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

THURSDAY, APRIL 1, 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 Gaylord Nelson presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Nelson, Bentsen, Haskell, Curtis, Fannin, Hansen, and Packwood.

Senator NELSON. Mr. Robert Flint has not arrived yet, so we will call upon Mr. John J. Douglas, executive vice president, General Telephone and Electronics Corp., on behalf of the U.S. Independent Telephone Association.

Mr. Douglas.

STATEMENT OF JOHN J. DOUGLAS, EXECUTIVE VICE PRESIDENT, GENERAL TELEPHONE AND ELECTRONICS CORP., ON BEHALF OF U.S. INDEPENDENT TELEPHONE ASSOCIATION

Mr. DOUGLAS. My name is John J. Douglas, executive vice president of finance, General Telephone and Electronics Corp.

Senator NELSON. If I may interrupt just a moment, Mr. Douglas, I have not had a chance to read your statement nor to see how long it is. Your statement will be printed in full in the record at the appropriate place. We have six witnesses, so in those parts at least where you can summarize for the purpose of economy in time, we would appreciate it.

I am informed we have a 10-minute time rule.

Mr. DOUGLAS. My summary will be less than 10 minutes.

I appear here today on behalf of the member companies of the U.S. Independent Telephone Association [USITA]. The 1,618 independent—non-Bell—telephone companies serve over 26 million telephones in 48 of the 50 States. A map showing independent-served areas of the United States and a tabulation showing the number of independent companies serving each State are included as exhibits to my written testimony, which was filed yesterday.

At this point, Mr. Chairman, I ask that my written statement be printed in full in the record so that we may devote our time here this morning to highlighting some of the more crucial issues. In addition, I ask leave to distribute at the conclusion of my remarks a booklet entitled, "Capital Formation * * * a Critical Problem for Utilities," which summarizes the capital problem and our proposed solutions in a fairly concise fashion.[1]

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[1] This document was made a part of the official files of the committee.

Secretary Simon's recent testimony before this committee reflects the administration's concern with the serious plight of electric utilities. The recommendations of the President's Labor-Management Advisory Committee to alleviate the problems of electric utilities, which have been endorsed by the administration, also deserve the support of Congress. However, close examination shows that the basic financing problems of the utilities are not unique to the electric utilities. In fact, all utilities—including the telephone utilities—face similar problems.

Demands for all utility services require large, growing and continuous capital outlays. Specifically, utility expenditures for new plant and equipment have grown substantially faster than other segments of the economy. [Chart 1.] Annual capital expenditures by the telephone and electric utilities have grown at about the same rate and are expected to continue to grow proportionately in the future. [Chart 2.] Both telephone and electric utilities are seriously concerned about the availability and price of funds to finance these large and necessary expenditures.

In the past the utility industry has utilized a disproportionate amount of debt to fund its rapidly growing construction expenditures. The utilities are now to the point where they cannot or should not finance their construction budgets by further increasing the ratio of debt to equity. The impact of high interest rates on the highly leveraged financial structures has resulted in a dangerous decline in interest coverage for both telephone and electric utilities. [Chart 6.]

This is particularly troublesome since interest coverage is a key measure of financial strength. The decline in coverage has reduced the credit worthiness of most utilities, thereby increasing the risk of investors and the cost to consumers.

In addition to being capital-intensive and highly leveraged, the utility industry is one of the largest employers in the United States. Within the industry telephone utilities employ approximately twice as many people as electric utilities and account for 56 percent of the total employment in the industry. [Chart 9.] Any tax legislation for electric utilities should be extended equally to all utilities in order to maximize job opportunities in the entire utility industry.

A first step toward alleviating the plight of all utilities is the prompt and permanent removal of inequities in the tax system which bear particularly hard on the ability of telephone and electric utilities to attract capital. USITA recommends three basic changes in the tax laws.

INVESTMENT TAX CREDIT (ITC)

The first such inequity is the permanent investment tax credit [ITC] rate of 4 percent for utilities as compared with 7 percent for nonutilities. Congress has temporarily equalized these rates at 10 percent for 2 years, which was a step in the right direction. However, a 2-year period is not long enough for utilities to effectively and efficiently plan and carry out large capital improvements and make up for past discrimination, and it injects another uncertainty for the future.

We support a permanent ITC of at least 12 percent for all industries, utility, and nonutility. This will immediately provide needed cash flow to strengthen capital structures and improve interest coverage, thus permitting increased expenditures for required construction programs.

Senator NELSON. I don't recall. What was the stated reason for the differential in the investment tax credit between utilities and other businesses?

Mr. DOUGLAS. I believe there were two primarily. This goes back quite a bit. My recollection is the first reason was that the utilities were obligated by their franchises to provide service to their customers, to the users of service. Therefore, because of this obligation it was assumed that they would not need an incentive. They had to provide the construction that was necessary.

Second, as a part of that, I believe the feeling was if it became necessary because of high money costs or capital squeeze to help the utilities finance their construction programs, the State regulators would permit satisfactory rates of return to give the utilities the flexibility to handle their construction programs.

I think those were the given reasons at the time. I think if we look back on the history over the last 5, 6, 7 years, I think we will find the reasons did not stand up.

Senator NELSON. Go ahead.

REINVESTMENT OF UTILITY DIVIDENDS

Mr. DOUGLAS. Second, the tax laws effectively foreclose the utilities from selling stock to a large body of potential investors. Utility stocks have been sold traditionally on the basis of high dividend payments, which are taxed to the recipient at ordinary income rates. The tax laws discriminate in favor of high-growth, low-dividend payout companies.

