse investment purposes as to purchase securities, acquire real property for future development, and to finance small business.

From the cited Committee Report, it is clear that the intent of the propsal is not to permanently disallow the excess investment interest deduction but rather to defer it to the time when investment income is received. However, as this provision is drafted, it does not ensure this result.

Under the provisions in Title I of this bill dealing with the limitatons on artificial losses, accelerated deductions to the extent tht they exceed related income are similarly subject to current disallowance and are placed in a deferred deduction account. These deferred deductions may be claimed in later years if net related income is produced. However, if LAL property is disposed of, any amount remaining in the deferred deduction account is allowed as a deduction in the year

* This document was received and made a part of the official files of the Committee.

of disposition. In cases of certin transfers, such as by gift or death, the transferee succeeds to the deferred deduction account.

Now, let us examine how Section 163(d) will operate. At best, the disallowed interest may be deferred until investment income or capital gains are received from the investment or until the taxpayer has investment income or capital gain from other investment property or a portion of the $12,000 allowance can be applied in subsequent years. However, if the taxpayer dies before any of these events occur, the deduction is lost forever.

If the investment property is sold at a loss or transferred in a non-taxable exchange, the disallowed interest may not be deducted in the year of disposition nor will the disallowed deductions be available to the transferee. In fact, if an investment results in a loss, the loss from the transaction may result in the disallowance of investment interest expense with respect to property which was disposed of at a gain. In this case, we are discussing true economic losses and not artificial losses. This inequity may be more clearly seen from the following example.

In 1977, a taxpayer has personal interest expense of $12,000. In addition, on January 1, the taxpayer incurs $50,000 indebtedness at 12 percent simple interest, which is used to purchase 100 shares of X Company for $25,000 and 100 shares of Y Company for $25,000. During 1977, the taxpayer received dividends of $2,000 from X Company. Under amended Section 163(d) the taxpayer would be allowed an interest expense deduction of $2,000 (equal to the amount of investment income from dividends) and the $4,000 disallowed investment interest expense would be carried over to succeeding years. The same facts apply in 1978, that is, $12,000 personal interest expense, $2,000 dividends received on X stock, and $6,000 investment interest expense paid on the $50,000 indebtedness. In December of 1978, the 100 shares of X Company are sold at a gain of $5,000 and the 100 shares of Y Company are sold at a loss of $5,000 with a resulting net gain of zero. In filing his 1978 return, the taxpayer would again have an allowable investment interest deduction of ony $2,000 (the amount of dividends received).

Therefore, in effect, not only has the taxpayer been denied the $6,000 investment interest deduction in 1977 and in 1978 on the $25,000 of indebtedness to acquire the 100 shares in Y Company, but he is denied a deduction for his full economic loss when the property is disposed of. Moreover, the taxpayer is allowed to claim an interest deduction for only $4,000 of total interest expense of $6,000 to acquire the shares of X Company which produced economic income of $9,000 ($4,000 dividends and $5,000 gains) because of the netting of the loss on the Y Company stock. The total disallowed deduction of $8,000 for this closed transaction will be deferred for an indefinite period until the taxpayer receives investment income or gain from unrelated investments. If he dies, the deduction will never be allowed.

Due to the operation of Section 163(d), the effective tax rate on capital gains for some taxpayers is increased, but not for others. If a taxpayer may claim an investment interest deduction because he has net capital gains in the year, the amount of gain equal to the allowed investment interest deduction is treated as ordinary income. Assume the taxpayer in the above example in 1979 has $12,000 of personal interest expense and sells 300 shares of stock of Z Company which he had acquired in 1974, at a gain of $8,000. If the taxpayer is in the 50 percent bracket in 1979 (after claiming the $8,000 interest disallowance in 1977 and 1978), the entire amount of unrelated capital gain will be treated as ordinary income resulting in a tax of $4,000 upon the gain. If the same taxpayer had $8,000 investment income in 1979 to offset the $8,000 carryover, he would pay a maximum regular tax of $2,000 on the gain. In this case, the taxpayer might also incure a minimum tax on one-half of the gain.

The minimum tax under H.R. 10612 on this item of tax preference, reflecting the increased rate and after deducting half the tax paid on the gain, would be $420, or a total tax of $2,420 on the same gain. In other words, the taxpayer in the above example would pay $1,580 more tax on the unrelated capital gain because of the operation of Section 163(d).

A broad, legitimate inquiry may be made by Congress as to the extent to which ordinary deductions should be allowed in respect to items which qualify for capital gains treatment or into the equity behind capital gains preferences. However, Congress should not pursue this goal by piecemeal measures such as amended Section 163(d) which has an uneven and inequitable approach to different taxpayers.

The above examples involve investment securities. The proposed amendment may also seriously affect the financing of small business. The Ways and Means Committee Report cites the example of the taxpayer who uses the proceeds of a mortgage on his home for his trade or business. If the business of the taxpayer in that example were incorporated, as is frequently the case, the proceeds of the loan would either be directly invested as additional capital or loaned to the corporation. Under existing case law, the loan to the taxpayer would probably not be considered indebtedness to purchase or carry on a trade or business or property held for use in a trade or business unless the taxpayer can establish that his dominant motivation in making a loan of the proceeds to his corporation was to keep his employee status or that the loan was approximately related to maintaining his trade or business as an employee.

The interest disallowance rules would also apply to investors who borrow to provide venture capital to small business. An individual who is not in the trade or business of lending money or of financing a particular type of business would not be allowed the interest deduction on the indebtedness he incurred unless the investment produces immediate income or gain—which is extremely unlikely during the development period—or he has sufficient investment income or gain from other sources. Moreover, such investments involve a high degree of risk so that no income or gain may be realized from the transaction and the capital loss may have the effect of postponing the deduction of other investment interest. Therefore, Section 163(d) may seriously inhibit or increase the cost of financing small business.

Further, amended Section 163(d) would create an administrative nightmare as different taxpayers attempt to allocate interest expense between exempt and taxable investments and to trace the use of borrowed funds among personal, investment, and business purposes. Elaborate recordkeeping will be necessary to keep records of any carryovers and to apply the two sets of transitional rules. The integration of this provision with the LAL provisions adds further complexity.

Finally, it should be pointed out that the Section 163(d) rules may penalize married taxpayers, deter refinancing of pre-existing indebtedness or the sale of property secured by such indebtedness, and cause taxpayers to attempt to structure loans in artificial or an uneconomic manner to avoid the presumption as to personal interest indebtedness.

Therefore, the American Bankers Association opposes this amendment to Section 163(d) and urges the Senate Finance Committee to delete Section 206 of H.R. 10612.

Foreign Income

The American Bankers Association is very concerned about certain proposals to change the rules on taxation of American business on income earned abroad because of the serious impact these changes would have on the competitive strength of the American economy in the world marketplace.

The American economy operates in a world environment. It must, together with all of the American people, succeed or fail in the world marketplace. Trade barriers, including proposals designed to discourage Americans from competing successfully outside the United States, will with certainty weaken the ability of the American economy to maintain and create jobs and provide adequate incomes for Americans. Many proposals now being supported as a means of protecting domestic jobs will have the opposite effect. The only effective means to protect American jobs is to enable the American economy to meet competitive challenges in the world on equal terms with others.

The present rules on taxation of income from foreign sources contained in the Internal Revenue Code were not enacted in order to encourage activities abroad. They had as their principal purpose to implement U.S. tax policies in a neutral way, recognizing simultaneously our claim to tax worldwide income of American citizens and corporations and the right of foreign countries to tax that part of such income which is earned within their boundaries.

Certain proposals start from the premise that because U.S. shareholders are assessed U.S. tax on dividends from foreign corporations when dividends are paid to them, rather than earlier when the corporation records profits potentially belonging at some future date to the shareholders, there exists a deferral of U.S. tax and a resulting benefit, which encourage investment abroad. The solution proposed would be to tax the American on such potential income whether or not it is distributed as dividends. The effect of any such rule would, in our view,

be to burden the American shareholder with tax costs in advance, to the detriment of their cash position and their ability to make investments currently. While theoretically, over time, the income taxed in advance to the American shareholder would be available to the shareholder as dividends, and eventually the only additional tax borne would be that owed after foreign tax credited, in fact the methods of calculating taxable income in foreign countries differ considerably from the U.S. methods, so that the income will not coincide, and credits will not be available in time or in corresponding amounts. A considerable portion of foreign taxes on profits are levied as withholding taxes on dividends when paid.

In addition to the direct cost of assessment in advance, there would be an immense administrative burden in recording income taxed in advance and reconciling such income with future dividend receipts and changes in the profit development of the foreign entity over time (e.g., intervening loss periods, (as well as in ensuring that new shareholders do not lose credit for taxes already paid by former shareholders. The proposals to end "deferral" would create very serious burdens for American shareholders in order to achieve what a number of studies reveal is already being achieved substantially by operation of the economic realities. It appears that in fact American shareholders are repatriating regularly, and paying U.S. tax on a substantial part of all of the profits of foreign corporations to which they have a claim.

Enactment of such proposals may also call forth countermeasures by foreign governments who would see such rules as designed to force early repatriation of profits.

Proposals to restrict in various ways the amount of foreign tax credits also appear to be aimed at abuses of the present rules which are in fact not present. The present rules provide flexible but very real limits to the amounts of credit which may be taken so that no more credit can be taken than the U.S. tax on foreign income over time. Such flexibility is necessary to allow for differences between U.S. tax law and foreign rules, and if this flexibility is taken away, the result would be an increase in the tax costs of the entire U.S. based enterprise thus restricting its ability to provide jobs and income now and here.

These potential costs are of real concern to banks, both because of the indirect effects a weakening of the U.S. economy would have on them and more importantly because the foreign business of U.S. banks supports a considerable number of jobs for Americans. For example, the eleven New York Clearing House banks recently estimated that over 12,000 jobs in New York are directly related to their overseas operations. With the growth in the overseas activities of banks outside of New York, the same will be true on a smaller but significant scale in other American cities.

For all of these reasons, present proposals to change the rules on taxation of foreign income appear to the American Bankers Association to threaten the competitiveness of the American economy in the world and a serious weakening in its ability to provide jobs and incomes for Americans.

Taxation of Americans Working Abroad

Proposals have been made to end the limited exclusion of a part of earned income of Americans working abroad. We believe that ending this exclusion would raise the already high cost of employing Americans in overseas posts and make effective competition abroad even more difficult. One of the American economy's valuable assets is its corps of trained specialists and managers, whose services can be exported. In order to use this asset, competition requires that these specialists and managers not forfeit those advantages which the American economy is able to provide at less cost than can foreign economies. The increased costs of providing housing, schooling, and a roughly comparable standard of living abroad is a cost of doing business there. The individual employee, however, does not enjoy a higher economic income by reason of these costs, as the aim of these benefits is to equate the overseas situation with his situation here. The exclusion provided under Section 911 has proved to be an effective means of ensuring that the individual is not penalized by reason of the increased cost of making him equal to his U.S. based colleagues. If the method of Section 911 is to be changed, the fact should not be lost sight of that the costs of maintaining him abroad do not represent income to him. Unless this fact is recognized in the form of an exclusion or of specified deductions, employment of foreign nationals will supplant employment of Americans, and both the use of and continued development of a significant export asset will be lost.

Statement of Thomas A. Melfe on Behalf of the American Bankers Association

SUMMARY

Section 301—The minimum tax

Whether the Minimum Tax is continued as an additional tax or becomes an alternative tax, trusts and estates must be allowed a distribution deduction under Section 651 or 661 of I.R.C.

Excess itemized deductions as new tax preference

Trusts and estates should be excluded entirely from this provision or, at a minimum, the definition of "excess itemized deductions" should exclude those deductions relevant only to trusts and estates to avoid double taxation.

Lump sum distribution from qualified plans

ABA recommends that plan participants have election to use ERISA provisions where conflict with H.R. 10612 exists.

Interest deduction limitation

If the interest deduction limitation provisions are not eliminated a deduction for "personal interest" should be available to trusts and estates, and interest on State and Federal estate, gift and income taxes should be allowable deductions without any limitation as to amount.

Throwback rule changes

ABA agrees that computation of tax on throwback income should be simplified. ABA opposes limitation of exact computation of tax method. ABA endorses new "short-cut" method of taxation of throwback income. ABA opposes elimination of tax refund which current law allows. ABA supports elimination of capital gains throwback, but opposes new Section 644 relating to taxation of gains in new trusts.

Other legislative recommendations

ABA recommends that revocable trusts used as will substitutes be given election to be treated as estates.

ABA recommends reinstatement of Treas. Reg. §§ 1.661(a)-2(e) and 1.662(a)-2(c), relating to tax treatment of support allowance for spouses, as they read prior to Treasury Decision 7287.

STATEMENT

Mr. Chairman and Members of the Committee: My name is Thomas A. Melfe. I am the Chairman of the Taxation Committee of the Trust Division of the American Bankers Association and an Executive Vice President of United States Trust Company of New York.

The American Bankers Association is a trade association composed of about 14,000 banks or some 96% of the banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the Association is keenly interested in the taxation of estates and trusts.

There are several provisions in H.R. 10612 which suggest to the ABA that some fundamental misunderstandings exist regarding the income taxation of trusts and estates and their beneficiaries. Before discussing these provisions, we would like to outline briefly (and to some extent oversimplify) the method of taxing these entities and their beneficiaries.

A trust or an estate is a fund of property in which one or more beneficiaries have interests. When taxable income is received by the trust or estate and distributions are made by the trust or estate to the beneficiaries, an allocation of the income for tax purposes must be made between the trust or estate and the beneficiaries receiving the distributions. This is accomplished in Subchapter J by, in general, treating any distributions as consisting of income (other than capital gains) received by the trust or estate during the period involved and having income retain the same character in the hands of the beneficiaries.

To the extent that current income is treated as being distributed to a beneficiary, the trust is entitled to a dstributions deduction under section 651 or 661 and the beneficiary is taxed under section 652 or 662 on the amounts so deducted. The distributions deduction is unique to a trust or estate.

A trust or estate may also be entitled to other special deductions. For example, when an estate or trust has charitable beneficiaries the "normal" rules are modified and the provisions of section 642(c) and 664 must be considered. In other cases, the income received by a trust or an estate may be subject to both income tax and estate tax. When this occurs, an income tax deduction is allowed under section 691 to the trust or estate (or beneficiary) in an amount equal to the estate tax on this income to avoid double taxation on the full amount.

It a trust accumulates income and in a later year distributes amounts in excess of the current year's income, a "throwback" rule contained in sections 665 through 669 is applied, which is intended to place the beneficiary receiving the distribution in roughly the same position that he would have been in if he had received the income in the year it was accumulated by the trust. The throwback rule is not applicable to income accumulated in an estate.

A number of distinctions other than the application of the throwback rule are made between estates and trusts. The rules for estates are more favorable. For example, an estate is entitled to a $600 exemption, while a trust receives either a $300 or $100 exemption. One possible reason for these distinctions is that an estate has a short duration while a trust usually exists for a longer period of time. During the last 15 years the use of a revocable trust as a will substitute has substantially increased. Such a trust is not considered as a separate taxpayer for income tax purposes while the grantor is alive. The reasons for using a revocable trust are largely non-tax oriented. The increased use of revocable trusts as will substitutes has focused more attention on the tax differences between trusts and estates. We have yet to hear anyone contend that there is a justifiable reason for treating a revocable trust which becomes irrevocable at death differently from an estate during the period required to satisfy the decedent's obligations, including estate taxes. Nevertheless, the distinctions continue to exist and are increased. As we will discuss later, H.R. 10612 creates a new distinction, which is unwarranted.

Section 301—the minimum tax

A. Trusts and Estates

The minimum tax provisions came into the tax law as a part of the Tax Reform Act of 1969. In the case of an estate or trust, the only minimum tax item of significance is capital gains. In fact, the application of the minimum tax to other types of trust income is so confused that the Service has refused to treat the minimum tax paid on other than capital gains as a tax imposed on the trust for purposes of the throwback rules. See Treas. Reg. § 1. 665(d)-1A. Proposals for change in the minimum tax have been considered by the House Ways and Means Committee during 1974 and 1975 and some changes are included in H.R. 10612. The fundamental policy question with the minimum tax is whether it should continue as an additional tax on preference income or should be changed to an alternative tax. During 1974 the House Committee on Ways and Means tentatively approved the alternative approach in modifying the Administration's minimum taxable income (MTI). In his testimony before the Committee, Secretary of the Treasury Simon renewed the Administration's support for MTI, but in a somewhat modified form.

Regardless of what form the minimum tax does take, the deductions unique to trusts and estates which we have referred to should be allowed in computing this tax. H.R. 10612 does not do so and MTI as modified would not do so. H.R. 10612 also fails to take account of other deductions which should be considered.

In H.R. 10612, "excess itemized deductions" are made a tax preference item and Secretary Simon indicated the term would be used with MTI. It is defined as the amount by which all deductions allowed to a taxpayer (including a trust or an estate) other than (1) those allowed in arriving at adjusted gross income, (2) the standard deduction and (3) personal exemptions exceed 70% of the taxpayer's adjusted gross income. In arriving at the "adjusted gross income" of a trust or estate, there would be no deduction for the section 651 and 661 distribution deductions mentioned above. The result would be that a minimum tax could be imposed on a trust or estate which distributed its entire income of dividends and interest currently to a beneficiary who was taxed on this income. This is obviously wrong and we assume is an oversight.

The problem is not limited merely to the distribution deductions under sections 651 and 661. As mentioned above, estates and trusts which have charitable beneficiaries are subject to somewhat different rules. Under current law, an

estate is entitled to a deduction under section 642(c)(1) or (2) for all amounts of income which are payable to charity. Application of the excess itemized deduction concept to such an estate could result in a minimum tax being payable on amounts which will be paid to charity. This also is wrong. A third demonstrable error in the excess itemized deduction concept involves the deductions under section 691(b) or (c), whether claimed by an estate or trust or an individual. As mentioned above, these deductions are allowed to mitigate double taxation. They should not be eliminated for minimum tax purposes so as to reintroduce double taxation by the back door.

The difficulties with the excess itemized deduction concept are not limited to the deductions just mentioned. They also extend to section 642(g), which permits administration expenses allowable as estate tax deductions to be claimed as income tax deductions provided a waiver is filed to use them as estate tax deductions, and section 642(h), which permits deductions in excess of gross income of a trust or an estate in the year of termination to be claimed by the beneficiary or beneficiaries succeeding to the property.

More fundamentally, the ABA submits that a trust or an estate should be excluded entirely from the application of the excess itemized deduction concept regardless of the form the minimum tax may take. The abuse cases which have been publicized whereby a combination of deductions have been used to avoid the payment of any income tax have involved individuals not trusts or estates. It is a mistake to impose inapplicable concepts to the trusts and estates area. Further, if the exclusion is not made, the statute should contain a "laundry list" of special deductions for a trust or an estate in order to produce fairness in the application of the tax. Such a list inevitably causes complexity and leads the uninformed to believe the trust or estate is "getting away with something," which is not true.

B. Lump Sum Distributions From Qualified Plans

The portion of a lump sum distribution attributable to pre-January 1, 1974 contributions is taxed as long term capital gain and one-half of this portion is subjected to the minimum tax. The modifications made in the minimum tax, *viz.*, increasing the rate of tax to 14%, denying a deduction for the taxpayer's ordinary income tax and restricting the availability of an exemption from the minimum tax, have the effect of eliminating the relation established by the ERISA changes in the method of taxing lump sum distributions between (1) the tax imposed by the ten year averaging device and (2) the tax paid by a retired participant who was a member of a plan prior to January 1, 1974. The unintended result is that a participant who was a member of a qualified plan prior to that date may be "penalized" through the imposition of a higher tax by not being able to use the special averaging method for the entire distribution as a participant who became a member of a plan after that date may do.

The ABA recommends that a pre-January 1, 1974 participant be given an election to compute his tax by using the special averaging method for the entire lump sum distribution.

Section 206—Limitation on interest deduction

This provision imposes deduction limitation of $12,000 ($6,000 in the case of a separate return by a married individual) on "personal interest" as contrasted to "investment interest". As discussed in Mr. Horne's statement, we agree with the Administration that the $12,000 limitation is undesirable. The minimum tax, whether as in H.R. 10612 or a MTI, will provide sufficient protection for "excess" interest. One type of itemized deduction should not be singled out for further special treatment.

Also, under section 206, a trust is not allowed any deduction for "personal interest". Proposed section 163(d)(5) provides that interest payable under section 6601 on any installment payment of estate tax is not to be taken into account in computing personal interest.

We fail to see why a trust should be treated as a second class citizen and allowed no deduction for "personal interest", which would include interest on a home mortgage. Our members often act as trustee of a trust holding a family residence. What is the policy which justifies denying the trust a deduction for the interest?

We assume that the policy reason for not permitting the deduction of all interest on State or Federal income, gift or estate taxes is to encourage the prompt payment of taxes which are due, but would point out this has already

been accomplished by (1) the interest rate change in Public Law 93-625 which is keyed to the current prime rate and (2) the Service's recent policy of asserting negligence penalties. Denying or limiting the interest deduction in the case of interest on taxes is overkill. This change is also undesirable because it (1) creates a distinction between corporations, which are not subject to the "personal interest" limitation, and individuals (including trusts and estates) and (2) ignores the fact that during the underpayment period the individuals will in most cases have earned income which has been subjected to income tax on the amount of the deficiency.

The failure to allow any deduction for interest on estate taxes to a trust which is required under applicable state law to contribute towards the payment of estate taxes (other than amounts deferred by law) plus interest is unfair and creates a new distinction between trusts and estates which has no basis in fact. Also, as discussed above, a revocable trust is being used in many cases as a will substitute for valid non-tax reasons and a distinction between a trust or an estate in terms of the interest deduction would create a further disparity of treatment for no good reason.

If the $12,000 limitation on "personal interest" is not eliminated, the ABA urges that proposed section 163(d)(1) contained in Section 206 denying a deduction to a trust for any personal interest be deleted and that section 163 (d)(5)(D) be broadened to provide that interest on any Federal or State income, gift or estate tax should be disregarded and not taken into account.

Section 701—Throwback Rule Changes

We believe the throwback rule changes in Section 701 taken as a whole improve current law. There are, however, some modifications in Section 701 which the ABA favors.

A. Simplified Computation Method

Under current law income accomulated in trust and later deemed distributed to a beneficiary retains the same character which it had when received by the trust and the beneficiary's income tax returns for the affected years are "opened up" in the sense that any percentage limitations applicable to medical expenses or charitable contributions must be adjusted to reflect the additional income. See Treas. Reg. § 1.668(b)-3A(b). The ABA suggested that the throwback computations could be simplified if the character rules and the "opening up" of returns were eliminated. The computations would then be accomplished merely by adding the throwback amount to the beneficiary's "taxable income" for the affected year or years. Section 701 contains these simplifications. Proposed section 667(a) eliminates the reference to section 662(b), except with regard to tax-exempt interest now contained in section 668(a), and thereby eliminates the character rule except for tax-exempt income. We believe the changes are desirable, although in individual cases the tax payable by the beneficiary may be more or less than he would pay under current law. This could occur with, for example, foreign source income.

We understand that some objections have been made to these simplifications. We continue to believe they are desirable.

B. Elimination of the Exact Method

Current law provides in general that a beneficiary receiving an accumulation distribution has the right to compute his tax under an exact method or a short-cut method. The ABA has been concerned with the ability of a beneficiary to use the exact method when a number of years have passed after the income being distributed was accumulated in the trust. Several years ago we suggested, along with simplification mentioned in A above, that the beneficiary's "taxable income" figure for prior years be retained by the Internal Revenue Service on computer tape if an appropriate request was made. We understand that when this matter was discussed with the Service, it focused (perhaps for the first time) on how information supplied by a beneficiary receiving an accumulation distribution as to his income for a prior year would be verified. Apparently, all taxpayer information on computer tape is erased after six years and all taxpayer returns are destroyed. We further understand that the Service desired to eliminate the exact method because of its information retention problem. Section 701 does so.

The ABA does not support the elimination of the exact method. When the beneficiary can supply copies of his returns for prior years, there is no reason

to deny him the use of the exact method. We believe that the Service will, in almost all cases, be able to verify information supplied by a beneficiary as to his income for a prior year. In the rare situation when it cannot do so, the problem should be resolved on a case by case basis.

C. New Short Cut Method

The ABA suggested that the short cut could be improved by using a five year base period and then eliminating the taxpayer's two years with his highest and lowest taxable income. Section 701 makes this change. We understand some concern has been expressed as to how the method would be applied if the taxpayer was not in being during the full five year period. We believe the full period he is in being should be used. If this matter cannot be handled by regulation, proposed section 667 should be modified to cover the point.

D. Tax Refunds

Under current law a beneficiary is entitled to receive a refund if his tax computed by the exact or the short-cut method is less than the tax paid by the trust and is not attributable to a year in which the beneficiary was not in being. Section 701 would eliminate a benficiary's right to received a refund. We believe this is wrong. There is no good reason to deny a refund when the beneficiary must use the short-cut method, which everyone acknowledges will on the whole produce a higher tax than the exact method.

E. Repeal of the Capital Gain Throwback and Proposed Section 644

1. Policy

Section 701 repeals the capital gain throwback, but couples this change with a new provision which is highly discriminatory and overkill. This provision (proposed section 644 treats as short-term capital gain all unrealized appreciation in property transferred to a trust if a sale should be made within two years after the transfer.

The ABA believes section 644 is addressed to a phantom problem—one that exists no more for trusts than for individual donees. This section would impose an additional tax factor which would interfère with a trustee's normal and reasonable investment decision. We consider section 644 both discriminatory and unnecessary.

Clearly, the *only* possible tax reduction in a case where a sale is made soon after the creation of a trust is the failure to tax the capital gain of the trust at the grantor's tax rates rather than the trust's tax rates. If proposed section 644 is retained in any form it should be keyed to this objective by providing that a trust's tax on any gain covered by section 644 will be the tax on the gain which the grantor would have paid if he had sold the property immediately prior to its transfer in trust.

2. Technical Objections

Proposed section 644 is technically deficient in two respects. First, as a result of the amount of short term gain being based on the amount paid by the trust, the short term gain may exceed the unrealized appreciation in the property at the time of transfer. Second, the wording of the section has the unintended result of creating short term capital gain treatment where there is a transfer from one trust to a second trust followed by a sale within two years of the transfer but more than two years after the inilial transfer in trust and having the short term gain treatment based upon the value of the property at the time of the transfer to the second trust rather than at the time of the transfer to the first trust. These deficiencies could be remedied by modifying (1) and (2) of section 644(a) to read:

(1) property is transferred to a trust and the fair market value of such property at the time of the transfer exceeds the trust's basis in the property, and

(2) the trust or another trust to which the property is distributed sells or exchanges such property at a gain not more than 2 years from the date of the initial transfer of such property in trust,

One other technical defect is the failure of subsection (h) of Section 701 (the effective date provision) to refer to "transfers" which is the operative word insofar as proposed section 644 is concerned. This section should apply only

to property initially transferred in trust after a specified date which should not precede the date the provision was finalized.

Legislative recommendations

We urge this Committee and House Committee on Ways and Means to extend their attention to solving some other taxpayer problems and we have two recommendations for the Committee's consideration which are important to our customers. If enacted, they would have virtually no revenue impact.

A. Revocable Trust—Operation Switch

As we noted at the beginning of our testimony, revocable trusts are being used with increasing frequency as will substitutes for primarily non-tax reasons.

The ABA submits that there is no reason to differentiate for tax purposes between property held in an estate and property held in a revocable trust during a period of administration. This distinction has concerned the ABA and the American Bar Association (see 29 *Tax Lawyer* 428 (1976)) and should be eliminated. We are attaching to our statement as Appendix A a proposed section 645 which would eliminate this distinction and as Appendix B a memorandum noting the reasons for creating a revocable trust and discussing the major tax differences between trusts and estates and the proposed statute.

B. Spouse's Support Allowance

We support H.R. 11436, introduced by Representative Mikva, which reinstates the Treasury's position as expressed in Treas. Reg. §§ 1.661(a)-2(e) and 1.662 (a)-2(c) prior to their amendment on September 26, 1973, by Treasury Decision 7287.

The Tax Section of the American Bar Association has recommended that allowances for support of a spouse or dependent be added to section 663 as an exception to sections 661(a) and 662(a). See 22 *Tax Lawyer* 1037 (1969).

SECTION 645. TRUST TAXABLE AS AN ESTATE AND ESTATE TAXABLE AS A TRUST

(a) Effect of Election.—If an election is made with respect to a trust as provided in subsection (b), all property held in the trust shall for purposes of Subtitles A and B be treated from and after the decedent's death as held in an estate, and all property held in the estate of the decendent be treated as held in a trust.

(b) Persons Making Election.—Any decedent who was treated immediately prior to his death pursuant to section 676 or section 678 as the owner of all property held in a trust may by will make the election provided by subsection (a) or, in the absence of a will provision, the executor or administrator of such decedent and the trustee of the trust may jointly so elect by written instrument in accordance with regulations prescribed by the Secretary or his delegate. The election may be made as to only one trust owned by the decedent.

APPENDIX A

MEMORANDUM CONCERNING PROPOSED SECTION 645

INTRODUCTION

Revocable trusts are being used with increasing frequency as will substitutes. This development has been given additional impetus in recent years as a result of the use of revocable trusts being publicized. Information obtained from several of the larger member banks of the Trust Division of the American Bankers Association indicates that more than one-third of decedents use a revocable trust as a major part of their estate plans. A number of differences exist between the tax treatment of property held in an estate as contrasted to property held in a revocable trust. There is no sound basis for these distinctions.

The purpose of proposed section 645 is to permit property held in a revocable trust to be subjected to the estate rules rather than the trust rules, in which event property held in the estate proper will be subjected to the trust rules. This objective is accomplished through the creation of an election exercisable by the decedent's will or, in the event the election is not so exercised, by his executor and the trustee of the trust.

APPENDIX B

DISCUSSION

A. Reasons for using revocable trusts

Some of the reasons for the increased use of revocable trusts are:

1. To reduce the expenses of administration.
2. To provide for uninterrupted management of the decedent's property in the event of senility or incompetency.
3. To avoid state laws which place restrictions upon persons who may administer property passing by will.
4. To avoid state laws involving a spouse's elective share or restrictions on charitable transfers that are imposed upon transfers by will.
5. To avoid publicity given to probate proceedings.
6. To receive payments from qualified pension and profit sharing plans without the loss of the exclusion provided by section 2039(c).
7. To receive life insurance proceeds which are exempt from state death taxes if payable to a beneficiary other than the decedent's estate.

B. Tax differences between trusts and estates

As previously mentioned, the federal tax law treats property held in a revocable trust during "the period of administration" differently from property held in an estate. The major differences are:

1. Income accumulated in a trust is subject to the throwback rules of section 665 through 669 while income accumulated in an estate is not subject to these rules.
2. A "set aside" charitable deduction is available for an estate under section 642(c) but not for a trust.
3. An estate has a $600 exemption while a trust has a $300 or $100 exemption depending upon whether the income is required to be distributed currently.
4. The depreciation deduction may operate differently for an estate than for a trust. See *Estate of Ida Wray Nissen* v. *Comm'r*, 345 F.2d 230 (4th Cir. 1965); *Lamkin* v. *United States*, 75–1 USTC ¶ 9479 (D.C. Tex. 1975).
5. The separate share rule of section 663(c) applies to a trust but not to an estate.
6. An estate and a trust are treated differently under section 691 regarding the realization of income upon the transfer of a right to receive income in respect of a decedent.
7. An estate, but not a trust, may elect under section 6152 to pay its income tax in four equal installments.
8. Section 267, disallowing losses between certain taxpayer, is applicable to a trust but not to an estate. See *Estate of Hanna*, 37 T.C. 63 (1961), *rev'd*, 320 F.2d 54 (9th Cir. 1963).
9. A distribution from one trust to another trust may accelerate the payment of estate tax attributable to a closely held business which has been deferred under section 6166, but a distribution from an estate to a trust will not cause such acceleration. See Treas. Reg. § 20.6166–3(e).
10. Treas. Reg. § 20.2056(b)–5(f)(9) stating that an interest is not to be regarded as failing to satisfy the conditions that the surviving spouse is entitled to all the income of a marital deduction trust and that the income be payable annually or more frequently because the spouse is not entitled to income on assets prior to distribution is applicable to estates but not to trusts.

C. Operation of proposed statute

As previously noted, proposed section 645 permits a decedent to elect by will to have property held in a revocable trust treated as being held in an estate. The term "property held in a trust" is intended to include property distributable to the trust as a result of the decedent's death. If an election is made, the decedent's estate is treated as a trust. For purposes of Subtitles A and B, relating to the income, estate and gift taxes. This includes the section 2039(c) exclusion for payments made from qualified pension and profit sharing plans attributable to an employer's contributions. Thus, if the election were made, payments made to a trust that would otherwise qualify for the exclusion would be treated as being made to the decedent's estate and the exclusion would be lost.

1. Trusts as to Which Election Available

There are two types of trusts that are subject to the election provided by section 645—(1) a trust created by the decedent as to which he is treated as the owner under section 676 and (2) a trust created by a person other than the decedent but as to which the decedent is treated as the owner under section 678. The most common illustration of the second type of trust is a marital deduction trust over which the surviving spouse has an unlimited power of withdrawal. Neither type of trust is a separate entity for income tax purposes prior to the decedent's death. In either case, the decedent is required to include all income received by the trustee in his return as if it had been received directly by him and is entitled to claim all deductions for amounts paid by the trustee that he would be entitled to deduct if he had paid them directly. Treas. Reg. § 1.671-3(a)(1). Upon the decedent's death, each type of trust becomes irrevocable, and the trustee may then elect to file federal income tax returns using a fiscal year or calendar year. Rev. Rul. 57-51, 1957-1 Cum. Bull. 171. Thus, these tax entities come into existence at the same time the decedent's estate comes into existence.

Consideration was given to permitting the election to be made as to any trust which was included in a decedent's gross estate. Such an approach was rejected for two reasons. First, the "additional" trusts would have been separate tax entities prior to the decedent's death and a problem would be presented in terminating this entity as of the decedent's death. Second, these trusts would not be "similar" to a decedent's estate, except as to a marital deduction trust over which the surviving spouse-decedent has a general testamentary power of appointment which would permit an appointment to the decedent's estate.

2. Will Contest

An election by will could be rendered uncertain by a will contest. The regulations would provide that in the event of a will contest an election would, until overturned, be presumed to be valid.

3. Election Procedure

Consideration was given to permitting the election to be made by a provision in the affected trust as well as by the decedent's will. While a dual approach would work satisfactorily with a trust subject to section 676, it would be troublesome for trusts subject to section 678 because a power of withdrawal may not include a power of amendment and a revocation and recreation of the trust would be necessary. Also where there are two or more trusts as to which an election may be made the possibility of an invalid "double" election is eliminated if an election is made in a neutral instrument—the will. Finally, the election does have significance to the estate since it will be treated as a trust, and therefore the will is a natural place in which to make the election.

In cases where the decedent fails to make an election, proposed section 645 permits executor and the trustee of the affected trust to make the election. Since both of the entities are affected by the election, both of the fiduciaries rather than only one of them should be parties to the election. The statute does not permit the two fiduciaries to "overrule" an election made by the decedent.

4. Duration of Election

It is intended that an elective trust would continue to be treated as an estate in accordance with the provisions of Treas. Reg. § 1,641(b)-3. So long as the decedent's estate has not terminated under Treas. Reg. § 1-641(b)-3(a), the trust would be treated as an estate. When the estate proper is terminated under this regulation, the elective trust would be subject to the normal trust rules. Similar termination rules are contained in the regulations to section 664 (see Treas. Reg. § 1.664-1(a)(5)(i), 1.664-1(a)(6)(iii), 1.664-2(a)(6)(ii) and 1.664-3(a)(5)(ii)) and will presumably be contained in the final regulations to section 4947.

D. Utility of proposed statute

Application of the estate rules to revocable trusts will be particularly useful when the trust is to be divided into a marital trust and one or more non-marital trusts upon the decedent's death. Under current law, the income tax consequences

of such a disposition are unclear. This subject is now a study project of the Committee on Income of Estates and Trusts of the Section of Taxation of the American Bar Association. See 29 Tax Lawyer 428 (1976).

1. Income Tax Throwback Rules

A common type of disposition will indicate one of the problems presented by the division upon a decedent's death of his revocable trust into two (marital and non-marital) continuing trusts, with the income to be distributed currently to the beneficiaries of each trust. The continuing trusts are "simple" trusts, *viz.*, trusts the incomes from which is to be distributed currently. Assume that the terminating revocable trust (i) earns income of $10,000 a year for each of the first two years after the decedent's death, (ii) makes no distribution of income in the first year and (iii) in year two distributes the entire $20,000 (reduced by the income taxes on the first year's $10,000) as income to the marital and non-marital trusts which in turn distribute such income immediately to the income beneficiaries of the two trusts. The result of such distributions would appear to be that (i) the terminating trust has made accumulation distributions to the marital and non-marital trusts in the amount of $10,000 for the first year's income, (ii) these distributions are included in the gross income of the marital and non-marital trusts (see section 668(a)) and in the distributable net income of each of these trusts and (iii) the distributable net income is taxed to the income beneficiary of each trust. It would appear, however, that the income beneficiaries are not entitled to claim a credit for the taxes paid by the terminating trust on the $10,000 earned in the first year because the distributions from the marital and non-marital trusts to the income beneficiaries are not accumulation distributions within the meaning of section 665(b) since they are not covered by section 661(a)(2). This result is obviously unfair and would be avoided if the terminating trust can be treated as an estate for income tax purposes.

Although the income tax throwback rules are not applicable to income that is accumulated in an estate, the "outside income" concept set forth in Treas. Reg. § 1.665(e)-1A(b) will prevent the trusts created from the revocable trust being able to avoid the throwback rules for income in respect of a decedent that is carried out to such trusts by distributions from the terminating revocable trust. Thus, a new loophole is not created by treating this trust as an estate.

The enactment of proposed section 645 would, in cases where the election is made and the decedent's residuary estate is "poured-over" to the elective trust, permit the throwback rules to be avoided in connection with a distribution from the trust to an individual beneficiary in a year other than that in which the trust receives an accumulation distribution from the estate. This same result may, however, be achieved under current law by a reverse "pour-over" from a trust to the estate. Thus, the election device does not cause a new inroad in the application of the throwback rules.

2. Section 642(c) Charitable Deduction

The failure of current law to permit a section 642(c) "set aside" charitable deduction for a trust which was subject to section 676 or 678 until the decedent's death is particularly unfair. The normally operative rule under section 643(a) is that capital gains are not included in a trust's distributable net income. Application of the rule will prevent gains which are eventually distributable to charity from being distributed currently so as to avoid an income tax on such gains. There is no sound policy reason supporting this result, which will be avoided by applying the estate rules to the trust.

3. Section 267

As mentioned previously, a revocable trust is often divided into a marital and non-marital trust after the decedent-grantor's death. When the marital trusts is in the form of a pecuniary bequest gain is recognized to the extent that the fair market value of property distributed in kind in satisfaction of the bequest exceeds its income tax basis. See Treas. Reg. § 1.1014-4(a)(3). On the other hand, section 267 prevents a loss from being recognized on such a transfer. The result is otherwise if the pecuniary bequest was being satisfied from an estate. As in the case of the "set aside" charitable deduction, there is no sound policy reason supporting such a distinction, which will be eliminated by the election device.

4. The Marital Deduction Income Requirement

When a marital deduction trust is created under a decedent's will, the two income requirements—that the surviving spouse is entitled to all income of the trust and that the income be payable annually or more frequently—are not applicable during the administration of the decedent's estate that is not unreasonably delayed. Treas. Reg. § 20.2056(b)-5(f)(9) state:

"An interest is not to be regarded as failing to satisfy the conditions set forth in paragraph (a)(1) and (2) of this section (that the spouse be entitled to all the income and that it be payable annually or more frequently) merely because the spouse is not entitled to the income from estate assets for the period before distribution of those assets by the executor, unless the executor is, by the decedent's will, authorized or directed to delay distribution beyond the period reasonably required for administration of the decedent's estate. As to the valuation of the property interest passing to the spouse in trust where the right to income is expressly postponed, see § 20.2056(b)-4."

No case or revenue ruling has dealt with whether this regulation will be applied to a marital deduction trust which is funded from property held in a revocable trust at the decedent's death. The policy considerations supporting the "liberal" rule of the regulation when a funding from an estate is involved seem equally applicable to a funding from a revocable trust. Since the amount of the marital trust is based upon the final federal estate tax determination, the value of the trust and the amount of income attributable thereto cannot be determined until the federal estate tax audit is completed. Thus, it is unrealistic to expect that this income can be distributed currently from the decedent's death.

In 1974 Northern Trust Company submitted to the Service an application for an information letter concerning the income requirements of a marital deduction trust funded from a revocable trust. The Service took the position that Treas. Reg. § 20.2056(b)-5(f)(9) was not applicable in such a case.

5. Section 6166

This section permits the estate tax attributable to a closely-held business to be paid in ten equal installments commencing nine months after the decedent's death.

Certain events occurring after a decedent's death may cause an acceleration of the deferred payments. One of the events that will cause acceleration is if 50% or more of the interest in the closely held business "is distributed, sold, exchanged, or otherwise disposed of". The quoted words are the same as those used in section 2032 in determining the alternate valuation date. Treas. Reg. § 20.6166-3(e)(1) states:

"A transfer by the executor of an interest in a closely held business to a beneficiary or trustee named in the decedent's will or to an heir who is entitled to receive it under the applicable intestacy law does not constitute a distribution thereof for purposes of determining whether 50 percent or more of an interest in closely held business has been distributed, sold, exchanged, or otherwise disposed of."

This result would appear to be inconsistent with the section 6166 result when the distribution is made from a revocable trust which becomes irrevocable upon the decedent's death. The section 6166 regulations do not deal with such a distribution, but do suggest that this inconsistency would occur since Treas. Reg. § 20.6166-3(e)(3) provides:

"An interest in a closely held business may be 'distributed' by either a trustee who received it from the executor, or a trustee of an interest which is included in the gross estate sections 2035 through 2038, or section 2041."

There is no sound policy reason for such an inconsistency.

Senator RIBICOFF. Mr. Libin, please.

STATEMENT OF JEROME B. LIBIN, SUTHERLAND, ASBILL & BRENNAN

Mr. LIBIN. Thank you, Mr. Chairman. I am Jerome B. Libin, I am a partner in the law firm of Sutherland, Asbill & Brennan, here in Washington and professor at the George Washington University Law

School. I am appearing today at the request of the firm of Lee, Toomey & Kent to provide you with an academic point of view on the very important question of tax deferral of foreign source income earned by subsidiaries of American corporations.

I have a full statement which I would like to request be put in the record.

Senator RIBICOFF. Without objection.

Mr. LIBIN. The starting points as I see it for addressing the question of tax deferral are certain very fundamental concepts and principles of international taxation which have a long history and are well established and which address the theory of the use of deferral in the international taxing order. The primary principle is that income is taxed in the country where it is earned—the country where the income originates has the right to tax that income.

Next, when the income is earned in a particular country by a foreign taxpayer, the taxpayer's country of residence may decide to tax that income as well if it chooses to tax the worldwide income of its taxpayers, but in such a case to avoid international double taxation the country of residence yields to the country where the income originates.

Finally, if income is earned in a particular country by a local entity organized, managed and operating in that particular country, but owned by a foreigner, the country of origin of the income again taxes that income when it is earned and the country of residence of the owner of the entity does not tax the income until it is remitted home through dividend distributions.

This latter principle is the principle of tax deferral.

At the present time no major nation in the world applies its tax laws in contravention of that very basic and fundamental principle, except in tax abuse or tax avoidance situations.

Now, the proposals which you have before you would like to eliminate that deferral concept and thereby revolutionize our own tax law and the international taxing order.

They overlook what is perhaps the most compelling rationale for retaining deferral. That is a very fundamental additional principle of our tax law, that all taxpayers similarly situated should have the opportunity to secure equal tax treatment.

Now, when companies operate in a particular country and engage in international commercial activity in that country, they may be subject to a variety of tax laws unless there is a mechanism for them to secure equal tax treatment in the particular marketplace where they are competing.

In the international context that mechanism has been the use of a local subsidiary, or to put it in our terms a foreign subsidiary, established in that particular country and subject only to its tax laws at the time the income is earned. In that fashion all competitors in a particular country, whether they are domestic competitors or foreign competitors, wherever they come from, can utilize the same legal technique to secure equal tax treatment in the marketplace.

Action by the Congress that would eliminate deferral for U.S.-owned foreign corporations and tax the income earned by those foreign subsidiaries on a current basis would make the United States unique,

would stand it alone in the world among nations that engage in foreign commerce, because we alone would be denying to our corporations, through their subsidiaries, the opportunity to compete on an equal tax footing in a particular marketplace. We would be denying to our corporations this very fundamental tax concept that all corporations and all taxpayers similarly situated should have the right to secure equal tax treatment as they earn their income.

The issue of eliminating deferral is not new to the Congress or to this committee. It has been raised for many years. It was first raised about 15 years ago.

At that time, rather than adopt such a sweeping proposal, the Congress opted instead for what is known as subpart F of the Internal Revenue Code. At that time, legislation of that nature was revolutionary. No other country had acted in the manner we did in 1962 when we enacted subpart F.

That portion of the Internal Revenue Code reaches out and does tax currently certain forms of income realized overseas by foreign subsidiaries of American corporations. It taxes certain types of rental income, royalty income, dividend income, interest income, sales income, services income, insurance income, and shipping income. While there are many exceptions and many complexities involved in the legislation, we do have a mechanism already in the Internal Revenue Code for taxing currently certain foreign source income derived by a foreign subsidiary of an American corporation.

In 1975 Congress acted to repeal some of the liberal features of subpart F and tightened even further its reach on the taxation of income earned abroad. There was the repeal of the minimum distribution rules; repeal of the less developed country reinvestment rules; the lowering to 10 percent of the threshold figure before subpart F would operate with respect to certain types of income earned by the foreign subsidiary. Indeed, there is very little left of deferral right now except the retention of earnings by corporations operating in nontainted businesses for use by them in meeting competition and growing and expanding in their particular marketplaces.

Yet, we continue to hear requests for elimination of deferral. The argument that has been suggested is that eliminating deferral would achieve a form of tax neutrality here at home. If all income wherever and whenever earned were taxed immediately at 48 percent there would be no incentive to go abroad and everybody would invest more money here.

I think the figures suggest that foreign investment is not undertaken solely to achieve tax benefits. There are many non-tax factors that go into the business decision to enter a new market overseas.

The neutrality argument is quite fallacious for a number of reasons. In the first place, as suggested by Senator Curtis, the asset depreciation range system and the investment tax credit, two very strong incentives to capital investment, are not available for foreign investment. They are available only for domestic investment. So there is no neutrality with respect to the investment credit or the asset depreciation range system.

Secondly, even if we were to eliminate deferral, it would have no effect with respect to investment by American corporations in high tax

countries because our foreign tax credit would be available to offset the tax imposed by those countries and no additional U.S. tax would be collected. The principle that the country where the income originates has the first right to tax it would cause the United States to yield to the high tax country through its tax credit mechanism.

The only place where eliminating deferral would have an impact would be in the lower tax countries, the countries whose tax rates are not equal to ours and who are in fact seeking to attract new investment by offering tax incentives. In those countries we would, by eliminating deferral, be denying to our corporations, through their subsidiaries, the opportunity to compete locally by denying them the opportunity to secure equal tax treatment with other similarly situated taxpayers.

We would, therefore, actually stultify investment in those countries. The policy decision to eliminate deferral would not have a neutral effect at all; it would have a determinative effect in stultifying investment in those countries.

In my opinion, we should retain the use of subpart F, rely upon that as a mechanism for taxing certain types of foreign source income which ought to be taxed currently under the policy decisions of this committee and the Congress.

We should pay special attention now to legislation adopted by the Canadians and the Germans, modeled after our subpart F but taking account of current international business practices, not those of 15 years ago. And we should review comprehensively subpart F, apply it as we think it ought to be applied today, but go no further at this time.

Thank you very much.

Senator RIBICOFF. Thank you very much.

Gentlemen, Mr. Horne and Mr. Melfe testified and no one had an opportunity to question them. I have asked them to remain and Mr. Libin would step aside in the event there are any questions for either Mr. Horne or Mr. Melfe.

Senator PACKWOOD. I have none, Mr. Chairman.

Senator HANSEN. I have none, Mr. Chairman.