The investor's return on investment in such "growth companies" is achieved largely through reinvestment of earnings by the corporation. The resulting capital appreciation is taxed to the investor at more favorable rates. This discrimination against investors in high-dividend-paying utility stocks results in a higher cost of capital to the utility—a cost that is reflected in higher rates to consumers.

The ability of the utilities to attract capital would be materially enhanced if the investors had the option of reinvesting dividends without a tax penalty. Utility dividends reinvested under an automatic dividend reinvestment plan should in equity be treated for tax purposes as a stock dividend.

DEDUCTION OF DIVIDENDS ON NEW PREFERRED STOCK

Third, the ability of the utilities to improve, or at least maintain, their debt-to-equity ratios by selling equity is severely hampered by the tax law's discrimination which allows the deduction of interest on debt, but does not allow a deduction for dividends paid on equity. The difference in tax treatment is particularly indefensible with respect to preferred stock, which has most of the characteristics of debt and which is a commonly used vehicle for utility financing.

The discrimination should be removed by making dividends on designated new issues of preferred stock tax deductible by the issuer. This could be done with minimal loss of tax revenue, since new preferred would not have the 85 percent dividend preference and would be used extensively as a substitute for debt, interest on which is already deductible. The resulting net tax revenue loss would be less than

the difference between the interest rate and the preferred stock dividend rate, since both interest and dividends would be fully taxable income to the recipients.

In conclusion, enactment of the changes in Federal tax laws recommended by USITA will help telephone and electric utilities to attract needed capital at lower net cost, thereby allowing them to provide required plant and equipment, stimulate employment, and operate more efficiently for the benefit of the public.

The telephone utilities should be given parity with the electric utilities in any new tax legislation. All utilities face similar financing problems. The electric and telephone utilities compete directly with one another for capital in the financial markets. The telephone industry employs more than one-half of the workers in the entire utility industry. Thus, for maximum effectiveness, without detrimental impact on any segment of the utility industry, the ITC and divident reinvestment provisions being considered for electric utilities should in equity be extended to all utilities, including telephone utilities.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. Mr. Douglas, why are your three proposals uniquely suited to solving the utilities' finance problems?

Mr. DOUGLAS. First of all, Senator Hansen, they can be implemented quickly. They have already been supported by many groups that have appeared here. They would provide strong and immediate cash flow which is needed in the utility industry. They would substantially improve the present precarious debt-equity ratios in the utility companies and, finally, would provide in the case of a dividend reinvestment program a very reliable and steady source of new equity infusion in the utility industry.

Senator HANSEN. Has the recent reduction in interest rates substantially solved your problem?

Mr. DOUGLAS. There has been, I guess I would call it, a cyclical reduction we are delighted to see. On the other hand, if you look back over the past six recessions, you see that after each recession when interest rates had bottomed, they climbed to a new peak so we have had five consecutive higher peaks. I would say the trend in the foreseeable future over any period of time is going to be in the direction of higher interest rates.

I would also like to point out that at the present time—I would like to use the General Telephone operating companies as an example. At the end of last year the imbedded cost of debt for our telephone companies was 7.25 percent. In order to turn the imbedded cost of debt downward, we would have to be selling our bonds into today's markets and in future markets at less than 7.25 percent [Charts 4 and 5.]

I might point out one of our better rated telephone companies sold securities last week, long-term debt at 8.66 cost of money. Not only is that substantially above the average and raising the average, but we must also consider as time goes on the older issues of debt are coming up for refunding. Some of those issues are carrying 4 percent and sometimes less, and they are being refunded at current interest rates.

Senator HANSEN. How will the investment tax credit affect the utilities' construction program?

Mr. DOUGLAS. The utility industry had a construction program of roughly $32 billion last year. I think a good estimate would be about

85 percent of those expenditures would be eligible for the investment tax credit. You can see then that this would provide very, very significant cash flow to the utilities to help them meet their construction requirements and this, in turn, would give confidence to investors and in the long run help the equity improvement part of the program.

Senator HANSEN. Thank you.

The CHAIRMAN. Senator Nelson.

Senator NELSON. I have no questions.

The Chairman. Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Chairman.

On the use of the investment tax credit, do you run into any problems with some of the State regulatory commissions in how they try to use the investment credit to bring about a lowering or reduction of rates in effect and thereby preclude the full utilization.

Mr. DOUGLAS. That problem was recognized and very well handled in the revision of the tax law, I believe, several years ago, so that now the problem is reasonably relieved throughout the United States and instead of immediately flowing through the benefits to the subscriber, it has helped. Some problems still exist in the State of New York.

Senator BENTSEN. Do you have any recommendations as to further implementation of legislation to try to stop that?

Mr. DOUGLAS. I believe that if it is not already clear in the legislation, which may be the case because I have mentioned one State that is causing some difficulty in this area, it should be clear that the purpose of the investment tax credit is to help the utilities solve their current construction cost problems and the funding thereof, and therefore to return those funds immediately to the subscribers is adverse to the interest of those subscribers in the long run.

Senator BENTSEN. Do you think the changes made pretty well take care of that?

Mr. DOUGLAS. Yes, sir.

Senator BENTSEN. Accountingwise do you get some overlapping on the chargeoff period, depreciation period, on pollution equipment that you put in with your investment tax credit?

Mr. DOUGLAS. I am afraid I can't answer that. I am in the telephone utility business and we don't have a pollution problem. Maybe one of the electric utilities will be able to speak to that.

Senator BENTSEN. Thank you very much.

The Chairman. Senator Packwood.

Senator PACKWOOD. No questions, Mr. Chairman.

The Chairman. Senator Haskell.

Senator HASKELL. No questions.

The Chairman. Senator Fannin.

Senator FANNIN. I have no questions.

The CHAIRMAN. I am sorry I was not able to be here at the beginning of this session. I had to discuss with the Budget Committee our recommendations with respect to how we will raise taxes. I think this committee should make the recommendations as to how we should or should not raise them.