Senator RIBICOFF. Senator Curtis?

Senator CURTIS. I have no questions at this time.

I believe that all these witnesses are giving us some very valuable testimony but I think most everything has been gone over in their statements.

Senator RIBICOFF. Are there any questions now for Mr. Libin?

Senator PACKWOOD. Well, on the theory of your argument, on page 8 now, you start the section titled—

Responses to Arguments for Ending Deferral,

by saying:

. . . the primary argument advanced by the opponents of deferral is that taxes should be a neutral factor.

Then in the next paragraph—

The fallacies in this argument should be apparent.

Then you go on to cite the investment tax credit, liberalized depreciation allowances not available to overseas subsidiaries.

It looks to me like you are saying that because part of the tax code discriminates in favor of domestics and we should tilt it in favor of

foreign subsidiaries to balance it. It is not a question of neutrality in either case but you are coming to a balance.

Mr. LIBIN. That is a very good point, Senator Packwood. Really if you thought neutrality was the desirable end result——

Senator PACKWOOD. That is what you believe, is it not?

Mr. LIBIN. Well, I certainly think neutrality is desirable. I do not think it is achievable. Therefore, I think it is a mistake to focus on neutrality as the sine qua non of proper tax policy.

Senator PACKWOOD. Everybody else focused on neutrality yesterday and today and all the statements we have had. You are saying all that is awash; we will not get neutrality; we ought to achieve balance?

Mr. LIBIN. This is the fundamental point in focusing on foreign investment. You are in a different context, in a different situation looking at foreign activity. We are dealing with well-established international tax principles on which all the nations of the world have built their tax policies and their investment policies. You cannot equate the rules in the international sphere with those that seem desirable and applicable in the domestic sphere on grounds of neutrality without recognizing the impact that would have on the entire segment of international business conducted by American corporations. It is not a case of doing business in California and Michigan, where we certainly would want to apply equal tax treatment domestically. It is a case of doing business here or in other parts of the world, where entirely different considerations are present.

Senator PACKWOOD. If we were to extend to foreign subsidiaries the—if we did not eliminate the deferral——

Mr. LIBIN. I am not sure that would be enough because, for example, foreign subsidiaries are not allowed to file consolidated returns with domestically affiliated companies. Foreign subsidiaries are taxed differently on distributions in kind——

Senator PACKWOOD. If we would achieve neutrality then, we could eliminate deferral?

Mr. LIBIN. If neutrality were achievable, we would have a different situation to look at. But it is not realistic to talk about that without in effect rewriting the entire Internal Revenue Code. I do not think that is desirable at this time. I think we should stay with the mechanisms we have; fine-tune them; and maintain the international taxing structure that has been well-established for many years.

Senator PACKWOOD. I did not hear the opening part of your statement. Who do you represent?

Mr. LIBIN. I am here as a member of the law firm of Sutherland, Asbill and Brennan; and a professor at George Washington University Law School.

I am here at the request of the firm of Lee, Toomey, and Kent to give an academic viewpoint on this.

Senator PACKWOOD. You are not here lobbying on behalf of any client who is paying you to do this then?

Mr. LIBIN. I am being paid by that firm. I am not here on behalf of any corporation paying me to do this.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator HANSEN. I have no questions.

Senator RIBICOFF. Senator Curtis?

Senator CURTIS. Mr. Libin, you have given us a very fine statement.

Mr. LIBIN. Thank you, sir.

Senator CURTIS. And it has been prepared so that it is very easily understood and it is most helpful and I thank you.

Mr. LIBIN. Thank you.

Senator CURTIS. Would you elaborate on what Canada and West Germany have done that you mentioned?

Mr. LIBIN. Certainly, I would be happy to. The Canadian and German legislation both aim at tax abuse, tax avoidance situations by corporations owned by nationals of those countries operating in the international arena.

Both are modeled after our subpart F. The German legislation, however, takes a somewhat different approach. Instead of defining specific types of income which are tainted income or undesirable income, it defines the types of income earned abroad which it favors, which it encourages, and says all other types of income should be subject to current taxation in Germany.

Senator RIBICOFF. If you would yield at that point. Give me some examples. What type of income do they favor and what kind of income do they disapprove?

Mr. LIBIN. They favor manufacturing income abroad; agricultural earnings abroad; they favor banking and financial income earned abroad; they are against purely passive activity, or activity that seems to be structured abroad in a very artificial way solely to escape German taxation. But the type of international competition we are discussing here, in the full range of business activity, is sanctioned. It is encouraged. It is not discouraged by the German Government.

Similarly, the Canadian legislation is aimed at passive investment income, income that seems to be earned from property that has been acquired or sent abroad rather than from funds invested in Canada to earn interest or rents or royalties or income of that nature. But not actual aggressive business activity which generates income in other countries.

The German legislation also does not apply if the income earned abroad is subject to a 30-percent tax in the foreign country. In other words, the German Government has decided that if the income is subject to some fair measure of taxation in the country where it is earned, then Germany is satisfied. We do not want to stultify the ability of our corporations to compete abroad, says Germany, so if they pay 30 percent tax overseas we will not tax currently the income which they earn. If they pay a lower tax than that, we may tax it currently.

Senator CURTIS. In other words, what was done in subpart F tried to separate those operating companies that go abroad and participate in something in order to secure a market we would not otherwise get?

Mr. LIBIN. That is correct.

Senator CURTIS. But more or less an investment company or maybe a type of holding company or something, something to locate abroad primarily for the purpose of receiving income.

Mr. LIBIN. That is correct.

Senator CURTIS. Or at least where that was a major element.

Mr. LIBIN. Certainly a very major element.

Senator CURTIS. And what Canada and West Germany have done has been to sort of follow our subpart F?

Mr. LIBIN. Follow our approach but recognize, Senator, that in some instances you may want to set up a company in a central location in a

certain part of the world to do business in other countries. Now, under our subpart F that becomes very difficult to do without incurring a current U.S. tax. But the Germans and the Canadians have seen that a base company located in a central location, as for example Switzerland in Europe, can serve legitimate business interests by selling in all the countries of the European sector. They would not penalize that operation.

Senator CURTIS. It is not uncommon to have a Swiss sales corporation promoting sales of products produced in the several European countries.

Mr. LIBIN. That is correct. But under our subpart F we may go too far in taxing that income currently. We may not mean to do that. We may be affecting our corporations' abilities to compete with Canadian and German industries under that mechanism.

Senator CURTIS. I have wondered about a jurisdictional problem. If we launch out and assert the right to tax income not earned in this country and not brought back into this country, and other countries say we have jurisdiction to do likewise, it seems to me it could end in a rather chaotic situation.

Mr. LIBIN. There are all kinds of——

Senator CURTIS. And we would find foreign countries extracting revenues from activities in the United States. The income would have been earned here and never transmitted abroad possibly.

Mr. LIBIN. You would be tinkering with the very delicate mechanism of international tax concepts. That is absolutely right, Senator Curtis, and you could be opening up opportunities for retaliation or double taxation of a horrendous nature, all of which would be highly undesirable.

Senator CURTIS. I do not know how important it is, but do we not tax individuals on that same basis, too?

Mr. LIBIN. Yes.

Senator CURTIS. If somebody goes to a foreign country and earns wages and the wages are spent there on his living, he is not subject to tax when he comes home; is he?

Mr. LIBIN. He is taxed by the United States on his worldwide income currently, unless he takes advantage of the special exclusion in section 911, that is correct. But individuals are obviously operating on a different basis from corporations——

Senator CURTIS. Yes.

Mr. LIBIN. Which are incorporated locally and operating under local laws.

Senator CURTIS. That is all, Mr. Chairman.

Senator RIBICOFF. In your answers to Senator Packwood, Mr. Libin, what you are really doing, you are arguing for neutrality and equality between the United States and foreign multinational corporations. Is that right?

Mr. LIBIN. Yes.

Senator RIBICOFF. What would you want to say about neutrality or equality between American multinational and domestic corporations?

Mr. LIBIN. Mr. Chairman, it seems to me that the issue there is not one of neutrality because, as was suggested earlier, there may come a point in time in the company's history when it has sold all the eleva-

tors it could in this country and it is looking for new markets in which to sell its elevators, and if we impose excessive tax burdens on our companies which wish to go abroad and tap new markets for their products, we do not guarantee that they would sell any more elevators here if they fail to make that foreign investment. It is just a totally different situation.

Senator PACKWOOD. They would export the elevators, would they not?

Mr. LIBIN. If the price is competitive they may well do so, but if the price is not competitive they effectively have given up the market and yielded to the Germans and the Japanese.

Senator CURTIS. Price may not be the control, the country in which the activity is located may say no one is going to sell that product here unless it is manufactured here.

Mr. LIBIN. That is correct, absolutely right, Senator, it could be a requirement of local——

Senator CURTIS. So if the American company does not go there to create the business activity, maybe some other industrial country would have the corporations that would move in the back way.

Mr. LIBIN. Very definitely.

Senator RIBICOFF. Of course, what is going on now?

I assume that comparative inflation and productivity and wages and social benefits in many of our competitors are now more costly than for American corporations or maybe American corporations could compete, which they apparently are in view of the increase in exports for the past couple years. But let me ask you, do you feel that the German and Canadian legislation is better legislation than subpart F?

Mr. LIBIN. In certain respects I think it is an improvement over ours. It is certainly no less complex than ours.

Senator RIBICOFF. In your opinion would the German and Canadian legislation bring in more tax revenue to the American Treasury than subpart F?

Mr. LIBIN. That is a difficult question for me to answer right now, Senator. I think in some respects it would not. In other respects it might. I cannot give you a——

Senator RIBICOFF. Mr. Woodworth, do you think the German and Canadian legislation if provided here, would differ much in revenue effect from the American version of subpart F?

Mr. WOODWORTH. I do not think it would be much different.

Senator RIBICOFF. Not much different at all. Thank you.

[The prepared statement of Mr. Libin follows:]

STATEMENT OF JEROME B. LIBIN, SUTHERLAND, ASBILL & BRENNAN

Proposals to Eliminate Deferral of U.S. Taxation on Foreign Source Income

SUMMARY

1. Fundamental legal principles of international taxation strongly support the continuation of our present system of taxing income earned by foreign subsidiaries of U.S. corporations.

2. The most compelling rationale for retaining deferral of active business income of foreign subsidiaries is the tax principle that all taxpayers similarly situated should have the opportunity to secure equal tax treatment. The most striking feature of the proposal to eliminate deferral is that it would place the

United States alone among nations in denying to its corporations the opportunity to compete on an equal footing in the international marketplace.

3. The Subpart F provisios of the Internal Revenue Code, as amended by the Tax Reduction Act of 1975, have largely remedied the problem of tax avoidance or abuse by U.S. corporations. Essentially all that remains in the way of true U.S. tax deferral of foreign source income earned by a controlled foreign corporation is income which is legitimately retained by the foreign corporation for use in its own non-tainted business activities..

4. The argument that eliminating deferral would promote "tax neutrality" is unsound.

5. Subpart F should continue to be relied upon as the appropriate vehicle for imposing a current U.S. tax on certain types of income earned by controlled foreign subsidiaries, but these provisions should now be reviewed in their entirety to assess their impact on current patterns of international business. As part of this review, serious attention should be paid to legislation recently enacted by Canada and Germany—two other major nations with interests similar to ours in this area.

STATEMENT

Mr. Chairman and Members of the Committee: The purpose of my remarks is to focus on certain fundamental legal principles of international taxation which I believe strongly support the continuation of our present system of taxing income earned by foreign subsidiaries of U.S. corporations. Indeed, a departure from our present system in favor of current U.S. taxation of all income earned by controlled foreign subsidiaries would make the United States unique among the leading nations of the industrialized world in the application of its tax laws to foreign source income.

General international tax principles

The proper starting point for resolving the question whether our present system of taxing controlled foreign subsidiaries is sound is, in my opinion, one of the very basic and fundamental principles of international taxation—that income derived from business activity conducted in a particular country is to be subject to tax in the first instance by the host country (the country where the income originates). Thus, when foreign business activity is not conducted through a separate taxable entity, e.g., when a corporation located in one country undertakes to operate in another country through a branch office, both the country where the income originates and the country where the corporation is located may assert a right to tax the same earnings currently. In such a case, under well-accepted principles, the country of residence yields to the country where the income originates in order to avoid international double taxation of the same income. The United States, which taxes the world-wide income of its corporations on a current basis, gives recognition to this basic principle by allowing a tax credit for income taxes paid to the country where the foreign source income originates. While the United States does exercise its residual right to impose a tax on such income, it collects only the difference between its tax and the tax imposed by the host country.

When foreign business activity is conducted through a separate legal entity, e.g., a controlled foreign subsidiary organized and managed in the host country, the primary right of the host country to tax the income earned within its borders is not in dispute. In such a case, the country of origin of the income and the country of residence of the entity are one and the same. The "residual" right to impose further taxes on the earnings of the controlled foreign subsidiary then rests with the country of location of the owner of the entity, i.e., the parent corporation. The applicable principle of taxation in such situations has also heretofore been well recognized: the parent corporation of the controlled foreign subsidiary is taxed, if at all, when the earnings of the subsidiary are distributed to it as dividends. Stated another way, exercise of the residual right to tax the earnings of a controlled foreign subsidiary is deferred until such earnings are actually remitted to the country where the parent is located. Only in situations evidencing tax abuse or international tax avoidance have certain countries, including the United States, asserted the right to impose a current tax on the undistributed earnings of a controlled foreign subsidiary.

Additional tax principle supporting deferral

Yet another fundamental tax principle, well engrained in both the U.S. tax law and the international tax order, provides an additional rationale for the

deferral of tax on the earnings of foreign subsidiaries. That principle is that all taxpayers similarly situated should have the opportunity to secure equal tax treatment. In an imperfect world, when overall foreign investment is of a substantial magnitude, but different countries impose various tax rates and employ widely different tax systems, it is essential that there be a means by which all business enterprises, both domestic and foreign, may compete in a particular marketplace on an equal tax footing. Otherwise, true economic competition across national boundaries would be seriously distorted by the divergent tax liabilities that would be imposed on the competing enterprises.

The internationally accepted mechanism for achieving current tax equality in the conduct of an active business in a particular country is through the formation of a separate legal entity which is taxed on a current basis only by the country in which the business is conducted. It is, of course, the parent company's choice whether to operate in a foreign country through a branch or a subsidiary. Frequently, non-tax factors will be determinative. However, if the parent seeks current tax equality, but its home country imposes a current tax on its worldwide income, the only technique available to it to achieve its tax objective is the use of a foreign subsidiary.

The elimination of tax deferral by Congress would have the effect of equating the taxation of U.S.-controlled foreign subsidiaries with the present taxation of U.S.-owned foreign branch operations, i.e., it would impose a current U.S. tax on the subsidiary's income when earned. It would, therefore, completely vitiate the internationally recognized mechanism which is available to place business enterprises in a particular country on an equal footing from a current tax standpoint. This, I submit, is novel and inappropriate tax policy. Surely, the adoption of such a sweeping change in our tax laws should only be undertaken for the most compelling of reasons, and should not be adopted before every reasonable alternative has been thoroughly explored.

Prior U.S. Approach to the Problem

The basic question here under consideration is, of course, not new to the members of this Committee or to the Congress. Fifteen years ago it was proposed that deferral be completely eliminated as it applied to income earned abroad by foreign subsidiaries of U.S. corporations. At that time, Congress rejected so radical a change in our tax system in favor of the more limited, albeit complex, approach embodied in Sections 951 et seq. of the Internal Revenue Code, commonly referred to as "Subpart F."

Under the Subpart F provisions, certain specific types of income derived from foreign operations conducted by a controlled foreign corporation (CFC) are taxed currently to the U.S. parent, irrespective of whether actual dividend distributions are made. The types of income subject to current taxation include the following:

(1) income of a passive nature such as rents, royalties, dividends and interest, with certain enumerated exceptions, including, by way of example, dividends received by a CFC from a subsidiary incorporated and operating in the same country;

(2) sales income from property purchased from, or sold to, a related person, if the property is manufactured and sold for use or consumption outside the country where the CFC is incorporated;

(3) income from services performed for or on behalf of a related person, if the services are performed outside the country in which the CFC is incorporated;

(4) certain shipping income;

(5) income from the insurance of U.S. risks; and

(6) earnings of the CFC invested in certain types of U.S. property.

The Subpart F provisions were designed to curb tax avoidance by U.S. individuals and corporations with respect to passive foreign investments and certain types of active foreign business operations. They represented a major innovation in the international tax order when adopted in 1962. Congress was rightfully concerned about the abuses which had resulted from the artificial shifting of income from high-tax to lo- or no-tax countries, largely through the use of so-called foreign base companies located in various tax havens. It can be fairly stated that the Subpart F provisions have been quite effective in remedying such abuse situations.

The recent amendments adopted as part of the Tax Reduction Act of 1975 have further tightened the grip of Subpart F on foreign source income derived by

controlled foreign corporations. In its original form, Subpart F contained certain exceptions which enabled U.S. corporations to cause the distribution of earnings from a second-tier foreign subsidiary to a first-tier foreign subsidiary located in a different country without automatically subjecting the full amount of such earnings to a current U.S. tax. These exceptions included the so-called minimum distribution rules and the less developed country reinvestment rules. In addition, unless at least 30 percent of the controlled foreign subsidiary's gross income was of the tainted variety, the provisions of Subpart F had no application with respect to such income. Last year, Congress acted to modify or eliminate these exceptions. Both the minimum distribution provisions and the less developed country reinvestment provisions were repealed, and the 30 percent threshold figure was reduced to 10 percent of gross income. As a result of these changes, when earnings are withdrawn from investments in any country, they will likely be subject to immediate U.S. taxation whether or not actually remitted to the U.S. parent company.

Indeed, as a result of the 1975 amendments, it has been suggested that very little is left in the way of opportunity for true U.S. tax deferral of foreign source income earned by a controlled foreign subsidiary. Essentially all that remains untaxed by the U.S. on a current basis today is the income that is retained by a controlled foreign subsidiary to expand its own non-tainted business activities. The current proposals for eliminating deferral thus actually seek to prevent even that legitimate use of foreign source income without first subjecting it to a full U.S. tax.

Response to arguments for ending deferral

The primary argument advanced by the opponents of deferral is that taxes should be a neutral factor in determining whether a U.S. corporation makes a domestic or a foreign investment. As long as deferral exists, the argument runs, our tax law encourages foreign investment, at least in those countries where the local tax rate is less than our 48 percent rate. Only by eliminating deferral, so that both foreign and domestic investments would be taxed at the same 48 percent rate, would taxes become a neutral factor in weighing investment decisions.

The fallacies in this argument should be apparent. First, other provisions in our Internal Revenue Code expressly discriminate in favor of domestic investment over foreign investment. As prime examples, the investment tax credit, generally regarded as the strongest single incentive to capital investment, and the liberalized depreciation deductions permitted under the Asset Depreciation Range (ADR) system, are not available for property used "predominantly outside the United States." No suggestion has been offered thus far to end these differences in treatment in order to neutralize the effect of our tax laws on investment decisions.

Further, assuming that the foreign investment is made through a foreign subsidiary, which is a prerequisite for the deferral of U.S. tax, numerous other distinctions between the treatment of domestic and foreign corporations are evident. Thus, with one very limited exception, foreign subsidiaries, in contrast to domestic subsidiaries, may not join in the filing of a consolidated return with their U.S. affiliates. As a result, losses of a foreign subsidiary may not be utilized to offset income derived by such affiliates. In addition, while distributions of appreciated property by a domestic subsidiary to its U.S. parent are taxed only to the extent of the subsidiary's basis in the distributed property, similar distributions by a foreign subsidiary are taxed at fair market value. Even if it is acknowledged that these differences in the treatment of foreign and domestic subsidiaries must be eliminated if deferral is to be eliminated, the U.S. tax law would not be neutral with respect to foreign investment so long as the investment tax credit and ADR system discriminate in favor of capital investment in the U.S.

Secondly, eliminating deferral would have no significant effect with respect to U.S. investment in the developed, industrialized countries of the world, where corporations are already subject to tax rates comparable to, and in some instances higher than, U.S. rates. Our foreign tax credit would substantially reduce, if not eliminate, any additional tax resulting from the removal of deferral with respect to foreign subsidiaries operating in such countries.

In this connection, it is noteworthy that the dollar amount of U.S. foreign investment in these countries at present far exceeds the amounts invested in the less developed countries. U.S. companies have chosen to invest in the developed countries notwithstanding the high tax costs incurred, because the reward potential associated with such investments is considered to outweigh the risks

involved, and because the U.S. investor can be assured of equal tax treatment with his foreign and domestic competitors there.

By contrast, the elimination of deferral would undoubtedly deter fresh investments in the low-tax countries. The non-U.S. investor would have a distinct competitive advantage in the marketplace, and the reward potential to the U.S. investor would be greatly diminished in relation to the risks inherent in such ventures. In addition, the imposition of a current U.S. tax would likely force the repatriation of earnings from an existing foreign subsidiary to its U.S. parent in order to permit payment of the tax. To the extent such funds are needed to maintain the subsidiary's competitive position locally, that position would obviously be impaired unless fresh funds were invested in the enterprise. The reinvestment of earnings for purposes of growth and expansion would be similarly restricted, quite possibly leading to a decision to cease further operations. Under the guise of neutrality, therefore, the opponents of deferral actually would achieve a blockage of foreign investment in the developing countries.

Moreover, since one effect of a decision by Congress to eliminate deferral would be to nullify, insofar as U.S. corporations are concerned, the tax incentives presently being offered by the less developed countries to attract foreign investment, retaliatory action should not be discounted. It is entirely possible that such countries would respond by increasing their income tax rates, or at least their withholding tax rates, to collect for themselves more of the tax dollars that would otherwise flow from investment in their countries to the U.S. Treasury. Since many developing countries do not presently have tax treaties with the United States, there can be no assurance such tax increases would not occur.

Recommendations

I urge that Subpart F continue to be relied upon as the appropriate vehicle for imposing a current U.S. tax on certain types of income earned by controlled foreign subsidiaries. It is clear, however, that the approach of piecemeal, fragmentary amendments to Subpart F has suffered from a lack of perspective. Every year or two fresh battles are waged on certain basic questions, but no overall review of the scope and effectiveness of the provisions has been undertaken. Yet, it is indisputable that many of the old patterns of conducting international business no longer exist, and many new ones have taken their place. I therefore urge that a complete re-examination be made of Subpart F in its entirety. My thought is that some presently covered categories of income would be eliminated to reflect the current realities of international business activity, while certain new categories of income might be added. At the same time, an opportunity would be presented to eliminate some of the complexity presently existing in Subpart F and its accompanying regulations. (It should be kept in mind that the removal of deferral would not necessarily simplify the tax treatment of foreign source income, since many technical problems would still have to be resolved.)

Subpart F was a revolutionary tax concept when first enacted. Its approach has recently been emulated in legislation adopted by two other major nations with interests similar to ours in dealing with problems of this type—Germany and Canada. Significantly, both countries have attempted to improve upon our basic approach, and have sought to tailor their legislation more precisely to current international business practices. Neither country has opted for the extreme action of eliminating deferral altogether. Should the United States so act, therefore, it would stand alone.

In re-examining Subpart F, Congress should study carefully the German and Canadian legislation. Consideration might be given, for example, to the German technique of defining what types of foreign source income would *not* be subject to current taxation, allowing all other types of income to be so taxed, or of limiting current taxation only to income not subject to a minimum level of taxation abroad, or to the Canadian technique of permitting the use of intermediate foreign holding companies to serve as vehicles for the financing of affiliated-company business activities without adverse tax consequences.

A thorough and complete study of the type here recommended would undoubtedly result in many improvements to our present tax treatment of foreign source income, without at the same time eviscerating fundamental tax principles which strongly support the viability of our complex and interdependent world economy.

Senator RIBICOFF. Perry Wilson, chairman of the board, Union Carbide, in behalf of the Manufacturing Chemists Association.

STATEMENT OF F. PERRY WILSON, CHAIRMAN OF THE BOARD, UNION CARBIDE CORP., ON BEHALF OF MANUFACTURING CHEMISTS ASSOCIATION

Mr. WILSON. Mr. Chairman and members of the committee, I am F. Perry Wilson, chairman of the board, Union Carbide Corp. and appearing here today on behalf of the Manufacturing Chemists Association. The association is a nonprofit trade organization representing more than 90 percent of the Nation's productive capacity of basic industrial chemicals.

Accompanying me are Matthew P. Landers, treasurer of Pfizer, Inc., and John F. Mooney, tax counsel of Union Carbide Corp. Our statement, Mr. Chairman, has been submitted which we would like the committee to accept for the record.

My discussion will summarize three main areas of interest. These are capital formation, taxation of foreign income, and DISC.

Chemical manufacturers constitute a capital intensive industry which must invest large sums in order to maintain modern, efficient industrial facilities, to increase productivity and to remain competitive at home and abroad. Additionally, these investments are particularly necessary to create new jobs for an expanding labor market.

The American economy currently faces a serious capital shortage which we in the chemical industry believe should be corrected as quickly as possible. Accordingly, it is our opinion that your committee should carefully consider policies which assist business to generate greater funds internally to meet capital requirements.

Any sound tax reform should contain capital formation incentives so as to encourage expansion of our industrial base and contribute to an increased productivity in this Nation. This, in turn, will reduce the present high unemployment and greatly assist in moderating and controlling inflation.

The Manufacturing Chemists Association has been consistent in its position that the investment tax credit and the asset depreciation range system are vital features of our Federal income tax structure.

Accordingly we urge that the 10-percent investment tax credit be made a permanent part of the income tax structure and that larger capital cost allowances be provided.

In addition, while we recognize the legislative difficulties involved, we recommend for your serious consideration the following provisions: Reduction of the corporate income tax. This would generate new capital funds internally for reinvestment and would provide higher yields, which will encourage new investment in equities. Eliminate the double taxation of dividends either at the corporate or shareholder level by integrating the present separate taxation of corporations and shareholders. Change the present method of taxing capital gains either by allowing reinvestment of capital assets to be excluded from tax or by providing that the tax diminish as the holding period of such assets increase.

Members of the chemical industry believe that foreign markets are best served by exports from the United States so long as foreign government regulations and competitive factors permit. Foreign operations are only established when it is impossible for the market to be served by manufacturing in this country. We do not build plants abroad for tax reasons.

The chemical industry is a positive contributor to the national trade account. The 1975 foreign trade surplus of the industry approximated $5 billion and the industry has provided a trade surplus of $27 billion over the past 10 years. There is also ample evidence that direct investment abroad has served to increase exports of U.S.-manufactured products to the same markets where the U.S.-owned foreign manufacturing exists.

My own company, which has a long history of international business, has made an in-depth study of our foreign operations over a 24-year period and, Mr. Chairman, copies of this study are on file with the staff of your committee.*

Our findings conclusively show that as foreign investments increase, so did our overall U.S. exports. These exports consisted of other allied, intermediate or accessory products, and these were higher due to the "pull effect" of our foreign investment base. Further, our U.S. employment was proportionately higher as a result of our increased exports.

In addition, it is fallacious to assert that if U.S. investments abroad were terminated, these markets would be supplied from the United States.

Similar studies by other companies, industry associations and government agencies are consistent with our findings.

The foreign tax credit historically has been the cornerstone by which the United States has eliminated international double taxation. Its repeal would increase the effective rate of taxation on most foreign operations by an additional 23 to 25 percent. When this is added to the normal income tax due in most countries, the combined effect is a tax rate of 72 to 75 percent of earnings generated abroad.

This repeal would be a gross discrimination against foreign operations, which would seriously affect the ability of U.S. corporations to compete, with the consequent loss of jobs in the United States and reduction in the flow of earnings from abroad. We recommend that the existing provisions of the tax law in this area be retained.

A basic principle of taxation both in the United States and abroad is that a corporation, like any shareholder, is taxable solely on income from investments only when received. Disregard of this fundamental concept will discriminate against U.S. interests which operate through foreign subsidiaries and will create an advantage to foreign competitors.

Current U.S. taxation of foreign earnings and profits of controlled foreign subsidiaries will result in a higher burden of taxation. Funds to pay these increased taxes will have to be withdrawn from these investments abroad and will seriously impede the U.S. capacity to compete in foreign markets. Again we recommend that no change in current law be made in this area.

The DISC concept was adopted in an effort to create more jobs for American workers and to reverse the downward spiral of our badly deteriorating balance of payments by making U.S. products more competitive on the international scene. We believe that the DISC incentive has accomplished what it was intended to accomplish.

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* The study was made a part of the official files of the committee.

U.S. exports for 1971 were approximately $43 billion. Since the enactment of DISC the U.S. export level has increased to $107 billion in 1975.

While some of this increase is attributable to dollar devaluation, no doubt DISC played an important role. DISC has enabled us to become competitive and places the national focus on U.S. exports.

In 1976, it is expected that increased raw material imports associated with our economic recovery will bring a significant decline in our balance of trade. Accordingly, it would be most imprudent to make any changes in the DISC provisions.

We urge that they be retained in their present form.

Lastly, Mr. Chairman, H.R. 10612 contains several items on which we have commented specifically in our extended written paper, which we call to your consideration.

We appreciate, Mr. Chairman, the opportunity of presenting our views on these areas of importance to the chemical industry.

Thank you very much.

Senator RIBICOFF. Thank you very much, Mr. Wilson.

Senator Packwood?

Senator PACKWOOD. Mr. Wilson, on the opening page of your summary you talk about reducing the corporate income tax rate and retaining DISC. I will ask you the same question I have asked others.

Which would you rather have, DISC and 48 percent or no DISC and 46 percent?

Mr. WILSON. Speaking for my own company we would take the 46 percent on the basis that you said it would be permanent.

Senator PACKWOOD. On all corporate profits, not just export profits.

Mr. WILSON. I can't answer for other companies, of course. I have no hesitancy on ours.

Senator PACKWOOD. It is an excellent statement. I agree with 90 percent of it.

Thank you very much. I have no other questions, Mr. Chairman.

Senator RIBICOFF. I was just curious. I asked our counsel what the difference would be in money to the Treasury of the 46 percent rate as against elimination of DISC. Do you know, Larry?

Mr. WOODWORTH. We understand that a 2-percent decrease in the corporate surtax rate would cost about $2.6 billion in revenue. A 2-percent decrease in the normal rate would cost about $2.9 billion, and a 1-percent decrease in the normal rate would cost about $1.45 billion.

The cost of the DISC provisions is estimated at $1.45 billion for 1977. This, however, does not take into account the recapture of amounts previously deferred. If recapture of amounts previously deferred were to be spread over a 4-year period, this would give rise to an additional revenue pickup of about $1.2 billion. This $1.2 billion added to the $1.45 billion from ending new deferrals would roughly match the revenue loss from a 2-percent drop in corporate rates.

Senator PACKWOOD. Thank you, Larry.

Senator RIBICOFF. Senator Hansen?

Senator HANSEN. I don't have any questions.

Let me compliment you, Mr. Wilson, on your statement.

Mr. WILSON. Thank you.

Senator RIBICOFF. Mr. Wilson, so there won't be any discrimination——

[Laughter.]

Senator RIBICOFF. I am going to have to ask you the same questions I have asked the other witnesses. How many manufacturing chemists are there in your association?

Mr. WILSON. There are 188.

Senator RIBICOFF. I would imagine out of those 188 some comply with the Arab boycott and some don't, like the rest of the segments of American business.

Mr. WILSON. I suppose.

Senator RIBICOFF. Do you think we should have a different treatment of those that do comply with the boycott and those that don't?

Mr. WILSON. Senator, from my own personal standpoint and my company's standpoint, we are opposed to boycotts. Our company policy has always been that in terms of trade that we engage in any place in the world, that we engage in it on the basis of nondiscrimination, based on race, creed, color, country or national origin.

Frankly I would think that the question that you have asked is one that can certainly be better answered by the U.S. Congress than by me as an individual.

I don't know whether the tax code is the place to handle this or not. I think the Senate would be in a position to make this judgment.

Senator RIBICOFF. Well, you can see something. Here you are, you are competing with many of the other companies——

Mr. WILSON. Right.

Senator RIBICOFF [continuing]. You have *a* country which will not allow your goods to be sold in their country because, let's say, you don't comply with the boycott and your competitor does comply with the boycott and he gets the business and you don't.

Now, in getting that business, he gets certain tax benefits because of our tax laws. Why should you and I be giving these benefits that you don't receive because you won't comply with the boycott?

[No response.]

Senator RIBICOFF. Thank you very much, Mr. Wilson.

Mr. WILSON. Thank you, sir.

[The prepared statement of Mr. Wilson follows:]

STATEMENT OF F. PERRY WILSON, ON BEHALF OF THE MANUFACTURING CHEMISTS ASSOCIATION

SUMMARY

1. Capital formation

The chemical industry is a capital intensive industry which requires large amounts of capital to modernize its plants and equipment, to increase its productivity, and to improve its competitive capabilities throughout the world. We recommend the adoption of tax incentives, such as making the 10% investment tax credit permanent, reducing the corporate income tax rate and providing additional cost recovery allowances, to assist industry to generate sufficient funds internally to meet capital requirements. The increased capital investment in production facilities, which these tax incentives will help to generate, will provide a boost to the economy, will create more jobs, and will reduce the inflationary trend.

2. Taxation of foreign income

In order to remain competitive with foreign industry both at home and abroad, it is important that U.S. industry not be placed at a disadvantage as compared to the tax treatment extended to foreign industries by their parent governments. We recommend that no change be made (1) in the foreign tax credit provisions and (2) in the timing of the imposition of U.S. tax on foreign earnings of foreign subsidiaries. In order to stimulate exports and to improve our balance of payments position, we recommend that DISC be retained. We also recommend that the provisions of the Internal Revenue Code relating to Western Hemisphere Trade Corporations and U.S. Possessions be retained. In order to avoid delays in regard to corporate reorganizations involving foreign subsidiaries, we propose that section 367 of the Internal Revenue Code be amended to delete the requirement that an advance ruling be obtained from IRS that the proposed exchange does not have as one of its principal purposes the avoidance of Federal income taxes.

STATEMENT

Mr. Chairman and Members of the Committee: My name is F. Perry Wilson. I am Chairman of the Board of the Union Carbide Corporation and appear before you today on behalf of the Manufacturing Chemists Association.

The Manufacturing Chemists Association is a nonprofit trade association having 188 United States company members representing more than 90 percent of the production capacity of basic industrial chemicals within this country. Our member companies also carry on extensive international operations throughout the world.

I sincerely appreciate the opportunity to present to this Committee the Association's views on tax revision. My testimony is directed to the two areas of particular interest to the U.S. Chemical industry, namely, capital formation and the taxation of foreign income.

Capital Formation and Tax Policy

The Problem

Today, the United States faces a severe capital shortage. Since World War II our investments have been inadequate to meet our aspirations for growth. Now, more must be invested, not only to create new jobs, but also to improve productivity and the supply of goods to avert another severe inflation-recession cycle.

A work force growing by 15 million in the next 10 years needs capital tools. The future requires greatly increased capital intensification as inflation has significantly increased the cost of plant and equipment over that experienced in recent years. Experts have estimated our capital needs at between $4 and $5 trillion for the period 1974–1985. The New York Stock Exchange has estimated a $4 billion per month capital shortage over the next 10 years.

The Cause of the Problem

Over a period of years the high emphasis placed on income taxes as a major revenue source has fostered a bias in favor of consumption spending rather than capital accummulation. Thus, an individual is naturally inclined toward current spending rather than investing funds where income accumulates very slowly because of the heavy tax burden. Furthermore, the total investment is eroded due to continuing inflation.

In addition, where such funds are invested in equities, the double tax on corporate profits—first to the corporation and then to the individual on dividends—discourages this form of investment. Even when the second tax is avoided by retention of corporate earnings, the ensuing growth in caiptal is subsequently subjected to capital gains taxes with little consideration given to the inflationary forces which have reduced the purchasing power of the capital accumulated.

Government monetary and fiscal policies have also exacerbated the capital shortage. Unless savings develop commensurate with capital requirements, government deficits create inflationary trends. In addition, high government borrowing competes for available capital, causing interest rates to rise and redirect-

ing funds otherwise available for equity investment. As capital expansion and productive capacity is thus restrained due to fiscal policies, the ultimate result is a failure to maintain economic growth and to meet foreign competition.

Finally, the need to develop higher environmental standards has contributed to the capital shortage. In 1974 about 11 percent, or $10.4 billion, of the capital spending in manufacturing was directed toward pollution control and occupational safety factors. In chemicals the percentage was 12.5%. From 1973 to 1982, pollution control expenditures have been estimated at about $90 billion. However necessary, we must not forget that such investments do not directly increase productivity but, instead, divert already scarce capital funds.

EFFECTS OF THE SHORTAGE

Insufficient capital investment curbs productivity, limits job opportunities and, in a growing labor market, creates unemployment. In the early 1970's capital formation per person added to the work force fell about 25% from the mid-1950's to mid-1960's. While capital has been declining in the current decade as approximately 15 million people enter the labor force, minimum capital investment of between $40–50 thousand will be needed to create each new industrial job; but we are falling far short of raising the amount of capital needed to maintain the growth in employment opportunities necessary to absorb this increased work force.

The high rate of inflation over the last 10 years has added to this unemployment situation. Because of it depreciation reserves have been insufficient to replace worn out assets with newer higher priced ones. This, in turn, has led to plant shutdowns and other operating insufficiencies.

One source of equity funds to combat inflation is through retention of corporate earnings. However, when earnings are adjusted to eliminate inventory profits and underdepreciation, 1974's rate of earnings drops to less than half of 1965's. The overstatement of income stemming from faulty accounting procedures means, in the last two years, corporations have been paying taxes at an effective rate of almost 70% and, after payment of dividends, have had no effective retention of earnings for growth.

One of the effects of inflation and lack of equity capital has been corporations' greater reliance on debt financing. In 1964 debt-equity rates were 25.4 percent. By 1973, the average was 44 percent. Another indication is the ratio of net operating income to interest. In 1960 it was over 14 to 1. Now it is under 5 to 1. As a result of these ratios, many companies are now experiencing increased difficulties in obtaining additional loans from banks and other financial institutions.

Finally, the U.S. economy is steadily losing its position as an international leader as indacted by the following facts:

United States fixed investment as a share of national output was last among a group of eleven major OECD countries.

The United States growth rate of real gross national product for the period 1960–1973 was 4.2% as compared to Japan's rate of 10.5%. Canada, France, Germany and Italy were all above the U.S. growth rate.

Depreciation practices in the U.S. lag behind those of other countries. The United Kingdom permits a one year write-off, Canada two years, and Sweden a 60 percent write-off in the first year.

POSSIBLE SOLUTIONS

To reverse current trends it is essential that a new emphasis be directed toward capital formation. Among the possible remedies that might be adopted are the following:

(1) Reduce the corporate tax rate. A greater proportion of profits would then be available for reinvestment or, if paid as dividends, the higher yield to individuals would encourage new investment in equities.

(2) Review the capital recovery system so that the cost of manufacturing facilities will be recovered over a shorter period of years. This could include liberalization of the ADR system.

(3) Make the 10% investment tax credit permanent.

(4) Reduce double taxation of corporate earnings by either adopting a split-rate system whereby distributed earnings would be taxed at a rate lower than retained earnings, or by allowing shareholders a credit or a deduction for taxes paid by the corporation.

(5) Reconsider present methods of taxing capital gains including possibly allowing reinvestment rollovers to be excluded from tax, or providing that the tax rate diminish as the holding period of the capital assets increases.

The Secretary of the Treasury, in his appearance before the Senate Finance Committee on March 17, 1976, recommended substantially all of the proposals enumerated above in some degree. He proposed a permanent reduction in the corporate income tax rate from 48 percent to 46 percent, a permanent 10 percent investment tax credit, a system of eliminating double taxation of corporate earnings, and a program for phasing down the tax rate applicable to capital gains the longer the capital assets are held. The Secretary emphasized that measures such as these are essential to continued long range capital formation, which is vital to the well-being of our country. The Manufacturing Chemists Association strongly supports the thrust of the Secretary's proposals.

Capital formation is essential to provide efficient machinery and equipment which will create improved productivity, economic growth and expanded job opportunities. The excessive emphasis on corporate income taxes, double taxation, and capital gains taxation has created a bias against equity investment. This bias has been further expanded by fiscal and monetary policies which have created competition of the government with business for needed capital. Current capital recovery rules and high inflation have prevented corporations from retaining needed funds to replace existing machinery. To reverse these processes it is essential that the corporate and individual income tax laws be revised so that capital formation is stimulated.

One final observation with respect to the possible remedies which might be adopted: The general rule in providing tax changes has always been to estimate the immediate tax effect of such changes. Under this rule, each of the remedies suggested seemingly would invlove loss of revenues which would have to be made up through other changes or balanced through reduced governmental spending.

What is often ignored is the fact that tax changes designed to increase capital formation improve productivity; this, in turn, increases income and employment, thereby yielding more taxes. It is only the net effect that is truly important. This effect, over a relatively short period of time will, in our estimation, prove positive.

TAXATION OF FOREIGN INCOME

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

In 1974, the level of chemical direct investment abroad amounted to $10.17 billion. This represents 14.7 percent of the 1974 U.S. chemical assets.

The chemical industry is a positive contributor to the national trade account. The 1975 foreign trade surplus of the industry approximated $5.0 billion with exports in the neighborhood of $8.7 billion and imports of $3.7 billion. The industry has provided a trade surplus of $27 billion over the past ten years.

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

TAXATION OF UNREMITTED EARNINGS OF FOREIGN SUBSIDIARIES

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

Any attempt by the U.S. Government to disregard this fundamental concept of taxing income only when earned by entities within its jurisdiction will dis-

criminate against U.S. interests which invest in foreign enterprises and will create an advantage to foreign competitors of U.S. industry. Current U.S. taxation of foreign earnings and profits of controlled foreign subsidiaries will result in a higher burden of taxation which will have to be paid currently. In most cases, funds will have to be withdrawn from investment abroad resulting in a serious reduction in U.S. enterprises' capacity to compete for the foreign markets.

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

1. Additional dividend withholding tax payments to foreign countries will presumably result since increased distribution of dividends would be the logical consequence. The combined income tax and withholding taxes in many foreign countries will serve to eliminate any U.S. taxes which might otherwise result from requiring full taxation currently of the foreign subsidiary's earnings.

2. Funds required by foreign subsidiaries for working capital, repayment of loans, and capital expansion will be drained away, thereby creating a strain on such companies' resources. Unilateral action by the United States which would lead to increased withholding taxes paid to foreign governments will do nothing to improve the U.S. economy but can limit the financial well-being of U.S. interests abroad.

3. Foreign countries with lower tax rates than the United States will have a tendency to increase their rates or increase their withholding taxes to offset any added tax imposition by the United States. Furthermore, some basic changes in the double taxation conventions which presently prescribe lower withholding rates may well take place.

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

The following table illustrates this point:

	Foreign income tax	Foreign withholding tax on dividends [1]		Effective foreign income tax rate
		Amount	Percent	
Canada	43.0	$5.13	15.0	51.6
France	50.0	1.50	5.0	51.5
Germany	44.0	5.10	15.0	49.1
Japan	44.0	3.36	10.0	49.6
Netherlands	47.0	1.60	5.0	48.6
United Kingdom	52.0	4.32	15.0	59.2
Average for group	46.6	3.50	10.8	51.6

[1] Per $100 earnings, assuming 60 percent payout of net earnings as dividends.

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

THE U.S. FOREIGN TAX CREDIT SYSTEM

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

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

[In percent]

	Country in which subsidiary operates and pays tax					
	Canada	France	Germany	Japan	Netherlands	United Kingdom
Corporate income tax rate on subsidiary's earnings	43	50	44	44	47	52
Statutory rate of withholding tax on dividends to parent located in the following:						
United States	15	5	15	10	5	0
Canada	...	15	15	15	15	0
France	15	...	25	15	5	0
Germany	15	0	...	10	10	0
Japan	15	15	25	...	5	0
Netherlands	15	5	10	10	...	0
United Kingdom	15	5	25	10	5	...
Tax imposed on dividends received:						
By the United Kingdom on United Kingdom parent	4	0	0	4	2	0
By all other countries on parent company located therein	0	0	0	0	0	0
By United States—if Burke/Hartke type proposal were adopted	25	23	24	25	24	23
Combined effective rate of tax on income retained by subsidiary and income distributed to parent located in the following:						
United States	48	52	49	47	49	[1] 52
Canada	...	55	49	49	52	52
France	48	...	53	49	49	52
Germany	48	50	...	47	50	52
Japan	48	55	53	...	49	52
Netherlands	48	53	47	47	...	52
United Kingdom	52	53	53	52	52	...
United States—if Burke/Hartke type proposal were adopted	73	75	73	72	73	75

[1] Under terms of a recently negotiated treaty yet to be ratified, United States shareholders would receive a partial refund of United Kingdom tax resulting in an effective tax rate of 48 percent.

Note: Above computations are based on assumed dividend distributions of 60 percent of net profits after foreign corporation tax.

The foregoing table illustrates the uniform pattern and consistency in tax rates and concepts which prevail in the capital exporting countries with respect to taxation of earnings, both domestic and foreign The dividend withholding taxes which range from 0% to 25%, with 10% and 15% predominating, are governed in many cases by a network of conventions for avoidance of double taxation.

It should be particularly noted that, with the exception of a small tax in the United Kingdom, no tax is paid to the country where the parent is located on receipt of dividends from earnings of subsidiaries in the other capital exporting countries. This situation would be severely changed by the United States for U.S. parents if the foreign tax credit were eliminated. This would create an additional tax of 23% to 25% as shown in the table. When this is added to the normal income taxes due in most countries, the combined effect is a tax rate of 72% to 75% for a U.S. parent with earnings abroad, a discrimination against foreign operations which would seriously affect the ability of U.S. corporations to compete.

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

In connection with our foreign tax credit system, proposals have been made for gross-up of dividends from less developed country corporations. Such a provision is contained in H.R. 10612, currently before your Committee. When the gross-up amendment was incorporated in the Internal Revenue Code in 1962 for purposes of computing the foreign tax credit, it was recognized that it would be inappropriate to extend this amendment to dividends received from corporations engaged in active conduct of business in less developed countries. To do so would have canceled out the advantage of generally lower income tax rates imposed by those countries in order to encourage development of their economy. We believe that no change should be made in this area. As long as it is the continuing policy of the United States to support economic expansion of less devel-

oped countries, the participation of private enterprise in this effort should be encouraged.

Under present law, alternative methods of computing the foreign tax credit are generally permitted. They permit taxpayers the flexibility of computing the credit according to their business requirements. Particularly, the choice between the overall limitation and the country-by-country limitation can be made depending on each taxpayer's own circumstances.

The Tax Reduction Act of 1975 eliminated the country-by-country limitation for the oil and gas industries. H.R. 10612 would eliminate this limitation for all taxpayers. Although it is our understanding that this method is only used by a limited number of taxpayers, nevertheless, the country-by-country limitation serves a useful purpose in encouraging investment in less developed countries. The reason for its adoption in 1954 is as sound today as it was when the Committee approved this election. The Committee pointed out at that time that with the overall method, losses in one country adversely affect the amount of the foreign tax credit allowable with respect to taxes paid to other foreign countries. The country-by-country limitation permits investment in less developed countries and at the same time continues the amount of foreign tax credit with respect to profitable countries.

For the foregoing reasons, the Manufacturing Chemists Association recommends that the foreign tax credit provisions be continued without change.

DOMESTIC INTERNATIONAL SALES CORPORATIONS

The DISC concept was adopted by Congress in the Revenue Act of 1971 in an effort to create more jobs for American workers, and to reverse the downward spiral of our badly deteriorated balance of payments by making U.S. made products more competitive on the international scene.

Many persons have attacked DISC as a high-cost item which has generated little tangible evidence that it has been effective in creating jobs and improving our balance of payments. The evidence of what DISC has accomplished is clouded mainly because dollar devaluation occurred at approximately the same time that DISCs were being implemented.

Nevertheless, the proof of the pudding is whether these objectives are being accomplished. The fact that other events have occurred which benefit DISC implementation and utilization should not be treated as detracting from DISC, but as catalysts which have aided in the successful use of DISC.

We believe that the DISC incentive has accomplished what it was intended to do. With respect to the creation of jobs, the Department of Commerce has estimated that each additional billion dollars of exports creates over 70,000 new domestic jobs and tends to create them in the most productive industries, thereby accelerating the overall economic growth and efficiency of the nation.