Mr. DOUGLAS. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Douglas follows. Oral testimony continues on p. 1609.]

TESTIMONY OF JOHN J. DOUGLAS, EXECUTIVE VICE PRESIDENT—FINANCE, GENERAL TELEPHONE & ELECTRONICS CORP. ON BEHALF OF THE UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION

SUMMARY

The long-term demand for communication and power services requires large and growing capital expenditures. During the past decade the utility industry has relied extensively upon the issuance of debt securities to finance these requirements. However, utilities cannot do so as heavily in the future because they have virtually reached the practical limit of their debt capacity. The overall financial deterioration of both telephone and electric utilities is further evidenced by sales of common stock below book value, the need to finance at high interest rates, erosion in interest coverage and numerous downgradings of security ratings. The recent economic recovery serves only temporarily to mask the long-term financing problems that utilities face, which if not solved, will result in higher costs to the consumer.

Because of the seriousness of the financial problems of telephone and electric utilities and their importance to the health and growth of the economy, it is important that Congress take prompt action to redress certain basic inequities in the tax laws which are particularly burdensome to utilities. Congress should:

Permanently increase the investment tax credit (ITC) to 12 percent for all businesses, equalizing the utility and non-utility ITC rates, and remove the 50 percent limitation on the credit:

Defer taxation of automatically reinvested dividends of utilities treating them as stock dividends (IRC § 305); and

Allow a corporate tax deduction by utilities for dividends paid on designated new issues of preferred stock (IRC § 247).

These measures will significantly help in:

(a) Removing inequities in the tax laws which encourage consumption over investment and which favor debt over equity;

(b) Restoring the financial integrity of utilities, reducing their outside capital requirements, and thereby helping to stabilize the financial markets generally; and

(c) Encouraging construction and employment, reducing the cost of capital and holding down the cost of services to the consumer.

The telephone utilities should be given parity with the electric utilities in any new tax legislation. All utilities face similar financing problems. The electric and telephone utilities compete directly with one another for capital in the financial markets. The telephone industry employs more than one-half of the workers in the entire utility industry. Thus, for maximum effectiveness, without detrimental impact on any segment of the utility industry, the ITC and dividend reinvestment provisions being considered for electric utilities should in equity be extended to all utilities, including telephone utilities.

STATEMENT [1]

Three changes in the tax laws are necessary to enable telephone and electric utilities to finance growing construction requirements and to strengthen their capital structures which have become dangerously overburdened with debt.

INTRODUCTION

The ability of the telephone and electric utilities to provide adequate services to the U.S. public is being undermined by serious long-term financial problems, while at the same time the demand for services continues to require extremely large capital expenditures. Specifically, the telephone and electric utilities have been financially weakened by a combination of factors, including record inflation, high interest rates, seriously strained debt capacity, and basic inequities in the Federal tax laws. The recent economic recovery serves only temporarily to mask the long-term problems utilities face in adequately funding construction programs required to meet future demands for communication and power services.

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[1] The United States Independent Telephone Association (USITA) represents the Independent (non-Bell) segment of the telephone industry in the United States. The Independent telephone industry consists of 1,618 telephone operating companies serving over 26 million telephones through 11,000 exchanges in over one-half of the served geographic areas of the nation. A map showing Independent-served areas of the United States and a state-by-state tabulation of Independent company statistics are attached as Exhibits A and B. These companies, together with the operating companies of the Bell System, provide exchange and inter-exchange telecommunications service through the integrated facilities of the telephone network.

In considering tax legislation, Congress should not focus solely on the electric utility half of the utility financing problem. Telephone and electric utilities compete directly with each other in a common financial market for their large external requirements. To strengthen only electric utilities through tax relief would disadvantage telephone utilities as the other major competitor for funds in the utility financing market, thereby driving up telephone utilities' cost of capital and ultimately prices to consumers. The telephone utilities are by far the largest employer among utilities. The electric utilities account for approximately 30 percent of the employment in the utility industry, and confining tax relief to electric utilities would not only be detrimental to telephone utilities but would materially limit the creation of new employment opportunities in the entire utility industry.

Utilities have unique financial characteristics and long-term financing problems requiring solutions beyond those addressed to capital formation generally. Prompt solutions are needed because of the large amounts of capital utilities must continually raise, because their regulated prices have not been permitted to keep pace with inflation, and because of the essential nature of the public service they provide.

The urst step toward alleviating the plight of utilities should be the prompt and permanent removal of basic inequities in the tax laws which bear particularly hard on the ability of telephone and electric utilities to attract capital.

Congress should:

Permanently increase the investment tax credit (ITC) to 12 percent for all businesses, equalizing the utility and non-utility ITC rates, and remove the 50 percent limitation;

Defer taxation of automatically reinvested dividends of utilities, treating them as stock dividends; and

Allow a corporate tax deduction by utilities for dividends paid on designated new issues of preferred stock.

These measures will significantly help in:

(*a*) Removing inequities in the tax laws which encourage consumption over investment and which favor debt over equity;

(*b*) Restoring the financial integrity of utilities, reducing their outside capital requirements, and thereby helping to stabilize the financial markets generally; and

(*c*) Encourging construction and employment, reducing the cost of capital, and holding down the cost of services to the consumer.

I. TELEPHONE AND ELECTRIC UTILITIES HAVE COMMON FINANCIAL PROBLEMS

(*A*) *Large capital outlays are needed to meet demands for utility services*

Demands for service require large, growing and continuous capital outlays by the utility industry. The growing rate of these outlays far outstrips the rates in other sectors of the economy. For example, during the period 1965 through 1975 expenditures for new plant and equipment for utilities increased by 195 percent whereas for manufacturing the increase was only 106 percent (Chart 1). Annual capital expenditures of all utilities were approximately $22 billion in 1970, increased to $32 billion in 1975, and are estimated to reach $54 billion by 1980 (Chart 2). The utility industry is concerned about the availability and price of funds to support these necessary expenditures. This concern will intensify as the economy recovers and the competition for and cost of funds increase.