U.S. exports for 1971 were approximately $43 billion. With the enactment of DISC, by 1973 the U.S. export level had increased to $70 billion and continued its climb through 1975 to $107 billion. Without the ability to be competitive and without a national focus on exports, we doubt that exports would have increased in such a dramatic manner.

Our U.S. balance of payments, which had deteriorated so badly in 1971, has been effectively checked so that during most of the period of DISC's existence, the U.S. balance of payments has not deteriorated any further. Obviously, the dramatic increase in U.S. exports has had a very substantial effect on this.

The OPEC energy situation has significantly increased the country's cost of imported oil. During the current year, increased imports of oil associated with the economic recovery in the United States have had a significant impact on our balance of trade. We, therefore, feel that the DISC provisions continue to be very important.

The DISC incentive has been criticized by a number of people as being too costly. The House Ways and Means Committee Report accompanying H.R. 10612 states that the cost of DISC is $1.3 billion in 1975 and it is projected to be $1.4 billion in 1976.

H.R. 10612 proposes an incremental approach for the future computation of DISC benefits which is considered by some to be less costly and more efficient. In brief, only the excess export receipts of a DISC over a base period average export receipts will qualify for benefits. What advocates of this change fail to recognize is that any cost must be considered in the context of the total result attained such as the increased benefits of exports and employment resulting

from the DISC provisions. It is often overlooked that U.S. taxes are currently paid on approximately three-fourths of the profits on these export sales, and that total tax collections have been much larger because of increased exports. There is also increased employment growing out of these export sales that with its multiplier effect has also produced additional U.S. taxes. Since competition by foreign corporations is intense, the U.S. taxes paid on increased U.S. exports cannot be ignored when compared with the alternative of not collecting taxes on sales generated by foreign competition. We, therefore, feel that any measurable loss of revenue from the DISC incentive is more than compensated by the economic benefits accruing from the reported increases in U.S. exports from $43 billion in 1971 to $107 billion in 1975.

As you know, many other countries, both developed and developing, have substantial export tax incentive programs to encourage expansion of export trade. Some countries exempt all export trade profits from income tax, some exclude exports from the value added tax, and others provide various types of incentives. The DISC program we have today certainly is not expensive in terms of benefit generated as contrasted to the cost incurred by other countries in promoting export trade.

We must recognize, particularly as long as other countries provide export trade incentives, that the DISC incentive as presently constituted is not only desirable but essential to maintaining a competitive position in the international marketplace.

WESTERN HEMISPHERE TRADE CORPORATIONS

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

The Manufacturing Chemists Association believes that removal of the Western Hemisphere Trade Corporation provisions under current conditions would have an adverse effect on U.S. business interests in the Western Hemisphere and particularly in Latin America. Accordingly, we recommend that section 1052 of H.R. 10612, which would phase out the Western Hemisphere provision over a four year period, be rejected by your committee.

U.S. POSSESSIONS

The provisions of the Internal Revenue Code which apply to the United States possessions stem from the Revenue Act of 1921. Under substantially unchanged provisions since that date, United States corporations and United States citizens have been accorded certain tax advantages with respect to business carried on in our possessions. In general, it is provided that if a domestic corporation derives 80% or more of its income from sources within a possession and 50% or more of its income from active conduct of a trade or business within the possession, all of the foreign income of that corporation is excluded from United States taxation. The purpose of these provisions is to encourage American development of its underprivileged possessions by placing United States businesses operating in possessions on equal footing with competing businesses from other countries.

In general, the possessions have their own revenue laws. Several have introduced economic development programs for the express purpose of reducing poverty and unemployment. These programs, together with a favorable U.S. tax policy extended to U.S. possession corporations, have been very effective in attracting private capital investment into the possessions.

The Manufacturing Chemists Association recommends that no change be made that would jeopardize the beneficial development programs of these possessions and that the existing provisions of the Internal Revenue Code which support these programs be substantially retained.

The Manufacturing Chemists Association believes that the provisions included in H.R. 10612, which would permit current tax-free distribution of profits to United States parent corporations, would be beneficial, both from the United States and Puerto Rican viewpoints.

INTERNAL REVENUE CODE SECTION 367

Where a foreign corporation is a party to a reorganization, it is required that an advance ruling be obtained from the Internal Revenue Service that the proposed exchange is not in pursuance of a plan having avoidance of Federal income taxes as a principal purpose in order for the Subchapter C nonrecognition provisions to be applicable to exchanges in the reorganization.

Due to the increasing tempo of world-wide business, the number of reorganizations subject to section 367 has increased substantially in recent years, generally for compelling business reasons which are not tax motivated. At the same time delays are experienced in obtaining a favorable ruling in order to meet what is frequently a critical timetable in order to proceed with a proposed transaction.

Furthermore, in recent years, more detailed reporting to the Internal Revenue Service is required in regard to organizational changes in foreign subsidiary corporations. Therefore, the need for an advance ruling to protect government revenues no longer seems appropriate.

We have consistently recommended that section 367 be amended to meet present day requirements. Thus, an advance ruling would no longer be required prior to giving effect to a corporate reorganization, but the taxpayer would be able to request such a ruling if he so desired. We believe that section 1042 of H.R. 10612 constitutes constructive steps towards this objective. We particularly endorse the provisions granting taxpayers permission to obtain a ruling from the Internal Revenue Service after the transaction has occurred and the right to appeal to the Tax Court for its review of any IRS decision on the ruling request.

INVESTMENT IN U.S. PROPERTY

Under present law, any increase in investment in United States property by controlled foreign corporations may constitute a taxable distribution to their United States shareholders within the provisions of section 956. The present law is very broad in the classes of property which constitute U.S. investment. The Manufacturing Chemists Association has consistently taken the position that these provisions serve no useful purpose, and, in effect, are detrimental to the best interests of the United States. H.R. 10612 would restrict substantially the scope of section 956. It would limit the coverage of section 956 to (1) stock or debt obligations of a related United States person and (2) tangible property which is leased to or used by a related United States person.

The Manufacturing Chemists Association supports the action taken toward limiting section 956. We believe, however, that section 956 should be repealed completely. Where investment in United States property would constitute a disguised dividend, other sections of the Internal Revenue Code provide adequate methods of preventing abuse. We believe repeal of this section will remove the detrimental effect of those provisions upon our balance of payments.

REVISION OF FOREIGN TAX CREDIT COMPUTATTION FOR CAPITAL GAINS AND LOSSES

H.R. 10612 proposes changes in present law for the computation of the foreign tax credit limitation in situations which involve capital gain transactions. One of these proposed changes relates to the netting of long-term and short-term gains and losses in cases where some are U.S. source related while others are foreign source related. One specific revision incorporated in H.R. 10612 would require that losses from sources within the United States offset gains from sources outside the United States for purposes of determining taxable income from sources outside the United States in computing any foreign tax credit limitation.

We wish to call to your attention the reverse situation which should be accorded comparable treatment. Where the taxpayer has a net capital loss from sources outside the United States which offsets a net capital gain from sources within the United States, such foreign loss should also offset United States source capital gains in determining any limitation on the foreign tax credit.

In brief, it is recommended that foreign capital losses be, in the reverse situation, treated similarly to the proposal with respect to United States source capital losses.

RECAPTURE OF FOREIGN LOSSES

Section 1032 of H.R. 10612 relates to the recapture of the tax benefits of foreign losses. The House Ways and Means Committee Report accompanying H.R. 10612 points out that where an overall foreign loss exceeds foreign income in a particular year, the excess offsets United States taxable income and reduces United States taxes. Subsequently, when income is derived from those activities which contribute to the loss, the foreign tax credit, in many cases eliminates, or substantially reduces, United States tax on such income. Section 1032 is designed to prevent this advantage by requiring that in cases where an overall loss from foreign operation reduces United States tax on United States source income, the tax benefit derived from the loss is to be recaptured by the United States when income is derived from abroad.

The recapture mechanism contains two steps. The first step requires that an amount of foreign income earned in succeeding years be deemed to be United States source income to the extent of prior year's overall foreign loss. The second step reduces the amount of foreign income taxes in suceeding years in the same proportion that the amount of foreign income treated as United States source income bears total foreign income. This second step recalculates the amount of foreign income taxes which may qualify for foreign tax credit purposes. Foreign income taxes which are eliminated by this second step cannot qualify at any time for deduction and cannot be carried forward or carried back to other taxable years.

The proposed recapture provision will not operate equitably in many cases in so far as the second step is concerned because of a lack of correlation with the tax policies of foreign countries in which the foreign losses arise. Where a foreign country permits losses to be carried forward and deducted in the computation of its tax in later years, there will be a double reduction in foreign income taxes—once because of the foreign country's carryover and again under this proposed provision in section 1032. The reason is that no consideration is given as to the way this loss is treated in particular foreign countries. We recommend that your Committee provide a more equitable policy by (1) permitting the taxpayer to prove that the foreign country or countries in which the overall loss arose will allow a deduction for these items over a reasonable period of time and (2) requiring a recapture of the loss on a country-by-country basis, not on an overall basis, as now proposed.

We further point out that the reduction required under the second step covers the amount of "income or profits or excess profits taxes paid or accrued (or deemed to have been paid)." The inclusion of "deemed" tax payments will encompass carryovers and carrybacks which have already been whittled down in prior years and which should not be covered within another recalculation as to the year to which carried. We recommend that this be corrected.

Senator RIBICOFF. Dennis Bedell is our next witness.

STATEMENT OF DENNIS P. BEDELL, CHAIRMAN, AMERICAN MINING CONGRESS TAX COMMITTEE, ACCOMPANIED BY DAVID T. WRIGHT, PARTNER, COOPERS & LYBRAND

Mr. BEDELL. Thank you, Mr. Chairman. I am Dennis Bedell, and I am appearing before you today on behalf of the American Mining Congress which is a trade association representing all segments of the mining industry.

I am accompanied by Mr. David Wright, a partner in the international accounting firm of Coopers & Lybrand.

Mr. Chairman, we have a number of comments in our statement on various aspects of the subject of capital formation, such as the question of the investment credit, integration, and capital cost recovery al-

lowances. Our recommendations and our comments on those matters are included in our prepared statement. In view of the demands on the committee's schedule I would like to confine my oral testimony to the tax treatment of foreign mining activities.

Senator RIBICOFF. Without objection, the entire statement will go in the record as if read.

You may proceed, sir.

Mr. BEDELL. To put the tax treatment of our overseas mining activity in proper perspective, I think it is helpful to briefly review the overall minerals picture facing this country.

The Secretary of the Interior has projected that in the years ahead there will be an increasingly large shortfall of domestic mineral production as compared to domestic mineral demand. In 1971 the shortfall was some $6 billion.

The Secretary of the Interior has projected this will increase to approximately $20 billion in 1985, and in the year 2000 to a shortfall of domestic production in the neighborhood of $50 billion. To meet this gap between domestic production and domestic demand for minerals we are increasingly having to rely on foreign sources. Our mineral imports run in the range of $9 billion.

At the same time as the projected shortfall of domestic production will be increasing another phenomenon is occurring, and that is there is an increased worldwide competition by other countries and other industrialized nations for the world's mineral resources. Thus, not only do we have ahead of us an increasingly large likelihood of a shortfall of domestic production but also increasing worldwide competition for minerals.

An extremely important characteristic of the domestic mineral situation is that in this country we physically do not have a number of the minerals we need. In other cases, while the minerals may be here physically, because of present economic conditions and the state of the technology, it is not feasible to extract these minerals.

In view of this, it is very important that the U.S. mining industry have the ability to effectively participate in the discovery and development of foreign mineral resources. Obviously, this is necessary in the short run; and indeed also in the long run for even assuming that we can further increase domestic production, there will still be a gap to be filled by foreign mineral sources.

I think it is important to emphasize that if the foreign mineral sources that this country needs are not developed by American mining companies, they will be developed by mining companies from other major industrialized nations of the world.

If this is done, it obviously introduces more variables and potential problems in our sources of mineral supply.

In addition, if the mineral resources of the world are developed by mining companies from other nations, it is likely that mineral processing activities and fabrication of products would be done abroad rather than in the United States by U.S. employees.

When American mining companies attempt to compete abroad with mining companies of other major nations, it is obvious that the relative tax treatment they receive from the United States vis-a-vis the tax treatment mining companies from other major nations receive

from their countries is a very important factor. To the extent we give a less favorable treatment to our mining companies, they are placed at a competitive disadvantage with their competitors.

As a means of comparing in quantitative terms the effect of the relative tax treatment by capital-exporting countries of their foreign mining activities, the American Mining Congress had a study prepared by Coopers & Lybrand in 1973 on this subject. This study was updated and expanded in mid-1975 and has just been further reviewed to ascertain that it still is currently valid in light of the changes that have occurred in the tax laws of the countries involved in the study.

In brief what the study did was select four minerals and construct mine models for these minerals. The minerals were iron ore, nickel, copper, and manganese. The study then selected a variety of capital-importing countries around the world where one or more of these minerals would exist, for a total of 28 different investment possibilities.

It then analyzed the relative effect of the tax systems on rate of return for a mining investment if the investment were made by a mining company from the United States, or from a number of other major capital-exporting countries, such as Belgium, Canada, France, Germany, Japan, Netherlands, Switzerland, and the United Kingdom.

In general, the study demonstrated that our present tax system places U.S. mining at a competitive disadvantage and indeed often a substantial one vis-a-vis mining companies from the other major industrialized countries of the world.

On an overall basis for the 28 situations for which the relative rates of return on these mining investments were compared by the study, the United States on a rate-of-return-on-equity basis ranked next to last of all the capital-exporting countries in the study.

Another significant factor is that the average rate of return for the U.S. mining companies on an overall basis was significantly lower than that for the country which had the highest rate of return—20-percent lower.

For two of the minerals in which we would have been in the worst situation, copper and manganese, the U.S. rate of return was approximately 30 percent lower.

Another basis of comparing the relative position of the United States is to look at these 28 situations and determine the number of times each of the other capital-exporting countries achieved the highest, or second highest rate of return. On this basis it is seen that the United States never attained the highest rate of return and indeed attained the second or third highest rate of return of the 28 situations only once each.

In comparison, other major capital-exporting countries achieved the highest or next highest rate of return a number of times, ranging from Canada, which achieved it in 8 out of the 28 situations; down to France, which achieved the highest rate of return in 3 situations, but second highest in 12 situations.

In other words, no matter which method of comparison is used, it is clear that our present tax system puts U.S. mining companies at a competitive disadvantage and hinders our ability to compete with foreign mining companies for the supplies of foreign minerals we need.

This is a time to be considering narrowing the discrepancy rather than increasing it.

I would like to briefly note that the situation in which our mining companies face the most serious disadvantage is where the host country in which the mineral is located requires the use of a local corporation, that is, a foreign subsidiary.

The effect of this requirement is that the development expenditures and other startup costs incurred by our mining companies produce no current tax benefit. This is in substantial contrast to the treatment the other major capital-exporting countries provide to their mining companies where they do allow a current tax effect for these types of expenditures even though the activity is conducted through a foreign subsidiary vis-a-vis that capital-exporting country.

I have a table on pages 18 and 19 in my statement which shows the effect of this, which is to put the U.S. rate of return in the range of 50 to 60 percent of the highest rate of return.

If these foreign subsidiaries were allowed to be treated as branches, the situation would be greatly improved.

Senator RIBICOFF. Is this all in your statement, Mr. Bedell, that you are giving us now?

Mr. BEDELL. The numbers are in the statement.

Senator RIBICOFF. Because your time has expired and we have other witnesses waiting to testify.

Mr. BEDELL. In conclusion, let me say, Mr. Chairman, that we believe the present situation calls for changes which would make us more competitive abroad, not changes such as those embodied in H.R. 10612 dealing with the foreign tax credit limitation or loss recapture, which would increase the tax burden on the American mining industry operating abroad and therefore further harm our competitive position.

Thank you very much.

Senator RIBICOFF. Thank you very much.

Senator Hansen?

Senator HANSEN. I don't have any questions, Mr. Chairman. I am pleased to have this statement by Mr. Bedell before us. I am on the Interior Committee and I think it is the opinion of people who have given much attention and study to this very important facet of the U.S. economy, and they have been predicting for some time that the growing foreign dependency upon oil and gas will be followed and indeed is now emerging clearly into view with respect to minerals. I couldn't agree more. I think that what you say is highly important and significant.

Thank you very much.

Mr. BEDELL. Thank you very much, Senator Hansen.

Senator RIBICOFF. Thank you very much, Mr. Bedell.

[The prepared statement and exhibits of Mr. Bedell follow. Oral testimony continues on p. 1015.]

STATEMENT OF THE AMERICAN MINING CONGRESS BY DENNIS P. BEDELL, CHAIRMAN OF THE AMC TAX COMMITTEE

SUMMARY

To meet the substantial projected gap between domestic mineral production and U.S. demand for minerals in the years ahead will require substantial additional capital to develop domestic reserves and will require the effective participation of the U.S. mining industry in the development of foreign mineral sources.

A recent study prepared for the American Mining Congress by Coopers & Lybrand demonstrates that, as measured by after-tax rate of return, our present tax system places U.S. mining companies operating abroad at a competitive disadvantage—often a substantial one—vis-a-vis mining companies of other major industrialized nations of the world. On an overall average basis for 28 situations for which rates of return were compared in the study, the United States ranked next to last of the other capital exporting countries considered. Furthermore, the overall average U.S. rate of return was significantly lower—more than 20 percent—than the country with the highest overall average rate of return. Accordingly, a sound tax and minerals policy calls for improvements in the tax treatment of foreign mineral investments so the U.S. mining industry may more effectively compete abroad, rather than for increased tax burdens on the U.S. mining industry. To this end we recommend that:

Where a host country requires the use of a local corporation for a mining investment in that country, a U.S. mining company should be allowed to treat such a required foreign subsidiary as a branch for U.S. tax purposes.

Carrybacks and carryovers should be allowed for foreign income taxes for which a foreign tax credit is denied under the special foreign mineral income limitation in section 901(e).

In view of the fact that sound policy calls for making the U.S. mining industry more, not less, competitive abroad, we are opposed to changes in the tax treatment of foreign income that would increase the tax burden on American mining companies operating abroad, such as repeal or limitation of the foreign tax credit, repeal of the per-country foreign tax credit limitation, recapture of foreign losses, elimination of deferral of tax on unremitted earnings of foreign subsidiaries, or the imposition of a minimum tax on foreign source income.

To assist the mining industry to raise the vast amount of capital it will need in the coming years, we recommend the elimination of the double taxation of corporate earnings through integration of the corporate and individual tax structures and the adoption of a system of meaningful, flexible capital cost recovery allowances.

We also believe the effectiveness of the investment tax credit should be improved by:

Providing a permanent 12 percent credit.

Allowing the full credit on equipment subject to rapid amortization.

Not reducing depreciable basis by the credit.

Allowing progress payment treatment for property that takes less than two years to construct.

An area in which the mining industry is faced with increasingly heavy capital expenditures is that of pollution control. To assist the mining industry in meeting the ever growing environmental requirements imposed on it, we recommend that a number of improvements be made in the presently allowed amortization deduction for pollution control facilities.

Finally, we recommend that the 10 percent minimum tax be made inapplicable to corporations.

STATEMENT

Mr. Chairman: My name is Dennis P. Bedell and I am appearing before you today on behalf of the American Mining Congress. Accompanying me is Mr. David T. Wright, a partner in the accounting firm of Coopers & Lybrand.

The American Mining Congress is a trade association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) more than 240 companies that manufacture mining and mineral processing machinery, equipment and supplies, and (3) engineering and contracting companies and banks that serve the mining industry.

The U.S. mining industry

In the Mining and Minerals Policy Act of 1970, Congress stated it was our national policy to foster and encourage private enterprise in the development of an economically sound domestic mining industry and in the orderly and economic development of domestic mineral resources. The critical importance of this national policy becomes readily apparent when it is realized that the United States faces a severe shortage of minerals, which are the lifeblood of our industrial economy and our national defense and are the basic products from which substantially all other products are derived.

The mining industry has peculiarly distinctive characteristics and circumstances which justify its present tax treatment and indeed warrant liberalizing changes in that treatment if the industry's after-tax rate of return on investment is to be sufficient to allow it to effectively compete abroad and to provide, and allow it to attract, the capital required for the needed tremendous expansion in output.

To put the distinctive features of this industry in context, it is useful to review the overall minerals picture. Recent authoritative sources for data on the present and projected supply and demand for minerals are the 1972, 1973, and 1975 Annual Reports of the Secretary of the Interior to Congress pursuant to the Mining and Minerals Policy Act of 1970. The Secretary's Annual Reports project that in the years ahead primary domestic demand for minerals will substantially exceed domestic mineral production at an everwidening pace. The gap was $6 billion in 1971 and is projected to increase to $20 billion in 1985 and to $52 bilion in the year 2000.

To meet this gap, we have been and will continue to be increasingly relying on foreign sources. In 1972, our mineral imports were valued at approximately $9 billion. Attached as Exhibit 1 is Figure 4 from the Secretary's 1975 Annual Report which shows for a number of minerals the percentage of U.S. 1974 demand which was supplied by imports.

Moreover, the Secretary's 1973 Annual Report points out (at page 25) that although "U.S. production has increased in quantitative terms, its relative role as a world consumer of mineral raw materials and as a world-manufacturer of products of mineral origin has shrunk." The result is that "the United States is encountering steadily increasing competition in the acquisition of nondomestic mineral raw materials as other industrialized countries also seek reliable sources of reasonably-priced mineral raw materials."

Thus, at the same time as our needs are increasing and the gap between domestic production and domestic demand is widening, there is likely to be increased world-wide competition for minerals which will make it increasingly difficult for us to fill the gap. In other words, we are facing a minerals crisis.

An extremely important characteristic of the mining industry is the fact that in the case of a number of minerals we physically do not have additional resources in this country. Moreover, in the case of a number of other minerals almost all of the high grade deposits have been discovered. The ones left generally are deep, low-grade deposits which either are not exploitable under present economic conditions or because of a lack of the necessary technology. There are on the other hand foreign mineral deposits of a higher grade than domestic deposits which accordingly may be developed at a relatively lower cost. As indicated before, however, there is also likely to be increased competition from other countries for these supplies of natural resources.

It is important for a number of reasons that the United States mining industry be able to effectively participate in the discovery and development of foreign mineral reserves. It is obvious that for some time to come the United States will be in need of significant and increasing amounts of foreign minerals if domestic demand is to be met. The mining of foreign reserves by U.S. companies provides a greater assurance that these foreign minerals will be available to us, although there are, of course, risks arising from the uncertainty of the political environment in some foreign countries. Moreover, because of economic conditions, the state of the technology and the lead time required for the development of new deposits, increased production of domestic minerals is simply not a viable means of meeting projected domestic demand.

This is not to say that the significantly increased efforts which are necessary for further exploration and development of those minerals which exist in the United States should not be undertaken from a long-run standpoint. These efforts should be pursued, but they should be pursued hand in hand with those efforts necessary to continue to assure ourselves of needed supplies of foreign minerals. The size of the projected gap between domestic demand and domestic supply of minerals is so great that in the long run very substantial increases in domestic production—even a doubling of production—will still leave a gap which must be filled by substantial imports of foreign minerals. It is in our national interest that the U.S. mining industry be allowed to effectively participate in the development of these foreign minerals. If these foreign mineral sources are not developed by American mining companies, they will be developed by mining companies of other major industrialized nations of the world. This would make the availability to us of needed foreign minerals even more de-

pendent on, and subject to variations in, the economic and political climates of other countries. It is also important to note that the availability of needed raw materials to American industry means that mineral processing and the fabrication of many products may be done in the United States by U.S. employees rather than abroad.

In addition to providing us with additional assurance that the minerals will be available to us, the development of foreign mineral deposits by the U.S. mining industry will also tend to mitigate the balance of payments effect of imports since the profits arising on the foreign operations of U.S. mining companies will be at least in part repatriated to the United States.

The United States mining industry has already made very substantial investments abroad for mineral exploration and development and for the very substantial capital facilities which are required for the processing and transportation of minerals. Moreover, substantial additional capital investments will be required to find and develop additional supplies of foreign minerals.

The tax treatment of foreign income

In attempting to carry on mining activities abroad, American mining companies must compete with mining companies from other capital exporting nations, such as the United Kingdom, France, Japan and Germany. To the extent American mining companies receive less favorable tax treatment from the United States than companies of other capital exporting countries receive from their home countries, the U.S. companies are placed at a competitive disadvantage.

Coopers & Lybrand comparative study

As a means of comparing, in fairly precise terms, the relative tax treatment by capital exporting countries of the foreign activities of their mining companies, the American Mining Congress had a comparative study made for it in 1973 by the international accounting firm of Coopers & Lybrand. This study focused on the effect which the tax systems of important capital exporting countries in conjunction with the tax systems of a varied range of capital importing countries have on after-tax rates of return of mining companies. The objective of this study was to apply a common measurement standard (i.e., after-tax rate of return) to the tax systems of the United States and its principal capital exporting competitors.

We believe this type of study is of substantial help to the Committee in considering the question of the proper tax treatment of U.S. mining companies' foreign mineral operations. Accordingly, the American Mining Congress had Coopers & Lybrand prepare a new study for it in mid-1975 to reflect the changes in the tax systems of the capital exporting and capital importing countries involved. The new study also analyzed the effect on after-tax rate of return of various tax proposals that would affect U.S. mining companies operating abroad. Coopers & Lybrand has just completed a further review of the changes in the tax laws of the countries involved in the study which have occurred since the study was made and is of the opinion that the conclusions of the study are basically unchanged. Copies of the study, dated May 12, 1975,* and a letter from Coopers & Lybrand, dated March 23, 1976, to the American Mining Congress regarding the current validity of the study are attached as Exhibits 3 and 2, respectively.

In general this study demonstrates that our present tax system places U.S. mining companies at a competitive disadvantage—often a substantial one—vis-a-vis mining companies of other major industrialized nations of the world.

In the study both the return on equity investment (after subtraction of the interest cost of borrowed money) and the return on total investment have been computed. The comparisons have primarily been made, however, on the basis of return on equity investment because as the study points out it is believed that this basis, which assumes a debt and equity capital structure, is more representative of typical mining investments and consequently is more illustrative of the effect of tax systems on mining companies from the U.S. and the other capital exporting countries. After-tax rate of return was chosen as the standard of comparison because it is a reasonable measure of an investor's capacity to make concessions to the host country and thereby outbid other potential investors who have significantly lower rates of after-tax return, and because it serves as a measure of a company's ability to borrow funds, or to allocate internally generated funds, for the needed capital investments.

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*This study was made a part of the official files of the Committee.

The after-tax rates of return of United States mining companies have been compared with those of eight other capital-exporting countries: Belgium, Canada, France, Germany, Japan, the Netherlands, Switzerland, and the United Kingdom. The rates of return have been computed on hypothetical models of mining ventures involving four minerals: iron ore, copper, nickel, and manganese.

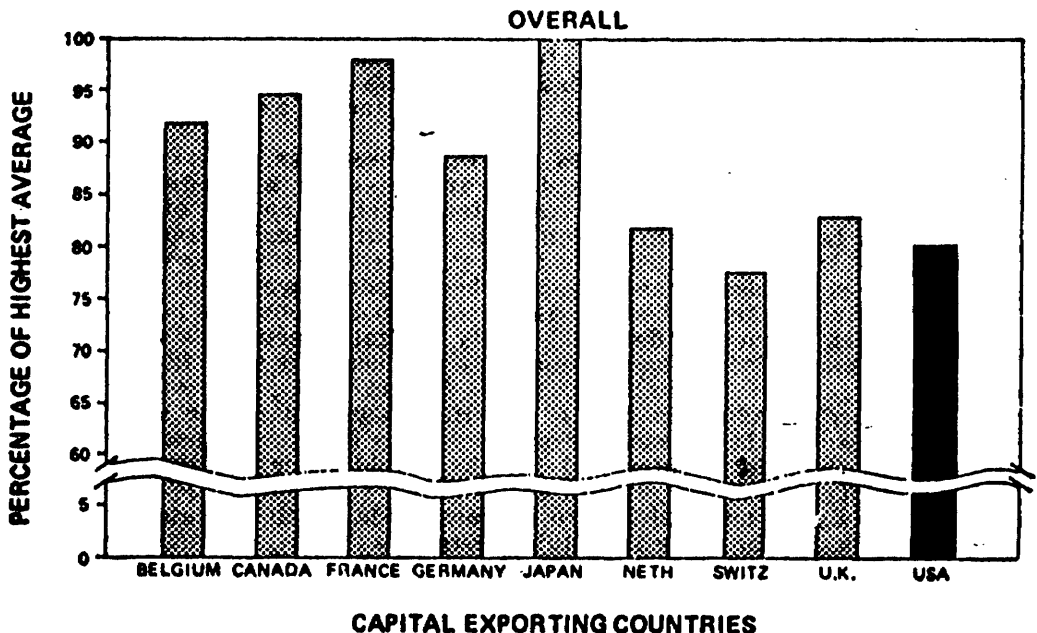
Twelve capital-importing countries were chosen for the study. They are Australia, Brazil, Canada, Indonesia, Iran, Ireland, Liberia, Mexico, New Caledonia, New Zealand, the Philippines, and South Africa. It was not reasonable to expect that all four of the minerals chosen for the study would be found in each of the 12 capital-importing countries, so the computations were made for each mineral only in those countries where it is reasonable to anticipate that commercial deposits of the mineral are located. Consequently, the study computes rates of return on an iron ore mine in each of seven countries, a copper mine in each of eight countries, a nickel mine in each of seven countries, and a manganese mine in each of six countries. In summary, 28 investment possibilities were considered.

It would be impossible for the study to cover all potential capital-importing countries. It is believed, however, that the countries selected cover a representative range of taxing systems, varying from New Caledonia, which had no income tax at the time of the study, to countries such as Canada, which has an income tax system similar in many respects to our own. (Although New Caledonia has now enacted an income tax system, this has not changed the study's conclusions.) Since the mine models utilized in this study were standard in all instances, the rates of return for each investment by each company were affected solely by the respective tax systems of the investor countries and the country in which the investment is made. Therefore, rates of return express the relative effect of each country's tax system.

The Coopers & Lybrand study shows that the U.S. tax treatment of U.S. mining companies operating abroad generally is significantly less favorable than that of most other major capital exporting countries. On an overall average basis for all 28 situations for which rates of return on equity were compared, the United States ranked next to last of the capital exporting countries in the study. Furthermore, the overall average U.S. rate of return was significantly lower—more than 20 percent—than the country—Japan—with the highest overall average rate of return. The following graph from the study shows the comparative position of the United States on an overall basis.

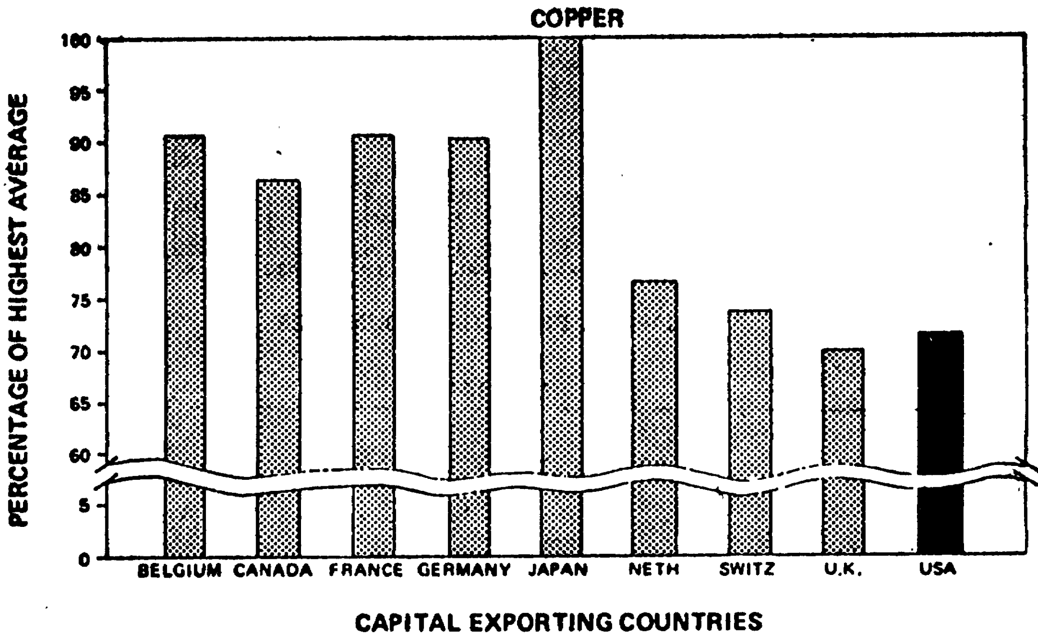
In terms of the four specific mine models utilized, the United States on an average rate of return on equity basis ranked eighth in the case of copper, sixth

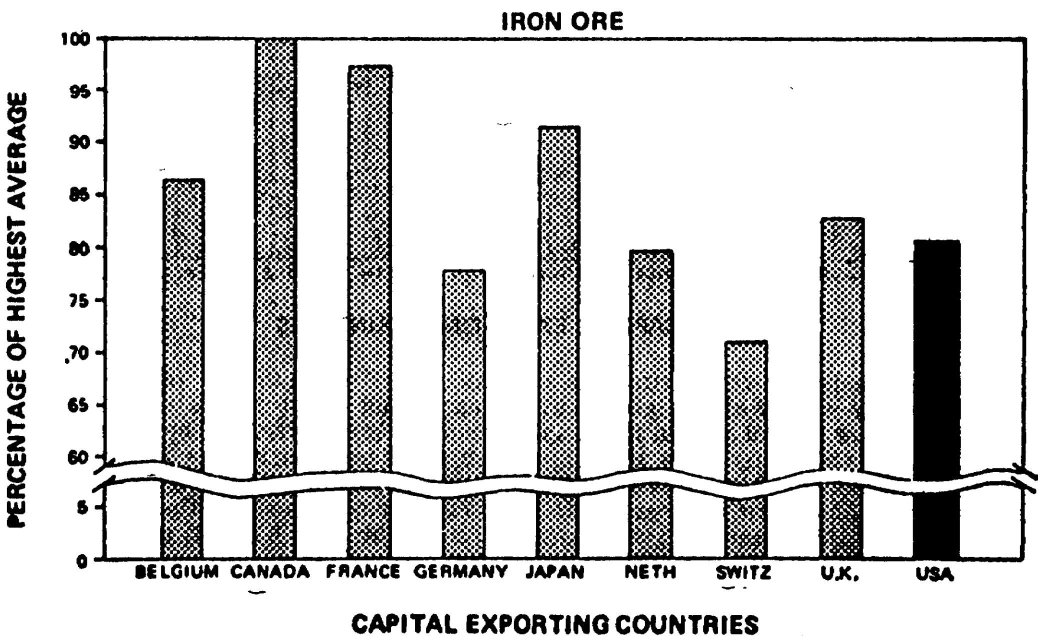
PERCENTAGE RELATIONSHIP OF RETURN ON EQUITY



in the case of iron ore, fifth in the case of nickel, and was tied for last in the case of manganese. Moreover, the magnitude of the disparity between the U. S. rate of return and the rate of return for the highest country for each mineral was substantial. In the case of nickel, where the United States ranked highest of the four minerals studied, the U. S. rate of return was only 85 percent of that of the highest country, Canada. In the case of iron ore, the U. S. rate of return was 80 percent of that of the highest country. In the case of copper and manganese—the two situations in which the United States would be in the worst competitive position—the U. S. rate of return was 71 percent and 72 percent, respectively, of that of the highest country. The graphs on the following pages, which are from the Coopers & Lybrand study, show the comparative position of the United States for each of these situations.

PERCENTAGE RELATIONSHIP OF RETURN ON EQUITY





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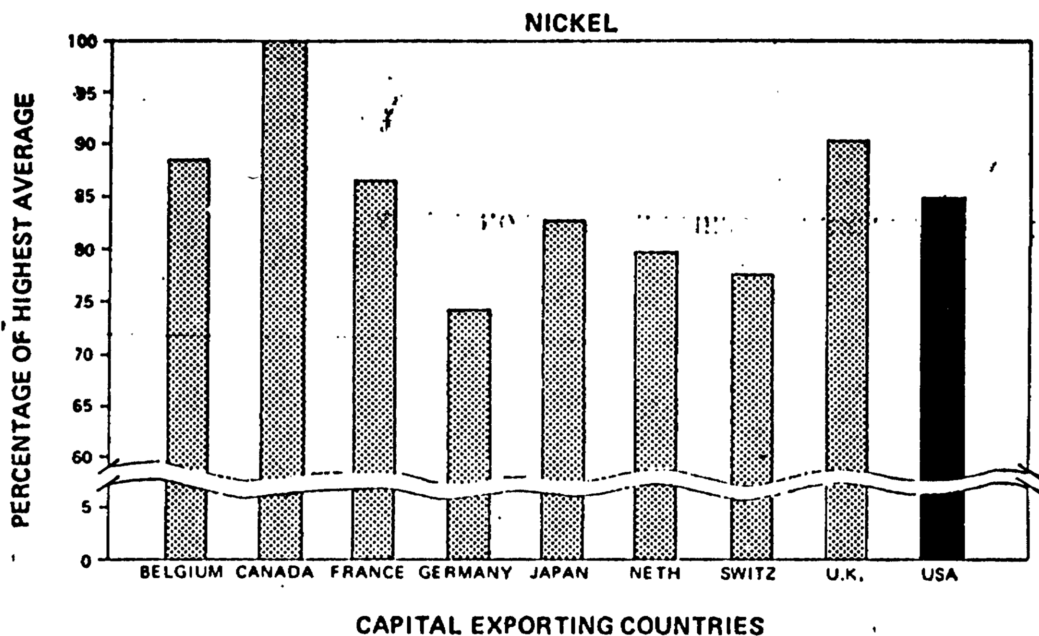

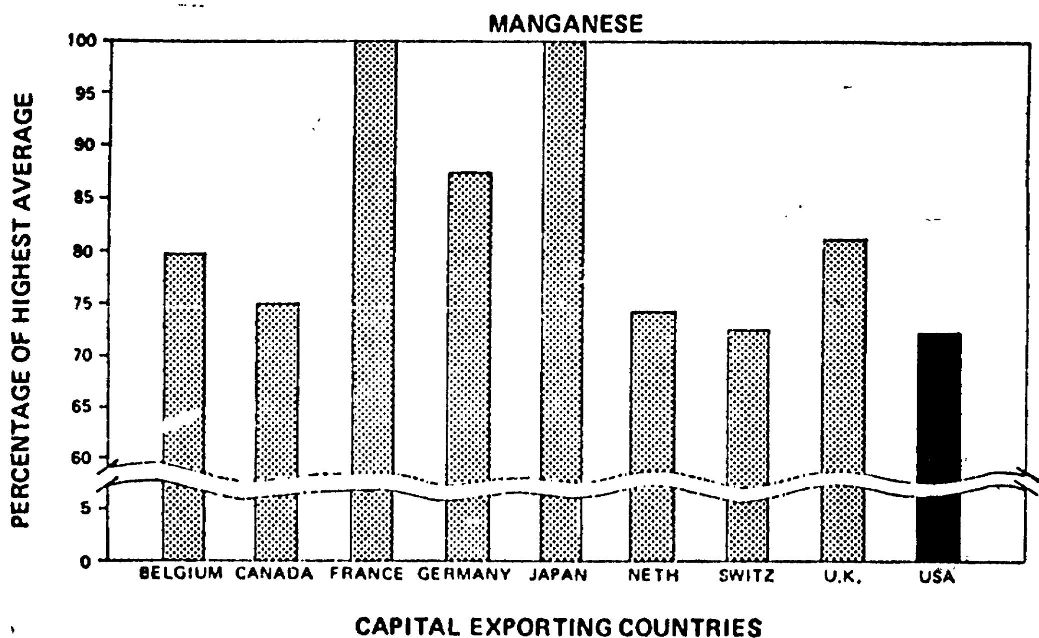

Another basis for comparing the capital exporting countries tax systems is the frequency with which a given capital exporting country obtains the highest or next highest rate of return in a capital importing country. Of the 28 situations compared in the study on a rate of return on equity basis, the United States never attained the highest rate of return and attained the second and third highest rate of return only once each. By comparison, most of the other major capital exporting countries achieved the highest, or next highest, rate of return a number of times, which is shown as follows:

	Times country achieved—	
	Highest rate of return	Next highest rate of return
Canada	8	
Japan	6	6
Germany	5	
Belgium	4	
France	3	12
United Kingdom	3	

Note: The number of instances in the above table of highest rate of return totals 29 because Japan and France tied for 1st in 1 situation.

It is clear that no matter which method of comparison is utilized, the present U.S. tax system treats U.S. mining companies considerably less favorably than the tax systems of the other major capital exporting countries treat mining companies based in those countries. Thus, our present tax system hinders the ability of American mining companies to compete with mining companies for the supplies of foreign minerals which this country needs.

It is important to emphasize that a frequent pattern of having United States mining companies fall significantly below the highest after-tax rate of return in competing with investors from other countries is extremely serious even if the United States investor's rate of return is comparable to the average for other potential investors. The reason is that the investor with the highest after-tax rate of return with comparable terms in the host country will be able to concede more to the host country and thus outbid any other potential investors who have significantly lower rates of return after tax.

Local incorporation requirement

U.S. mining companies operating abroad are at the most serious disadvantage in those capital importing countries that, either directly or indirectly, require mining activities in that country to be carried on by a corporation organized under the local law. United States companies that are, thus, effectively obliged to operate through such a locally incorporated subsidiary are at a particular disadvantage because mine development and other start-up expenditures by these foreign subsidiaries cannot be deducted and these foreign subsidiaries are not eligible for percentage depletion deductions when the mines reach the producing stage.

Several of the capital exporting countries provide a means whereby their mining companies may obtain a current deduction for mine development expenditures and therefore not be penalized by an external requirement that they conduct operations through a foreign subsidiary. For example, France permits its companies to consolidate, for fixed periods of time, foreign subsidiaries with domestic activities for purposes of computing taxable income. This consolidation election is for a ten-year period after which the foreign subsidiary need not be consolidated. Thus, preproduction tax losses produce a current tax benefit. Dividends from a foreign subsidiary, if not included in a subsequent consolidation after the ten-year period has lapsed, are eligible for further preferential tax treatment. Germany also provides a method to obtain a tax benefit for preproduction losses realized by a foreign subsidiary of a German company. Germany allows its companies to claim a tax-deductible reserve against investments in foreign subsidiaries in amounts equivalent to preproduction losses, subject to certain limitations. Such reserves are restored to income as the venture generates income or after a specified period of time has lapsed.

Of the capital importing countries included in the Coopers & Lybrand study, Brazil, The Philippines, Mexico, Indonesia, and Iran require a local corporation to conduct mining ventures in their countries. The following table from the study shows the rate of return on equity of U.S. mining companies from investments in these countries, expressed as a percentage of the highest rate of return for a capital exporting country company's investment in that country, both with the foreign subsidiary treatment to which U.S. mining companies are limited under present law and as if they could be treated as branches.

COMPARISON OF U.S. RETURN ON EQUITY EXPRESSED AS A PERCENT OF HIGHEST RETURN ON EQUITY IN COUNTRIES REQUIRING LOCAL INCORPORATIONS

	Percent of highest—	
	Subsidiary	If branch treatment were allowed
Copper:		
Indonesia	56.4	80.0
Iran	40.7	59.3
Mexico	52.2	71.8
Philippines	55.2	79.0
Iron ore:		
Brazil	56.8	96.0
Philippines	60.6	93.9
Nickel:		
Indonesia	67.7	100.0
Philippines	75.8	100.0
Manganese:		
Brazil	58.9	77.6
Iran	58.0	78.6
Mexico	53.3	75.1
Philippines	66.0	87.3

As can be easily seen, if U.S. mining companies could qualify for branch treatment under United States tax law in these situations, the rate of return on equity investment would be increased sharply in every case.

Recommendation

The failure of the United States tax system to keep United States mining companies competitive in those countries where local corporations must be used is serious. Furthermore, the problem is likely to grow as other capital-importing countries adopt the requirement of local incorporation. To solve this problem and to avoid a further deterioration of the competitive position of the United States mining companies, we recommend that in those situations where the use of a local corporation is in line with the policy of the host country, United States mining companies be permitted, at their option, to treat stock ownership in the foreign corporation that is engaged in mining operations as though the mining operations were conducted by a branch of the United States company or by a partnership in which the United States company owns a partnership interest.

Proposals to increase taxes on foreign mineral operations

A number of changes in the tax treatment of foreign income that would further worsen the competitive position of American mining companies operating abroad are contained in H.R. 10612. Other changes that would have adverse effects have been proposed. We oppose any change in the tax treatment of foreign income that would increase the tax burden on U.S. mining companies operating abroad. Changes of this type would further hinder the ability of U.S. mining companies to secure the resources which this country vitally needs.

It should be noted that in a January 29, 1976, report to the Congress by the Comptroller General, entitled "U.S. Dependence on Imports of Five Critical Minerals: Implications and Policy Alternatives," the importance of foreign minerals sources to this country was recognized. Furthermore, the GAO stated (at page 62) that "the Congress should be cognizant of tax code changes tending to deter foreign mining investment when domestic self-sufficiency is not a practical alternative."

The Coppers & Lybrand study computed the effect which various proposals would have on U.S. mining companies operating abroad. These include repeal of the foreign tax credit with allowance of foreign income taxes as a deduction, repeal of the per country limitation on the foreign tax credit, and the proposal to recapture foreign losses which were deducted from U.S. source income by disallowing a portion of the foreign tax credit when operations in the foreign country in question become profitable. The latter two proposals are contained in

H.R. 10612. The Coopers & Lybrand study shows that any one of these proposals would place U.S. mining companies in last place among the capital exporting countries in terms of overall average return on equity. Furthermore, in a number of cases, the present discrepancy between the United States and the capital exporting country with the highest overall average return on equity would be very significantly widened. If the foreign tax credit were repealed and instead a deduction was allowed for foreign income taxes, the U.S. overall return on equity as a percentage of the highest capital exporting country would fall, according to the study, from 80 percent to 62 percent. Similarly, if the per country foreign tax credit limitation were eliminated as is proposed in §1031 of H.R. 10612, the United States would fall from 80 percent to 67 percent. In the case of the loss recapture proposal which is contained in § 1032 of H.R. 10612, the drop would be from 80 percent to 76 percent. Although this is a smaller decrease, what is significant is that a U.S. mining company would be 24 percent below a company from the capital exporting country with the highest return. Accordingly, we strongly oppose proposals of this type and recommend that sections 1031 and 1032 of H.R. 10612 be deleted.*

Proposals also have been made for a minimum tax on foreign source income, either directly by an additional tax on foreign income or indirectly by making the foreign tax credit a tax preference item subject to the present 10-percent minimum income tax. It should be recognized that proposals of this type are simply complex backdoor methods of repealing a portion of the foreign tax credit. Accordingly, we oppose any proposals of this type which would result in additional tax on foreign income and thereby through the imposition of double tax burdens further worsen our competitive position abroad.

Other proposals which would also have a deleterious effect on American mining companies operating abroad include the repeal of Western Hemisphere Trade Corporation treatment as provided in § 1052 of H.R. 10612, and the elimination, as provided in § 1033 of H.R. 10612, of less developed country treatment under the foreign tax credit (i.e., requiring dividends for these countries to be grossed-up) and under section 1248 which treats a portion of the gain realized on the sale of stock of a foreign subsidiary as ordinary income rather than as a capital gain. Increasing the tax burden of the American mining industry by proposals of this type is not a wise course of action. It would only hurt the industry's ability to supply the minerals this country needs now and will increasingly need in future years. Accordingly, these provisions should be eliminated from the bill.

We also believe that the present deferral treatment accorded foreign source income of foreign subsidiaries should not be eliminated. If this were done, this foreign source income would be subject arbitrarily to United States taxation as earned which would further aggravate the competitive position of United States investors compared with investors of other capital-exporting countries.

Exemption for income earned abroad

Present law provides a limited $20,000 per year exemption ($25,000 in certain cases) for income earned abroad by U.S. citizens who reside abroad for substantial continuous periods—17 out of 18 months. After a 3-year phase-out period, this exemption would be repealed under § 1011 of H.R. 10612. Even with the tax exemption provided under present law for income earned abroad, however, the mining industry finds it difficult to induce qualified executive and technical personnel to go abroad. It is to the advantage of the United States as well as the businesses involved to have competent personnel in charge of the operations abroad, and the Mining Congress believes that if the exemption is eliminated, it will increase the cost and lower the efficiency of operations abroad. Accordingly, this provision of H.R. 10612 should be deleted.