(*B*) *Increasing reliance on borrowing is no longer practical*

Largely because of the bias in the tax laws favoring the issuance of debt rather than equity, the utility industry utilized a disproportionate amount of debt to fund its rapidly growing construction expenditures from 1966 through 1975. Key indicators of financial strength now show that telephone and electric utilities are virtually precluded from financing their future construction requirements by further increasing the proportion of debt in their capital structures. The level of debt of independent telephone utilities at year end 1975 was 56% of total capitalization, slightly greater than that of electric utilities (Chart 3). The important fact is that both telephone and electric utilities have about reached the practical limit of their ability to increase leverage because of indenture restrictions, the need to protect bond ratings, or the reasonableness of risk that security holds can be expected to assume. Because of the acute nature of the overall debt problem, many utilities, both telephone and electric, have been forced to sell large amounts of new common stock below book value.

The adverse consequences of the extensive use of debt have been magnified by the rapid increase in interest rates during the period 1960 through 1975. Interest rates on "A" rated utility bonds increased from 4.8 percent into 1960 to 10.1 percent in 1975. Although there has been a modest cyclical decline in interest rates recently, the secular trend of long-term interest rates remains upward (Chart 4). Because of anticipated future inflation, long-term interest rates are expected to remain far above historical norms. As a result, the utilities will have to refinance the debt sold prior to the mid-sixties at two-to-three times the original interest rates, while simultaneously financing new construction at the higher rates. The combined will be to significantly and inevitably continue to increase the embedded cost of capital to utilities (Chart 5).

Extensive use of debt and the escalation of interest rates has caused a dramatic erosion in the interest coverage of utilities. Average pre-tax interest coverage for both independent telephone and electric utilities fell to approximately three times in 1974–75, as compared to four to six times a decade ago (Chart 6). Some individual utilities' interest coverage ratios have even dropped below two times, the point at which most utilities are prohibited by indenture limitations from issuing additional long-term debt. The decline in the utilities' interest coverage has reduced the credit worthiness of most utilities and increased the risk to investors. During the period 1971 througr 1975, Standard & Poor's downgraded the bond ratings of 104 public utilities while upgrading only 37. As a direct result, utilities have found it more difficult and more expensive to raise needed capital.

The overall financial deterioration of telephone and electric utilities, as evidenced by (i) extensive use of debt, (ii) sales of common stock below book value, (iii) need to finance at high interest rates, (iv) erosion in interest coverage, and (v) downgradings of securities, can only lead to higher prices to conumers.

(C) Capital intensity

The financial problems of utilities further magnified by their capital intensive nature. Independent telephone and power utilities invest nearly 5 times as much as the average manufacturer for each dollar of annual sales (Chart 7). Therefore, utilities must rely far more heavily on external financings than industrials.

(D) Competition for external capital

Utilities account for a large and increasing share of the private external capital financing in the U.S. (Chart 8). Telephone and electric utilities compete directly with each other, and with all others including the Federal government, for the limited amount of available capital. Because of large capital needs, strained debt/equity ratios, and reduced credit worthiness, utilities find themselves disadvantaged competitors in the intensely competitive financial markets.

(E) Utility employment

In addition to being capital intensive, the utility industry is one of the largest employers in the United States. Within this industry telephone utilities employ approximately twice as many people as electric utilities and account for 56% of the total employment in the industry (Chart 9).

II. CONGRESS SHOULD INCLUDE IN THE CURRENT TAX BILL PROVISIONS TO STRENGTHEN THE UTILITIES' ABILITY TO FINANCE THEIR CONSTRUCTION REQUIREMENTS

To alleviate the financial problems facing telephone and electric utilities, to remove basic inequities in existing tax laws, and to stimulate the economy and employment, Congress should promptly adopt the following three tax proposals:

Permanently increase the investment tax credit (ITC) to 12 percent for all businesses, equalizing the utility and non-utility ITC rates, and remove the 50 percent limitation on the credit;

Defer taxation of automatically reinvested dividends of utilities, treating them as stock dividends (IRC § 305); and

Allow a corporate tax deduction by utilities for dividends paid on designated new issues of preferred stock (IRC § 247).

(A) The investment tax credit (ITC) should be made permanent at 12 percent for all businesses

There is little question that the ITC has proven to be an effective tool for fighting recession, unemployment, and inflation. A permanent 12 percent ITC

for all businesses, including telephone and electric utilities, will immediately provide needed cash flow to strengthen capital structures and to improve interest coverage, thus permitting increased construction programs. Private and governmental studies indicate that the long-term effect of ITC on tax revenues is favorable, because an increased, permanent ITC will both directly and indirectly stimulate tax revenues by providing jobs and improved earnings.

Increasing the ITC clearly provides a strong stimulus to investment. Historically, there is a strong correlation between changes in new fixed investment and changes in total employment (Chart 10).

The recent increase in the ITC for all industries to 10 percent from the prior 7 percent for industrial companies and from a discriminatory 4 percent for all public utilities was a step in the right direction, but it was limited to two years. The increased ITC must not be allowed to expire as scheduled at year end 1976 and all utilities returned to the discriminatory 4 percent level, nor should Congress establish a lower rate for the telephone utilities than for other utilities.

Furthermore, the long-term benefit of the ITC is greatly reduced by an on-again, off-again policy, particularly in the case of utilities, which require long lead times in construction planning.