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* If the repeal of the per-country limitation contained in § 1031 of H.R.10612 is retained, a technical change in proposed section 904(e) of the Code is needed to assure the applicability of the transitional rules contained in such subsection in the case of a taxpayer who did not claim a foreign tax credit for its last taxable year before 1976 but which had not elected the overall limitation for its most recent pre-1976 taxable year in which it did claim a foreign tax credit. This situation could occur where the taxpayer in its last taxable year before 1976 had an overall loss or claimed a deduction, rather than a credit, for its foreign income taxes.

Dividend and interest withholding taxes

Secretary Simon, in his statement before this Committee during these hearings, urged the abolition of the 30-percent withholding tax imposed under present law on dividends and interest paid to foreign persons. He stated that "the many benefits of eliminating the tax outweigh the small revenue loss." We agree with Secretary Simon's statement and support his recommendation that the present withholding taxes on all dividends and interest be eliminated.

Section 901(e)

The Tax Reform Act of 1969 enacted a new section 901(e). It requires that the amount of foreign taxes paid on "foreign mineral income" from sources within any foreign country or possession that is otherwise available for foreign tax credit, be reduced by the amount by which the foreign taxes paid exceed the United States tax on the same income, due to the allowance of a percentage depletion deduction by the United States. We oppose subjecting the mining industry to more restrictive rules than other industries in computing the foreign tax credit. Consequently, we recommend that section 901(e) be repealed. In the absence of repeal, we recommend that 901(e) be amended to allow carrybacks and carryovers of the portion of the foreign tax credit that has been denied under this section since inequities can arise as a result of timing differences in the United States and the foreign country. We think the failure to allow carrybacks and carryovers may have been inadvertent in the 1969 Act. We specifically recommend that section 901(e) be amended to provide for a two-year carryback and a five-year carryover the amounts of foreign income tax for which a credit is denied under the "foreign mineral income" limitation in those years. This would grant the mining industry the same carrybacks and carryovers of unused foreign income taxes on "foreign mineral income" that are available for foreign taxes on nonmineral income.

Other recommendations

In its Declaration of Policy, the American Mining Congress has adopted three other proposals that would improve the competitive position of U. S. mining companies operating abroad. First, we recommend that the tax treatment of foreign expropriation losses be revised to provide a more realistic definition of expropriation, to assure that business losses will always qualify as ordinary losses, and to extend the carryforward period for the use of such losses. Second, the Asset Depreciation Range System, and any more flexible capital recovery allowance adopted for domestic assets, should be extended to foreign assets. Finally, we recommend that a foreign tax credit be allowed for taxes that are excused by developing countries that are seeking to attract capital so the incentives allowed by those countries can have a meaningful effect. This treatment is already accorded by a number of other major industrialized countries, such as Canada, France, Germany, and Japan. We urge the Committee to adpt these recommendations.

Need for capital

To meet the challenge of obtaining the minerals we will need in the years to come will require the expenditure of tremendous amounts of capital. Existing facilities must be expanded and modernized to more effectively exploit known mineral deposits. New deposits must be discovered and developed.

The discovery and development of minerals in the United States is becoming more and more costly. Most of the high grade mineral beds have already been discovered, and low grade deposits are the only ones left. Today, the mining industry must expend great sums of money on exploration and development in the United States. This exploration requires sophisticated and expensive geological, geochemical, and geophysical equipment. Exploring underground is particularly costly. Moreover, in many cases, the deposits that are discovered are of such a low grade that the technology required to make it economically feasible to mine and process them must first be developed. Also, to process low grade ores at an economically attractive cost requires tremendous capital investment in facilities for large scale operations.

In addition to these expenditures, the American mining industry is faced with large increases in required capital expenditures as a result of the great amount

of environmental and health and safety legislation affecting the industry which has been enacted in recent years. These expenditures, which do not add to productive capacity or result in any significant economic return, further increase the mining industry's capital needs.

Where will the enormous amount of capital required to meet these needs come from? In recent years the industry has been required to turn increasingly to debt financing, thereby significantly increasing the industry's debt burden and its debt/equity ratio. The industry's ability to generate capital internally and to attract outside capital is dependent on its profitability for that determines its cash flow and return on investment. The lower the industry's profits are, the less funds there are generated internally to meet capital needs. Moreover, inadequate profitability seriously impairs the industry's ability to obtain external financing. Even if the industry is able to attract the needed funds in the first instance, inadequate profits impairs its ability to service new debt burdens.

The heavy inflation of recent years also has placed substantial additional burdens on the mining industry. As a result of inflation, the industry is encountering substantially higher replacement costs. Moreover, it is faced with rapidly escalating costs on uncompleted mine development projects. The discovery of an ore body and the development of a mine is a long-term, 5 to 10 year project. The inflation induced escalation of costs of mining projects has imposed substantial new and uncontemplated capital expenditure burdens on the mining industry. Our tax laws must provide adequate incentives to allow the mining industry to obtain the capital it needs if we are to have the needed modernization and expansion of productive capacity.

Integration and capital recovery

We strongly believe that new initiatives must be undertaken in our tax system to eliminate the double taxation of corporate earnings by integrating the corporate and individual tax structures and to allow much more rapid capital cost recovery. We recommend the adoption of a system of flexible cost recovery allowances for plant and equipment, deducted at the taxpayer's discretion over as short a period as 5 years and under any of the present permissible methods of depreciation, including accelerated methods. The positive stimulative effect of such a capital recovery system should not be diluted and impaired either through a reduction in the amount of the otherwise allowable investment credit or through the treatment of capital recovery allowances as tax preference items for purposes of the 10-percent minimum tax. A capital recovery system of this type would substantially improve the present tax climate for the mining industry, would be simple and flexible to apply, would encourage needed investment, and would mitigate the problems created by inflationary replacement costs, obsolescence, and foreign competition.

Investment tax credit

Over the years, it has been well demonstrated that the investment tax credit is an important incentive to encourage capital investment and to assist industry in meeting its capital needs. We believe the strengths of this incentive should be continued and improved. Specifically, we recommend the following with respect to the investment tax credit:

The investment credit should be increased to 12 percent on a permanent basis.

The full investment credit should be allowed, regardless of whether the equipment in question is subject to depreciation or rapid amortization.

The depreciable or amortizable basis of equipment should not be reduced by the amount of the investment credit.

Progress payment treatment, which allows the investment credit to be claimed as expenditures are incurred, should be available without regard to whether it takes two years or more to construct the property and without any phase-in period.

Pollution control

The mining industry has been faced with increasingly heavy capital expenditures to meet the many new environmental requirements being imposed on it. Moreover, in future years the mining industry will be required to spend staggering amounts of capital for pollution control facilities. The present section 169

of the Code allowing the write off of pollution control facilities over a five-year period is so limited and restricted that it has not been effective in easing the industry's financial burden of meeting pollution control standards.

To increase the effectiveness of the tax laws in combating air and water pollution, we recommend that the deduction for the cost of pollution control facilities be liberalized and many of the restrictions in the present law be removed. The most significant change we recommend is that taxpayers should be allowed to elect to deduct the cost of pollution control facilities currently, rather than over a five-year period as under present law.

At the very least, the following modifications to existing law are essential if the write off allowed for pollution control facilities is to be of meaningful assistance to the mining industry.

Taxpayers should be permitted to use accelerated methods in computing their pollution control facility amortization deductions over a five-year period and should be allowed the maximum investment credit on these facilities.

The existing 60-month amortization rule applies only to facilities to control pollution in plants that were in operation before January 1, 1969. The definition of qualified pollution control facilities should be extended to include the cost of pollution control facilities used in connection with new as well as old plants.

We recommend removal of the restriction under existing law that makes the five-year amortization inapplicable if it appears that by reason of additional receipts derived through recovery of waste the cost of the pollution control facility will be recovered over its life.

The requirement that pollution control facilities must have Federal and state certifications to qualify for five-year amortization should be removed. The test for qualification should be whether the primary function of the facility is pollution abatement.

Under existing law a pollution control facility must be placed in service by the taxpayer before January 1, 1976 to qualify for 60-month amortization. We recommend that the definition of qualified facilities be extended to include facilities placed in service on or after January 1, 1976.

The restriction of five-year amortization to a fifteen-year portion of the actual life of a pollution control facility which has a useful life of over fifteen years should be removed.

Under existing law a deduction for amortization of a pollution control facility that is part of a taxpayer's mining operations will reduce the taxpayer's taxable income from the mining property, and this reduction may result in a lower percentage depletion deduction for the mine—thus offsetting, in part, the effect of the amortization provision. We recommend that any increase in deductions for pollution control not be offset by applying the increased deductions to reduce the 50 percent of taxable income limitation on percentage depletion deductions.

Under existing law the excess of deductions for amortization of pollution control facilities over ordinary depreciation deductions is included in the tax base for the 10-percent "minimum" tax as an item of tax preference, thus diminishing the effect of section 169 in many cases. We recommend that pollution control facilities be deleted from the base of the 10-percent minimum tax.

The 10-percent minimum tax

The 10-percent minimum tax imposed under present law is in reality an additional tax, not a minimum tax. Moreover, for the mining industry and corporations generally, it is essentially an additional tax on percentage depletion deductions and capital gains. Its effect, thus, is in large part to reduce through an indirect approach the incentive effect of a specific provision in the tax law which is of substantial assistance to the mining industry. The imposition of the minimum tax on corporations is not a sound policy. This is especially true at a time like this when it is clear that sound policy requires greater, not reduced, tax incentives to assist industry in meeting its capital requirements. The time has come when the inappropriateness of the imposition of the minimum tax on corporations should be fully recognized and the tax made inapplicable to corporations.

Respectfully submitted,

AMERICAN MINING CONGRESS,
DENNIS P. BEDELL,
Chairman, Tax Committee.

EXHIBIT 1

IMPORTS SUPPLIED SIGNIFICANT PERCENTAGE OF TOTAL U.S. DEMAND IN 1974

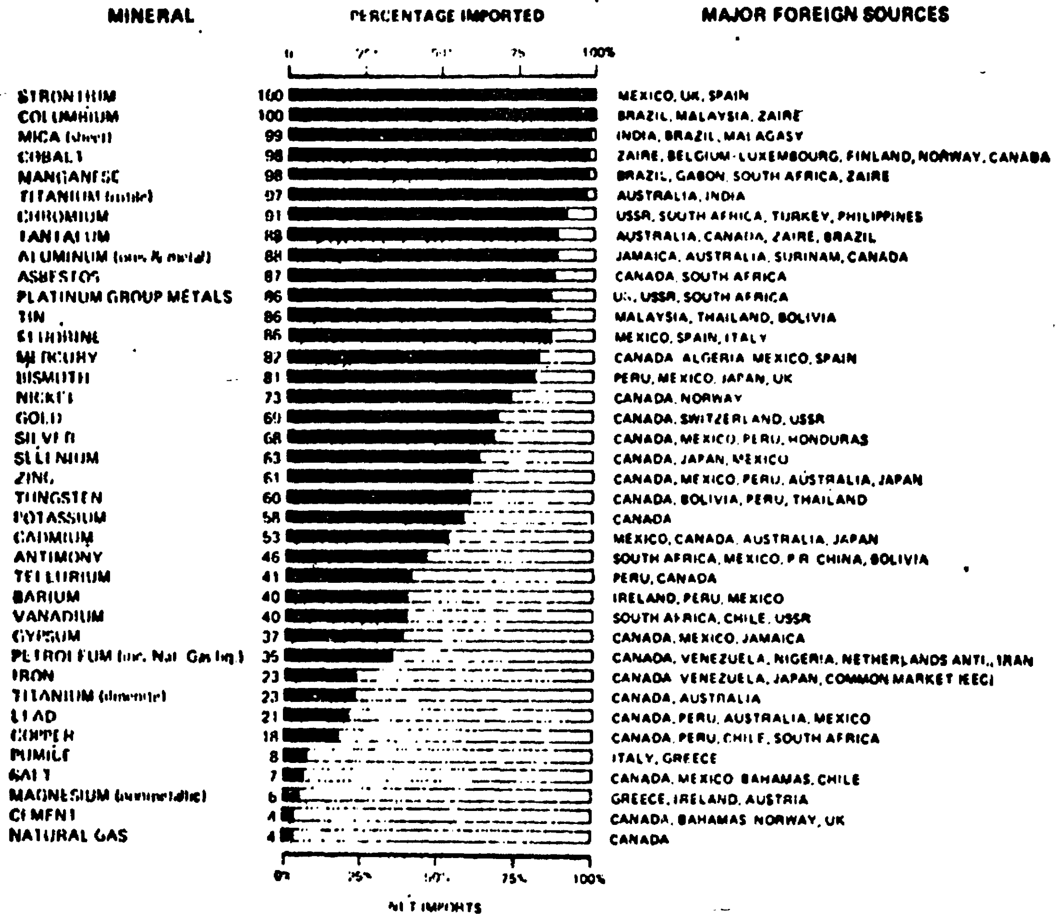

FIGURE 4

EXHIBIT 2

COOPERS & LYBRAND,
New York, March 23, 1976.

Mr. J. ALLEN OVERTON, Jr.,
President, American Mining Congress, 1100 Ring Building, Washington, D.C.

DEAR MR. OVERTON: As you requested, we have surveyed each of the capital importing and capital exporting countries included in our report "A Comparative Study of Tax Systems and Their Effect on Foreign Mining Investments" dated May 12, 1975 (hereinafter referred to as the Study) as to whether there have been any changes in the tax laws of those countries which would modify the

conclusions of the Study. The changes in tax laws, which have occurred, are summarized in the Exhibit enclosed herein.

BACKGROUND

As you know, the Study analyzed the tax structures of eight leading capital investing countries, namely:

Belgium, Canada, France, Germany, Japan, The Netherlands, Switzerland, and United Kingdom.

(Hereinafter described as capital exporting countries) and measured the U.S. tax structure against the tax structure of each of those countries. To measure these tax systems, we utilized four distinct mathematical models which represent possible investments in mines with various degrees of profitability and required capital investment. Rates of return were computed for these mine investments assuming such investments were made in various foreign ("capital importing") countries by each capital exporting country. These rates of return were computed utilizing the available tax elections which would provide optimum rates of return in each circumstance.

The tax systems of foreign countries in which it was assumed investments were made are reasonably representative of the wide range of tax systems which exist around the world.

The mine models utilized in determining the various rates of return were standard in all instances so that the rates of return achieved by each capital exporting country were affected solely by its tax system and the capital importing countries' tax systems. It should be emphasized that these models do not represent actual mines or actual rates of return or the relative degree of profitability for the various minerals; rather, they are examples of complex mining ventures which reflect a range of financial possibilities in terms of capital expenditures, revenues and operating costs.

The rates of return achieved by each capital exporting country for each assumed mining investment (i.e., mine model) were averaged and a ranking of the various capital exporting countries was made on the basis of these results. In addition, to provide a perspective for these rates of return, a percentage relationship was determined by assigning a percentage of 100 to the highest average rate of return and expressing all other countries' rates of return as a percentage of 100. For example, if the highest rate of return for an investment is 16% and the next highest is 14%, the percentage relationships would be expressed as 100.0% and 87.5%, respectively. For purposes of this Study, these relationships are called "Percentage of Highest Average Rate of Return." These overall averages and percentage relationships present a balanced comparison of the exporting countries' tax laws, since results from atypical situations are minimized.

The overall results of these comparisons are reflected in the bar charts and tables on pages 4 and 5 of the Study. We have also summarized in bar charts and statistical tables the average rates of return for each capital exporting country by mineral; see pages 6 through 9 of the Study for these results.

We computed rates of return on both a return on equity (ROE) basis and on a return on total capital invested (ROI) basis, i.e., with no debt financing. See Appendix A of the Study for a discussion of the ROE and ROI bases. However, we believe the return on equity basis, which assumes a debt and equity capital structure, is more representative of typical mining investments and consequently is more illustrative of the effect of the tax systems on mining companies in the U.S. and other capital exporting countries. Therefore, our comparisons were made primarily on an ROE basis. Based on the Study, the results for a U.S. mining investor were as follows:

U.S. POSITION COMPARED TO THE 8 OTHER CAPITAL EXPORTING COUNTRIES

	Copper	Iron ore	Nickel	Manganese	On an overall basis
Comparative position of the United States to other capital exporting countries based on average ROE	8	6	5	[1] 8	8
U.S. average ROE as a percentage of highest average ROE	71.3	80.5	84.8	72.1	79.6

[1] Tied for 8th (last) position with Switzerland.

The above percentages of highest average rate of return reflect the degree by which the U.S. rates of return fall below the country with the highest rate of return. It is also significant to note those countries whose rates of return consistently exceed the U.S. rates of return.

It was noted in the Study that, on an ROE basis, France, Canada and Belgium had higher average rates of return than the U.S. for all four mine investments; the United Kingdom and Japan had higher average rates of return than the U.S. for three of the four mine investments and Germany had a higher rate of return than the U.S. return in two of the four mine investments.

The Study also analyzed the frequency with which a given capital exporting country attained a rank, in terms of return on equity, such as first or second in a capital importing country, since such frequency provides further insight and another basis for comparing the capital exporting countries' tax laws. The tables which reflect the frequency with which a given rank was attained by each capital exporting country in the capital importing countries for each mineral are set forth on pages 12 and 13 of the Study.

In this connection, our Study noted that, on an ROE basis, the U.S. never attained the highest rate of return in any of the capital importing countries and attained the second and third highest rate of return only once each. To give perspective to the above statistics, it should be noted that there are 28 opportunities to attain the highest rate of return ranking.

By comparison, the highest rate of return, on an ROE basis, was achieved by Canada eight times, Japan six times, Germany five times, Belgium four times, France and the U.K. three times each. Further, the second highest rate of return, on an ROE basis, was achieved by France twelve times and Japan six times.

Review of Changes

We reviewed the changes in the tax laws of the capital exporting and capital importing countries and considered their effect on each assumed investment. It should be noted that the changes in the capital exporting countries' tax laws will improve the rates of return on investments for those countries vis-a-vis the U.S. rates of return.

The changes in the tax laws of capital importing countries were reviewed as to the effect on cash flow from those countries and the related effect on the rates of return realizable by the capital exporting countries. Where the changes in the tax laws of the capital importing countries will have a substantial effect on the capital exporting countries' rates of return, those rates of return were recomputed to measure the impact on the average rates of return for each mine model to determine whether the U.S. position relative to the other capital exporting countries was affected. Further, the effect of such changes on the relative position of the U.S. as reflected in the tables of frequency of rankings were also inferred (see pages 12 and 13 of the Study).

Based on these reviews and analyses, we believe that the conclusions and results set forth in the Study as to the U.S. position relative to other capital exporting countries are basically unaffected by the changes in the tax laws of the capital importing and capital exporting countries, which have occurred since May 12, 1975.

Very truly yours,

COOPERS & LYBRAND.

EXHIBIT

The changes in the tax laws of the capital exporting and capital importing countries are summarized on the following pages.

COUNTRY: THE NETHERLANDS

Rate of income tax

The tax rate on taxable income in excess of DFL's 50,000 has been reduced from 48% to 47%.

Loss carryovers

For taxable years 1974 through 1976, operating losses can be carried back two preceding years instead of just one year. The carryforward period remains unchanged at six years.

Tax treaties

A tax treaty with Australia is now under negotiation.

The changes in tax treaties between the capital importing and capital exporting countries may be summarized as follows:

Germany—South Africa treaty

The instruments of ratification were exchanged during 1975. However, the treaty is effective retroactively to 1965 with respect to interest and dividends.

Under the treaty, dividends received from South African corporations which are at least 25% owned by a German corporation will be taxed at a 7.5% withholding rate, rather than 15%, and will not be subject to the German corporation tax. (Formerly, these dividends were subject to German corporation tax, reduced in whole or part, by a credit for South African income and withholding taxes.) Further, South African branch income will no longer be subject to German corporation tax.

Germany—Liberia treaty

The treaty entered into force during 1975 when the instruments of ratification were exchanged. It is effective retroactively to 1970.

Under this treaty, dividends received from Liberian corporations which are at least 25% owned by a German corporation are subject to Liberian withholding tax at the rate of 10% rather than 15%. Under the treaty, dividends from 25% or more owned Liberian subsidiaries are exempt from corporation tax. Liberia is considered a developing conutry for German income tax purposes; thus, even prior to this treaty, dividends from Liberian corporations effectively were not subject to German income tax. Under the treaty, branch income also is not subject to German corporation tax. Finally, the withholding tax rates on interest were reduced from 15% and 30% to 10% and 20% for financial institutions and all other taxpayers, respectively.

Germany—Brazil treaty

The treaty between Brazil and Germany was ratified in December, 1975.

Under this treaty, withholding rates have been reduced from 25% to 15% for dividends and interest. The effective dates are January 1, 1978 in the case of dividends and January 1, 1977 in the case of interest payments.

The Brazilian treaty calls for the same tax exemption for dividends received in Germany as under the Liberian treaty. Brazil is also a developing country for German income tax purposes, so that the German income tax rules that previously applied to Liberia and are discussed above also applied to Brazil.

COUNTRY: AUSTRALIA

There have been two changes in the Australian tax law which will affect mining companies.

Reduction in the general tax rate from 45% to 42.5%.

Accelerated depreciation allowances were extended to certain assets.

In addition, the government has proposed that an investment allowance be enacted retroactive to January 1, 1976; which incentive is expected to be adopted.

Accelerated depreciation

For the year ended June 30, 1976, the assets eligible for the double depreciation allowance were expanded. To qualify for this benefit, these assets must be used or installed before July 1, 1976; such assets would continue to be depreciable at the double rates until fully written off. Normal rates of depreciation would apply to new assets used or installed after June 30, 1976. (This assumes the investment allowance discussed below is enacted.)

Investment allowances

The new allowances will apply to eligible plant ordered on or after January 1, 1976. Eligible assets ordered or contracted for between January 1, 1976 and June 30, 1978 will attract an allowance of 40% of the cost of each item in excess of $1,000 provided the asset is first used or installed ready for use by June 30, 1979; such allowance will be allowed as a deduction. Eligible assets ordered or contracted for between July 1, 1978 and June 30, 1983 will be eligible for an allowance of 20% of the cost of each item in excess of $1,000 provided the plant is first used or installed ready for use by June 30, 1984.

The investment allowance does not reduce the tax basis of the asset for depreciation purposes and such assets may be depreciated at normal rates.

The new investment allowance will apply to all new depreciable plant and equipment other than items specifically excluded. Thus, expenditures on qualifying assets in the mining industry will not be eligible for this allowance if they are claimed as a current deduction under the special industry provisions. At present, current deductions are allowed for certain exploration and prospecting plant and equipment. However, a taxpayer may elect to claim normal depreciation on such plant and thereby qualify for the allowance.

The pertinent items of the mining industry which are specifically excluded from the investment allowance are:

Certain structural improvements, for example, wharves and jetties and primary producers' boundary fencing and employees' cottages.

Jigs, tools, dies, and tooling.

COUNTRY: BRAZIL

Withholding taxes

The temporary reduction in withholding tax to 5% on interest has lapsed and the rate has returned to 25%. However, in the case of certain loans incurred for the purchase of equipment, 85% of the 25% withholding tax is refunded to the local borrower. This refund applies only in the case of loans amortizable over five years or more.

Where the withholding tax on interest is reduced by treaty, the amount refunded to the local borrower is 85% of the applicable withholding amount.

COUNTRY: CANADA (IMPORTING)

Federal corporate income tax

The tax rate on production profits from a mineral resource in Canada has been reduced from 50% to 46%, effective January 1, 1976. The rate for income from processing beyond the "prime metal stage" remains at 40%, which rate also applies to general manufacturing and processing income.

Provincial mining taxes

Provincial mining taxes, which can be substantial, are not deductible for federal and generally not for provincial income taxes purposes. In lieu of providing a deduction for provincial mining taxes, there was a 15% abatement of the federal income tax rate. This abatement has been repealed. In its place a resource allowance is now granted equal to 25% of production income after deducting operating costs and capital cost allowances (depreciation). Since the resource allowance is deducted from income before calculating depletion, the amount of depletion that may be claimed will be reduced. The following illustrates the calculation of the federal income tax under this provision:

	Amount
Production revenue	$100.00
Less:	
Operating costs	(15.00)
Capital cost allowance	(5.00)
	20.00
	80.00
Resource allowance (25 percent×$80)	20.00
Less:	60.00
Canadian exploration expense	(18.00)
Canadian development expense	(8.00)
Interest expense	(2.00)
	28.00
	32.00
Depletion (25 percent×$32)	8.00
Taxable income	24.00
Federal tax (46 percent less 10 percent provincial income tax abatement)	8.64

Those provinces which decide not to allow a deduction for the resource allowance may well decide to allow a deduction for the mining taxes in computing taxable income for provincial income tax purposes.