Similarly, the relaxation of the 50 percent limitation on the credit in Section 46 of the Internal Revenue Code should be continued. Otherwise, the benefits of the increased rate will be denied to those less profitable businesses with the highest capital needs.

The legislation should continue to require normalization for utility rate-making purposes.

Because of serious technical impediments, most telephone utilities have been precluded as a practical matter from availing themselves of the additional one percent investment tax credit for contributions to Employee Stock Ownership Plans (so-called ESOP). Five remedial amendments are needed in order to give the Independent telephone companies a realistic option of establishing ESOP for their employees. The five technical problems are discussed in detail in Appendix A to this testimony. Note particularly the fifth point dealing with the 80% affiliation test, which problem among telephone companies is peculiar to the Independents.

Extension of the present two-year life and an increase in the one percent funding level provided in the 1975 Act would afford more adequate, long-term financial incentives to establish such employee plans.

(B) Stockholder reinvestment of utility dividends should be taxed in the same way as stock dividends

Stock issued under automatic dividend reinvestment plans of utilities should be treated for tax purposes under Section 305 of the Internal Revenue Code just as though it had been received as a stock dividend. Under this proposal, utility stockholders would be permitted to reinvest their dividends in newly issued stock of the dividend-paying corporation without being penalized by having to pay a tax on dividends they never actually receive.

Investors in utility stocks traditionally seek a high dividend yield. As a result, the dividend payout of most utilities ranges between 60 percent and 70 percent of net income, a much higher rate than traditionally paid by industrial firms (Chart 11). Because of the nature of their investors, utilities do not have the same degree of flexibility in dividend payouts as do most industrial firms. The importance of dividends to utility investors can be illustrated best by the traumatic experiences of Consolidated Edison when it omitted a dividend payment in 1974 and General Public Utilities when it unsuccessfully attempted to switch from cash to stock dividends.[1]

Since cash dividends are taxed to the recipient at ordinary income tax rates, the tax laws in effect discriminate against high-dividend-paying companies (e.g., utilities) while favoring companies which retain more of their earnings for internal growth (Chart 12). This discrimination against investors in high-dividend-paying utility stocks results in a higher cost of capital to the utility—a cost that is reflected in higher rates to consumers.

If investors had the option of reinvesting dividends under automatic dividend reinvestment plans without a tax penalty, the adverse effects of existing discrimination would be significantly reduced because investors in utilities would be treated more equitably with investors in industrial companies. Furthermore, the ability of utilities to obtain much needed equity capital from a far broader investor constituency would be enhanced.

[1] "A Case For Dropping Dividends," Fortune, June 15, 1968, page 181.

One particular advantage of this proposal is that it builds on existing dividend reinvestment plans which have proven to be popular particularly among utility investors. Consequently, many utility companies have already established these plans. As an illustration of the success of these programs, participation in GTE's Dividend Reinvestment Plan has increased from 11 percent of registered holders in 1972 to nearly 20 percent in 1976. The amount of money invested annually by participants has increased about threefold, from $5 million in 1972 to an estimated annual rate of more than $15 million in 1976 (Chart 13). The increased participation provides an important source of new equity capital to the company.

These plans are particularly well suited to the needs of the small investor, because they provide a convenient, systematic and inexpensive means of investing. For example, participants in GTE's Dividend Reinvestment Plan purchase new shares without paying brokerage commissions or service charges. The popularity among small investors is illustrated in the case of GTE's plan wherein 74 percent of the participants own 100 shares or less. Conversely, participation among investors with large shareholdings is modest (Chart 14).

The adoption of this tax proposal would significantly increase participation in existing dividend reinvestment programs and induce other utilities to establish similar programs for their shareholders. It would enhance the attractiveness of high-dividend-paying utility stocks for prospective investors interested in capital appreciation, while retaining traditonal investment appeal for shareholders seeking cash dividends. The increased equity investment would help strengthen the capital structure of the utility industry, reduce reliance on outside capital markets and help provide funds required to increase capital expenditures and employment.

The first order revenue loss of this proposal to the Treasury is not only small[1] but would be quickly overcome by the resulting expanded economic base, including jobs created both directly and indirectly. Statutory language to implement this proposal is suggested in Appendix B to this testimony.

(C) Utilities should have the option of offering designated new issues of preferred stock with dividends tax deductible to the issuer

The ability of the utilities to at least maintain their debt/equity ratios by selling equity is severely hampered by discrimination in the tax laws which allows the deduction of interest on debt but does not allow the deduction of dividends on equity. The difference in tax treatment is particularly indefensible with respect to preferred stock which has most of the characteristics of debt and which is a commonly used vehicle for utility financing. The discrimination should be removed by making dividends on designated new issues of preferred stock deductible by the utilities.

Enactment of this proposal would make an important and substantial contribution to the ability of utilities to raise needed equity capital and to improve or at least maintain their debt-to-equity ratios. The market for preferred stock would be substantially broadened to attract new investors because the issuer could economically pay a higher dividend rate than is currently available on most fixed income securities of similar quality. Enactment of this proposal could enable utilities to almost double the amount of preferred stock sold at approximately the same cost, thus economically increasing their equity bases. Utilities not electing this new alternative could continue to sell, more advantageously, the traditional preferred stock to institutional investors who would continue to utilize the 85 percent dividend received deduction (IRC § 243). Indeed, some utilities might offer both types of preferred stock.

This proposal would cause a minimal loss of tax revenue, since the new preferred would not have the 85 percent dividend preference of the old preferred and could be used extensively as a substitute for debt, interest on which is already deductible. Therefore the resulting tax revenue loss would be less than the difference between the interest rate and the preferred dividend rate since both interest and dividends would be fully taxable income to the recipients. Utilities with adequate debt capacity would not find this proposal economically advantageous to use, thus further minimizing the potential tax loss to the Treasury.