Investment tax credit

For "qualifying assets" acquired during the period from June 23, 1975 through June 30, 1977, a five percent investment tax credit is allowed as a credit against federal income taxes payable. The credit which may be claimed may not exceed $15,000 plus one-half of the tax payable. The unused credit may be carried forward for five years. The credit actually claimed must be deducted from the depreciable base of the qualifying assets. Such assets include practically all mining assets except cost of acquiring mineral properties and "Class 12 assets" such as haulage ways and cross-cuts.

In certain cases, the investment credit will be available with respect to the cost of completing buildings under construction on June 30, 1977.

COUNTRY: MEXICO

Withholding taxes

The withholding tax rates have been increased as follows:

[Amount in percent]

	From	To
Dividends	20	21
Interest:		
Normal	(1)	42
Foreign financial institutions	10	21
Public interest loans	20	21

[1] 5 percent graduated to 42 percent.

COUNTRY: NEW CALEDONIA

Possible forms of doing business

Branch or subsidiary.

Corporate income tax

An income tax on profits from mining operations in New Caledonia has been adopted retroactive to January 1, 1975. The rate has been set at 50%, which is applicable to both branches and subsidiaries (certain capital gains are subject to tax at lower rates). In addition, a new export tax has been adopted retroactive to January 1, 1975; however, the amount of the export tax payable is reduced by the income tax on profits.

Formerly, New Caledonia imposed only an export tax on the gross value of the minerals.

Withholding taxes

Dividends: 10%.

Branch earnings are subject to a 10% "withholding" tax, when earned. If the branch operation is conducted by a company incorporated outside of this "zone franc" area over which the French government asserts exchange control jurisdiction, only 75% of that branch's New Caledonian income is subject to the withholding tax.

Interest: 10%.

Note: A 3% surtax on dividends, interest and branch profits has been imposed for an unlimited period, which effectively increases such taxes to 13%.

Treatment of major items in mining operations

The costs of acquiring mineral leases and/or mineral concessions normally must be amortized over the period of the lease or of concession; certain related fees such as legal fees and finder's fees may be deducted in the year in which they are incurred, or carried forward at the option of the company and deducted against the initial profits.

Exploration and development expenditures must be amortized over the life of the lease or the concession.

Equipment with a normal life of less than three years, and industrial buildings with a useful life of 15 years or more, must be depreciated on a straight-line basis. However, equipment with a useful life of three years or more, and indus-

trial buildings with a useful life of less than 15 years, may be depreciated on an accelerated basis. If assets are depreciated on an accelerated basis, the following percentages are used:

Useful life:	*Percentage of straight line*
3 to 4 years	150
5 to 6 years	200
More than 6 years	250

Depreciation may be claimed in the year an asset is acquired or constructed.

In tax loss years, depreciation may be deferred and deducted in full from profits in subsequent years.

In profitable years, depreciation may also be deferred; however, in this event, only the amount of depreciation in excess of straightline depreciation may be deducted from subsequent profits. The straight-line depreciation which is deferred may be amortized on a straight-line basis at the end of the asset's normal useful life assuming it remains in service. Such amortization would be based upon the asset's remaining useful life. The straight-line portion of the deferred depreciation not subsequently deducted is reflected in the basis of the asset for purposes of computing gain or loss upon disposition of the asset.

A percentage depletion allowance, similar to that available under French system, may be claimed as a deduction. The amount of such deduction is the lesser of:

a. 5% of gross income from mining, or

b. 15% of the taxable net income arising from the sales of mineral products (including sales of refined products).

The percentage depletion deduction must be recaptured as taxable income in subsequent years unless equivalent amounts are expended on:

a. exploration in New Caledonia

b. improving the recovery of minerals

c. or for investment in corporations or ventures whose object is the same as above.

At the end of two years, recapturable percentage depletion amounts to one-third of the allowance which is "unexpended"; at the end of five years, recapturable depletion amounts to the balance of the allowance which is unexpended.

Limitations on deductibility

Home office expenses incurred outside of New Caledonia are generally deductible.

Net operating loss carryovers

May be carried forward five years, but not carried back.

Tax treaties with capital exporting countries

New Caledonia has no income tax treaties with any capital exporting countries.

Other taxes on mining operations

The new export tax is applied as follows:

Tax on ore exports.—15% of the sales price FOB New Caledonia.

Tax on processed minerals.—6.5% of the sales price FOB New Caledonia for 1975 reduced gradually to 3% for 1979 and later years. When products other than nickel matte are exported to France for further processing, the tax is imposed upon 95% of the sales price FOB New Caledonia. Similarly, when nickel matte is exported to France for further processing, the tax is imposed upon 75% of the sales price FOB New Caledonia.

The amended export tax laws and the income tax law described above do not apply to mining companies that were granted special tax concessions before 1975, unless they elect to be covered by the new laws.

Exchange controls

There are no exchange controls in New Caledonia.

Accounting principles relating to mining

In general, the accounting principles are similar to French accounting principles.

Senator RIBICOFF. Mr. Holmgren, please.

STATEMENT OF ROBERT E. HOLMGREN, VICE PRESIDENT, H. H. ROBERTSON CO., ACCOMPANIED BY ROBERT T. COLE

Mr. HOLMGREN. Thank you very much, Mr. Chairman.

I am Robert Holmgren, vice president of the H. H. Robertson Co., and we understand that the Senate's Finance Committee is holding these hearings primarily to deal with major tax issues.

The H. H. Robertson Co. is here to discuss an issue which is significant to it and may be significant to other taxpayers in the future.

The reason we are here is that the tax law worked in a way which we were subject to a tax which was unfair. We were taxed twice on the same income. Having said that we are here because of our problem does not mean that the problem we have is not a general problem. The double taxation of the same income resulted from the general problem which you are now considering in connection with the tax reform bill dealing with the requirements for an advanced ruling from the Commissioner of Internal Revenue under section 367, and the standard to be used by the Commissioner to extract the toll charge as a condition to the issuance of a favorable section 367 ruling.

As stated in the House report, one of the reasons for the proposed changes is that—and I will quote, "There may be cases where these standards are inappropriate or not being correctly applied."

Robertson's situation is one case where the standard was inappropriate and therefore should be corrected.

The Robertson Co. is a corporation engaged in the manufacture and erection of industrial and institutional-commercial building products both in the United States and overseas. The income of our United Kingdom subsidiary was taxed by its government in the year it was earned but in accordance with the U.S. tax system was not subject to a U.S. tax on a current basis. However, when the dividends were declared the dividends were then subject to U.S. tax.

In 1965 Robertson decided to reorganize its corporate structure by liquidating its United Kingdom subsidiary and thereby bring back to the United States the earnings and business of its subsidiary which were previously not subject to any U.S. income tax. Robertson sought to have the liquidation of its subsidiary treated as a tax-free liquidation under the appropriate provisions of the code so that no U.S. tax, subject to appropriate toll charge, would be due upon this reorganization. Therefore, Robertson requested appropriate rulings from the Internal Revenue Service including a request for an advanced determination under section 367 that the liquidation did not have as one of its principal purposes the avoidance of Federal income taxes.

As a condition to the issuance of the section 367 ruling, the Internal Revenue Service extracted a toll charge whereby Robertson agreed to include in its gross income as a dividend an amount equal to the earnings and profits of the United Kingdom subsidiary. While a toll charge was proper, it got out of hand and led to U.S. taxation on $1.6 million of earnings that we didn't have.

Thus, under the earnings and profits rule the $1.6 million was doubly taxed for reasons I don't fully understand. What I do know is that from its inception until liquidation the United Kingdom subsidiary earned $9.1 million and the total amount of its income on which the Robertson Co. subsequently paid tax was $10.7 million. This was the

equivalent of an employee being taxed upon $10,700 of salary income, when the actual salary income was $9,100.

This toll charge extracted by the Internal Revenue Service was unfair. However, since the Internal Revenue Service stood on the only bridge, on the only road to be traveled, Robertson had no choice but to pay the toll the Internal Revenue demanded.

We respectfully request that you afford Robertson the relief it needs.

I would now like to call on Mr. Robert Cole, counsel for the Robertson Co.

Mr. COLE. Senator Ribicoff, I will just briefly try to in 2 or 3 minutes to give you an idea of what the problem is.

Senator RIBICOFF. By the way, I read your full statement so your entire statement is in the record as though read.

Mr. COLE. The problem is the IRS picked up a convenient term from another area of the Code and misapplied it in determining how much this company should be taxed when the deferral of its foreign earnings were needed. A previous witness talked about the problems of ending deferral. There is one case under the current law where deferral is ended, and that is when you liquidate a foreign subsidiary and tax the U.S. corporation. But it is important that the deferral be ended in a fair way.

What happened is that the IRS picked out a term which was inappropriate and said, "We will tax this company on earnings and profits," but what they should have said is, "We will tax this company so that it is treated as it would have been if it had used a U.S. corporation."

One can sympathize with the IRS using the technical term but what we are asking is that we be taxed as if we had always used a U.S. corporation. What we are asking for is tax neutrality on the ending of deferral.

Now, one important thing is that in this case Robertson was hurt but in the next case the insistence on using the technical term could whipsaw the Government and find the Government collecting less tax than it should. It could even be that the insistence on the use of the term "earnings and profits" could serve as a shield for hiding foreign bribes, and I think it is important for the tax law to be applied without all this technicality in a way that achieves the right results and not by the use of inappropriate concepts from one area to another just because it serves some convenience.

Now, as I understand it, the staff is concerned about departing from these technical terms and one of the reasons Robertson asked me to join them in this testimony was because I have worked in the international tax area for 16 years, including part of that time with the Treasury Department, and in my role as expert what I want to tell you is that you can deal with this problem on the ending of deferral on liquidation of a foreign company without getting into this entire area, this earnings and profits area in other contexts.

Indeed, in 1971, that is exactly what the Congress did.

So what we are asking you to do is to follow the 1971 precedent and say that even though the Internal Revenue Service was attached to a technical term and was afraid to give the right result in this case, we hope that the Senate Finance Committee with its broader jurisdiction can make an appropriate amendment to a section that is already in the House bill, the very section that is involved in the House bill.

What we are asking for is to make a minor change to prevent the whipsawing effect against the taxpayer, or against the Government, and to get the right result.

Thank you.

Senator RIBICOFF. The staff informs me that they are aware of this matter and are studying it for the committee. So the staff is involved in your problem there.

Thank you very much, gentlemen.

[The prepared statements of Messrs. Holmgren and Cole and the legislative brief follow:]

STATEMENT OF MR. ROBERT E. HOLMGREN, VICE PRESIDENT, H. H. ROBERTSON COMPANY

We are mindful that the Senate Finance Committee is holding these hearings primarily to deal with major tax issues. H. H. Robertson Company (Robertson) is here to discuss an issue which is significant to it and which may be significant to other taxpayers in the future. In our system there are some tax issues that can only be dealt with by legislation, and this is one of the two places to which we can address ourselves.

The reason we are here is that the tax law worked in a way in which we were subject to tax in a manifestly unfair way. We were taxed twice on the same income.

Some might think that such an occurrence is something that cannot be helped and that we should go about our business without trying to do something about it. On the other hand, one of the geniuses of our system is that our various agencies and, especially Congress, are sensitive to the needs of even one citizen or the needs of one company. Indeed, recently the Department of Health, Education and Welfare decided that it will deal with all complaints rather than just with complaints involving a general principle and many of our institutions both public and private are trying to make themselves more attuned to individual situations.

Having said that we are here because of our problems does not mean that the problem we have is not a general problem. The double taxation of the same income resulted from the general problem which you are considering in connection with Section 1042 of H.R. 10612 dealing with the requirements for an advance ruling from the Commissioner of Internal Revenue under Section 367 and one standard used by the Commissioner to extract the "toll charge" as a condition to the issuance of a favorable Section 367 ruling. As stated in the House report, one of the reasons for the proposed changes is that, and I'll quote, "There may be cases where these standards are inappropriate or are not being correctly applied." Robertson's situation is one such case where the standard was inappropriate, and, therefore, should be corrected.

Robertson is a corporation engaged in the manufacture and erection of industrial and commercial building products both in the United States and through its foreign affiliates abroad. The income of Robertson's U.K. subsidiary was subject to taxation by the government of the U.K. in the year it was earned, but in accordance with the U.S. tax system for taxing earnings of foreign subsidiaries, was not subject to a U.S. tax on a current basis. When dividends were declared, the dividends were, then, subject to U.S. tax. In 1965, Robertson decided to reorganize its corporate structure by liquidating its U.K. subsidiary and thereby bring back to the United States the earnings of its U.K. subsidiary which were previously not subject to any United States income tax. Robertson sought to have the liquidation of the subsidiary treated as a tax-free liquidation under the applicable provisions of the Code so that no U.S. tax, subject to the appropriate toll charge, would be due upon this reorganization of its corporate structure.

Therefore, Robertson requested appropriate rulings from the Internal Revenue Service including a request for an advance determination under Section 367 that the liquidation did not have "as one of its principal purposes the avoidance of Federal income taxes". As a condition to the issuance of the Section 367 ruling, the Internal Revenue Service extracted a toll charge whereby Robertson agreed to include in its gross income as a dividend an amount equal to the "current and accumulated earnings and profits of the U.K. subsidiary". The effect of this condition was that the liquidation of its U.K. subsidiary was only partially tax

free and that Robertson was required to pay a tax in the year of liquidation on an amount to be computed in accordance with the condition. However, the final ruling issued did not contain a specific dollar amount for the earnings and profits which it was required to include in income.

Originally, its request for rulings included a request for an earnings and profits ruling which would have fixed the amount of the toll charge. However, when its request was under consideration, Robertson was advised by the Internal Revenue Service that if the earnings and profits rulings were desired, final action on the Section 367 ruling would be postponed beyond the time when the Section 367 ruling would be of any significance to Robertson. Accordingly, in order to obtain the mandatory Section 367 ruling within Robertson's time schedule Robertson voluntarily withdrew its request for the earnings and profits ruling. Subsequently, after the issuance of the Section 367 ruling which was conditioned upon the payment of the toll charge, Robertson and the Internal Revenue Service had a dispute over the proper manner to compute the amount of the "current and accumulated earnings and profits" of the U.K. subsidiary. The issue was litigated and the government's interpretation of the proper calculation of the term "current and accumulated earnings and profits" prevailed.

Under this standard Robertson was subject to double taxation of the earnings of its U.K. subsidiary for reasons which I don't fully understand, but which have been explained to me as resulting from the technical application of the Code. Counsel for Robertson, Mr. Robert T. Cole, who will testify upon the completion of this testimony, will explain the technical aspects of this issue. What I do know is that from its inception until liquidation the U.K. subsidiary earned $9.1 million and the total amount of its income upon which Robertson subsequently paid tax was $10.7 million. This is the equivalent of an employee being taxed upon $10,700 of salary income when the actual salary is only $9,100. The additional $1.6-million was attributable to basing the toll charge upon the earnings and profits standard. We are not here taking issue with the decision of the court, but we are taking issue with the insistence of the Internal Revenue Service in requiring the toll charge to be based upon the earnings and profits standard.

When a foreign subsidiary, which has income which was not previously subject to any U.S. tax, is liquidated, it is appropriate for the Internal Revenue Service to impose a tax in the form of a toll charge on the deferred income as a condition for the issuance of a Section 367 ruling. However, where there is only a simple reorganization of corporate structure in the form of a liquidation, we believe that there is no basis to impose a penalty which will have the effect of deterring the returning of these earnings to the United States. If we had operated as a branch, there would not have been double taxation to the extent of $1.6 million.

We submit that the proper toll charge should not involve double taxation and that the Internal Revenue Service's insistence of basing the toll charge upon earnings and profits is inappropriate. The payment of tax upon an amount equal to our deferred foreign earnings, in the language of Section 367, is certainly enough to prevent the avoidance of Federal income taxes. Taxing the income twice is not contemplated by the statute. Accordingly, we believe that the toll charge demanded and extracted from Robertson was too high. Since the Internal Revenue Service stood at the only bridge on the road to be travelled, Robertson had no choice but to pay the charge it desired to extract. We respectfully request that you afford Robertson the relief that it now seeks and provide that in no event will the toll charge exceed the amount of the paying corporation's historical earnings and profits.

STATEMENT OF ROBERT T. COLE, ESQ., ON BEHALF OF H. H. ROBERTSON CO.

As explained by Mr. Robert Holmgren in his testimony, the reason H. H. Robertson Company (Robertson) was subject to double taxation was because of the technical and complex rules associateed with the concept of earnings and profits. Before I discuss how these rules intermeshed to reach the harsh, and what I believe to be an inadvertent result, I would like to address myself to the more fundamental question of whether, based upon current law, the section 367 toll charge upon a liquidation of a foreign subsidiary was properly geared to the standard of earnings and profits. I submit that it was not and that it certainly should not have been geared to that standard in a case where a taxpayer

is taxed twice upon the same income. The statutory foundation allowing the imposition of a toll charge is contained in section 367 where the only statutory guidance is a standard to prevent the avoidance of Federal income tax. This statutory standard is met where a domestic corporation liquidates a foreign subsidiary which had $9.1 million of earnings and pays U.S. taxes at ordinary rates on a total of $9.1 million, but is exceeded where tax is paid on the equivalent of $10.7 million of earnings.

The context of this problem involved the liquidation of a foreign subsidiary. As to Robertson, the parent corporation, this amounted to a recording or restructuring of its corporate organization with no independent economic significance. Normally, where domestic subsidiaries are involved such a reorganization of corporate structure can be accomplished without the imposition of U.S. income tax. However, when a foreign subsidiary is liquidated a different set of circumstances is involved.

The present U.S. system generally gives full recognition to a separate corporation even though the foreign corporation is a wholly-owned subsidiary and with certain exceptions does not impose a U.S. tax upon the income of a foreign corporation in the year the income is earned. Therefore, at the time such a foreign corporation is liquidated, it may have earnings which, although subject to tax in the foreign country, were not subject to any U.S. tax. This is different than the liquidation of a domestic subsidiary because the earnings of the domestic subsidiary would have been taxed in the year income was earned. If, as in the situation with a domestic subsidiary totally tax free liquidation were permitted, the deferral of U.S. tax on those earnings would continue. Therefore, the liquidation of a foreign subsidiary is the proper triggering event to end deferral and impose a U.S. tax, subject to appropriate foreign tax credits, otherwise, the liquidation could be used as a method to continue deferral and thereby avoid the imposition of U.S. tax upon the deferred earnings. To prevent this future tax avoidance as a consequence of the contemplated transaction, the extraction of a toll charge as a condition to the issuance of a section 367 ruling is proper and in conformity with the standard in section 367. However, imposing a toll charge which does more than prevent the avoidance of Federal income tax and extracts a penalty of taxation of the same income twice is not in conformity with the statute nor with the historical treatment of such deferred income.

The goal of the toll charge, as applied to Robertson, was to insure that the principal purpose of the transaction was not the avoidance of U.S. income tax by making sure when the assets of its U.K. subsidiary were returned that the U.S. income tax was imposed upon the same amount of income upon which U.S. tax was deferred. This goal was not achieved through application of the earnings and profits standard since the toll charge to Robertson resulted in it being subject to tax on $1.6 million in excess of its historical earnings. The proper toll charge should be based upon an analogy to the circumstances which would have occurred if the taxpayer had operated abroad in the form of a branch and not used a foreign subsidiary. The branch income would have been taxed upon a current basis without reference to earnings and profits.

The reasons the standard of earnings and profits does not work in this context is that one of the adjustments required to be made to the earnings and profits account, like many other rules, was designed or evolved out of domestic circumstances and was then incorporated or used in the international area without adequate consideration of its impact, or incidental effects. Earnings and profits is a special tax concept, which is different than the accounting definition of retained earnings. Originally, its basic function was to determine the extent to which individuals were taxed upon distributions from domestic corporations in the form of dividends, as opposed to a return of capital. Earnings and profits has never been defined in the Code, although Congress has sporadically provided for various adjustments to be made in calculating earnings and profits. The complexity of these mechanical rules evolved for calculating earnings and profits should not obscure the function of the term. It is not an accounting or corporate concept, but a measure of taxability. When using the term earnings and profits as a measure of taxability one should not overlook the underlying basis for the imposition of the tax and allow the concept itself to control. Blindly using the concept to measure taxability upon liquidation of a foreign subsidiary does just this when it results in taxation of the same earnings twice.

In 1962 Congress, desiring to increase the measure of taxation upon distribution of appreciated property from foreign corporations in order to prevent an

abuse, unrelated to a liquidation of a foreign subsidiary, enacted an amendment to the earnings and profits section of the Code dealing with the adjustment to be made to the earnings and profits account upon the distribution of property, as opposed to cash. The application of this provision in computing Robertson's toll charge produced the double taxation. This 1962 amendment was part of basic changes made in the taxation income and distributions from foreign corporations. Again, earnings ad profits was used as a measure of taxibility, but the underlying reasons for the 1962 amendment to the earnings and profits section and the other changes dealing with foreign corporations is totally inconsistent with taxation of the same income.

A thorough, detailed and complex analysis of these rules is set forth in a Legislative Brief prepared in connection with this issue. With the Chairman's permission, at the conclusion of my testimony, I would like to submit it for the record.*

Briefly, the 1962 Act was designed to end deferral of U.S. tax on certain types of foreign earnings and to foreclose opportunities for repatriating earnings at capital gain rates so that repatriation of the earnings, irrespective of the manner of realization, would have the same consequences. As part of these policies the earnings and profits amendment was added so that nonliquidating distributions of property by a foreign corporation would be taxed in the same way as distributions of cash. No consideration was given to the effect of the earnings and profits amendment upon a liquidation of a foreign subsidiary. Nowhere was there any expression of intent to tax an amount in excess of the earnings of the foreign corporation or impose a penalty as a result of the deferral in those circumstances where it was permitted to continue. To the contrary in effectuating these policies Congress went through a series of elaborate provisions to prevent double taxation of previously taxed earnings. These expressions of intent indicate that any double taxation resulting from the application of the rules was not intended, not contemplated and inconsistent with the provisions designed to prevent such a result.

Accordingly, earnings and results are not an appropriate standard to measure taxability for these purposes and should be abandoned. Previously when this has been demonstrated, Congress has made corrections. In the Tax Reform Act of 1969 Congress recognized this with respect to the relationship between the earnings and profits calculation and depreciation and provided relief.

We recognized that the concept of earnings and profits has ramifications in both the domestic and foreign area beyond the circumstances of a liquidation of a foreign subsidiary and that imperfections in the concept can produce improper results similar to the unfair double taxation of the same income. Although this might suggest an overall review of earnings and profits to ascertain whether the concept is working as a measure of taxability, correction of the imperfection involving reorganizations of foreign subsidiaries can easily be corrected without changing or affecting the existing earnings and profits rules in these other contexts. Thus, a review of the broader ramifications, although desirable, is not required in order to provide relief for Robertson. This can be accomplished by providing a toll charge limitation in section 367, which would not change existing rules in these other areas in any way. All that would be required is an addition to proposed amendment, section 1042 of H.R. 10612, which would provide that the amounts to be included in gross income as a toll charge shall not exceed the amount of the historical earnings and profits of the foreign corporation minus the amount of such earnings and profits otherwise included in income. Additionally, in order to benefit Robertson and other taxpayers similarly situated, some transitional rule is required. We believe this is appropriate because the issue arose in the context of the Commissioners' arbolute power under section 367 and the issue involves double taxation which is generally not sanctioned by our tax system. There is ample precedent for such action under section 367 and other Code sections, indeed the House-passed bill already contains such a provision in the proposed changes to section 367.

Senator RIBICOFF. The committee will stand adjourned until 10 o'clock Monday morning.

[Whereupon, at 12:47 p.m., the committee was recessed, to reconvene at 10 a.m., Monday, March 29, 1976.]

*The brief referred to was made a part of the official files of the committee.

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