CONCLUSION

The long-term demand for utility services requires large and continous capital expenditures. In the past, utilities have depended heavily upon the issuance

[1] There would, of course, be no revenue loss with respect to dividends paid to those shareowners who do not participate in Dividend Reinvestment Plans.

of debt securities to finance capital requirements. They can no longer depend as heavily upon this source of capital in the future because they have virtually reached the practical limit of debt capacity. The overall deterioration of the financial strength of utilities is reflected in the erosion of interest coverage, sales of stock below book value and the numerous downgradings of utility securities. These adverse factors must necessarily be reflected in higher costs to the consumer.

Because of the importance of telephone and electric utilities to the health and growth of the economy, their financial deterioration calls for prompt action by Congress. Three changes in the tax laws are recommended which would help remedy the financing problems of utilities and remove basic inequities in the tax laws:

Permanently increase the investment tax credit to 12 percent of all businesses;

Defer taxation of automatically reinvested dividends of utilities, treating them as stock dividends; and

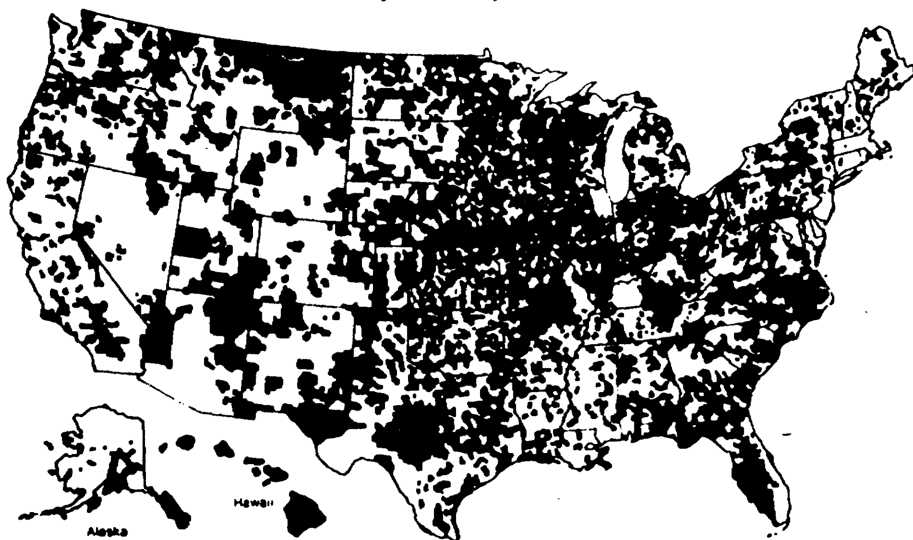
Allow a tax deduction by utilities for dividends paid on designated new issues of preferred stock.

Enactment of these provisions will help telephone and electric utilities to attract needed capital at lower net cost thereby allowing them to provide required plant and equipment, stimulate employment, and operate more efficiently for the benefit of the public.

The telephone utilities should be given parity with the electric utilities in any new tax legislation. All utilities face similar financing problems. The electric and telephone utilities compete directly with one another for capital in the financial markets. The telephone industry employs more than one-half of the workers in the entire utility industry. Thus, for maximum effectiveness, without detrimental impact on any segment of the utility industry, the ITC and dividend reinvestment provisions being considered for electric utilities should in equity be extended to all utilities, including telephone utilities.

EXHIBIT A

UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION (USITA)

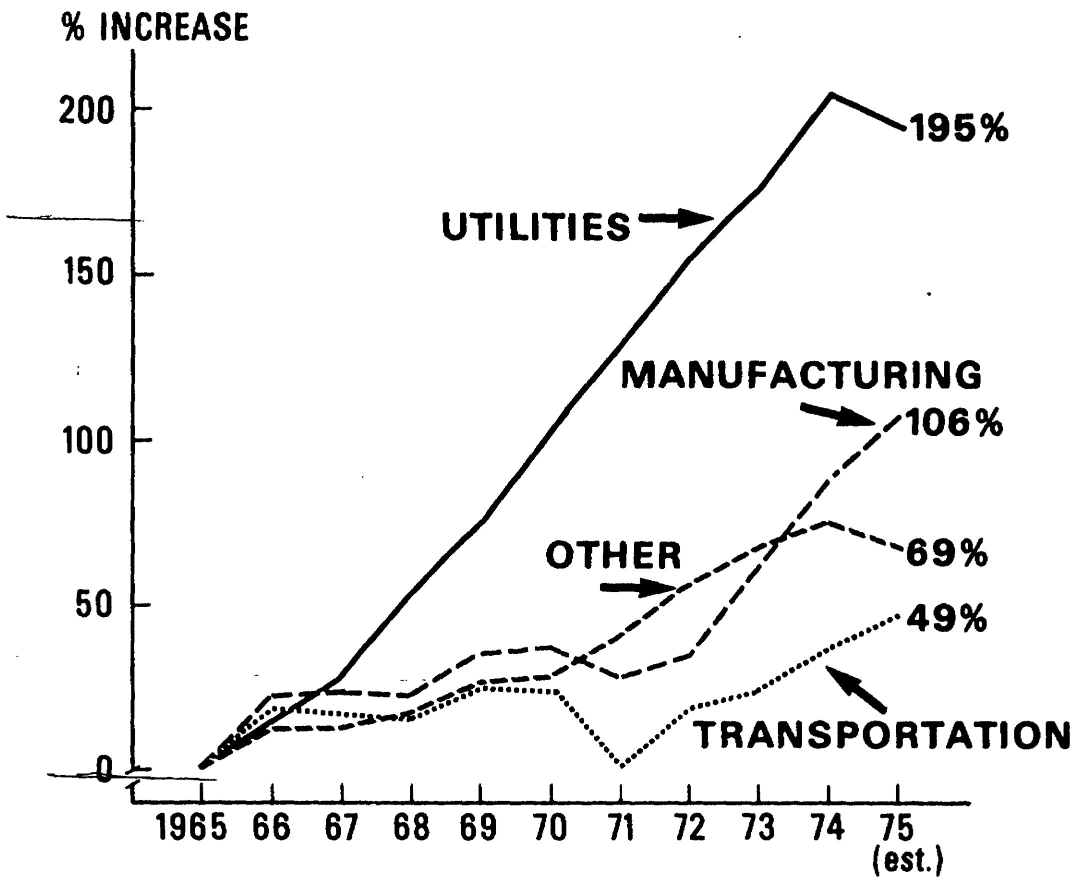


INDEPENDENT TELEPHONE COMPANIES SERVE 51% OF THE LAND AREA OF THE UNITED STATES

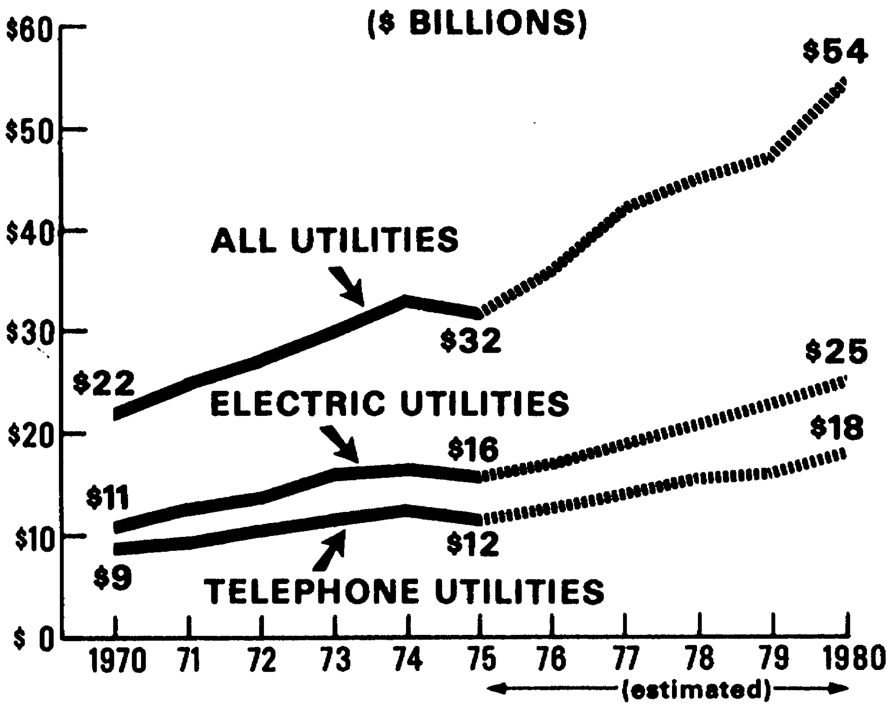
EXHIBIT B

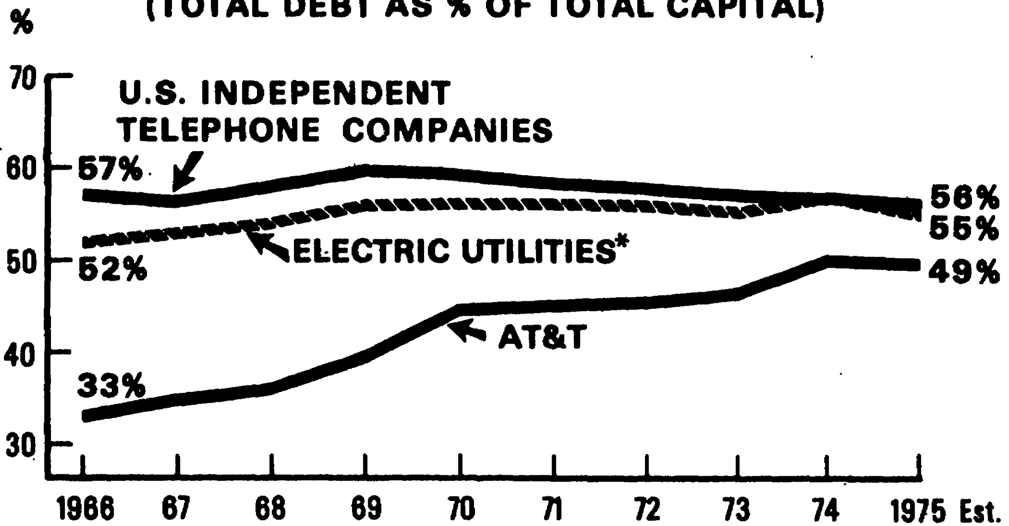
INDEPENDENTS BY STATE
Year End 1975

STATE	COMPANIES	TELEPHONES
ALABAMA	32	339,000
ALASKA	23	189,000
ARIZONA	6	52,000
ARKANSAS	33	337,000
CALIFORNIA	27	3,492,000
COLORADO	29	30,000
CONNECTICUT	2	16,000
FLORIDA	17	2,166,000
GEORGIA	39	462,000
HAWAII	1	568,000
IDAHO	13	106,000
ILLINOIS	62	1,490,000
INDIANA	56	1,238,000
IOWA	166	606,000
KANSAS	46	266,000
KENTUCKY	20	538,000
LOUISIANA	22	128,000
MAINE	17	74,000
MARYLAND	1	4,000
MASSACHUSETTS	3	4,000
MICHIGAN	52	777,000
MINNESOTA	97	641,000
MISSISSIPPI	23	61,000
MISSOURI	48	639,000
MONTANA	18	81,000
NEBRASKA	55	465,000
NEVADA	5	352,000
NEW HAMPSHIRE	12	28,000
NEW JERSEY	2	120,000
NEW MEXICO	12	89,000
NEW YORK	49	1,166,000
NORTH CAROLINA	31	1,520,000
NORTH DAKOTA	19	123,000
OHIO	48	1,753,000
OKLAHOMA	40	239,000
OREGON	42	391,000
PENNSYLVANIA	58	1,577,000
SOUTH CAROLINA	29	453,000
SOUTH DAKOTA	37	79,000
TENNESSEE	23	418,000
TEXAS	88	1,480,000
UTAH	11	28,000
VERMONT	7	40,000
VIRGINIA	24	702,000
WASHINGTON	38	592,000
WEST VIRGINIA	12	123,000
WISCONSIN	114	863,000
WYOMING	11	16,000
TOTAL:	1,618	26,820,000



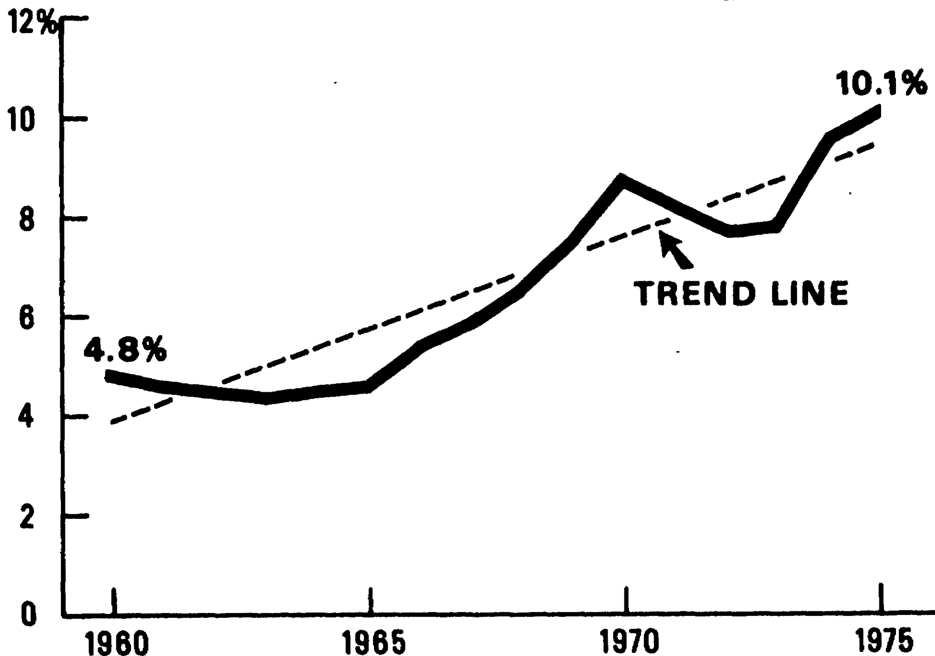
EXPENDITURES FOR
NEW PLANT AND EQUIPMENT
1965-1975
% INCREASE
200
150
100
50
0
UTILITIES
195%
MANUFACTURING
106%
OTHER
69%
49%
TRANSPORTATION
1965 66 67 68 69 70 71 72 73 74 75
(est.)
SOURCE: U.S. DEPARTMENT OF COMMERCE


UTILITY INDUSTRY
Expenditures for New Plant & Equipment
($ BILLIONS)
$60
$50
$40
$30
$20
$10
$ 0
ALL UTILITIES
$22
$32
$54
ELECTRIC UTILITIES
$11
$16
$25
$18
$12
$9
TELEPHONE UTILITIES
1970
71
72
73
74
75
76
77
78
79
1980
(estimated)
SOURCES: U.S. DEPT. OF COMMERCE, KIDDER PEABODY
DATA RESOURCES, INC., U.S.I.T.A. AND AT&T



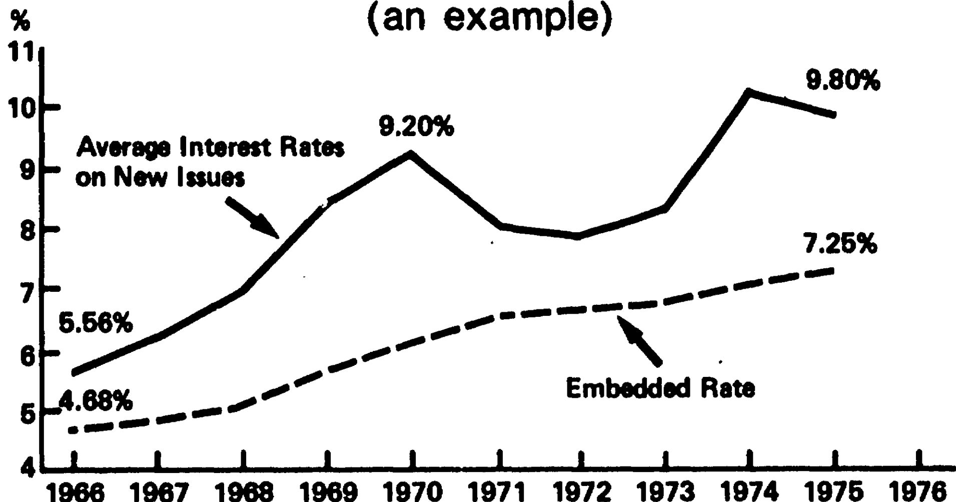
*As compiled by Pacific Gas & Electric Company in Comparative Financial Data: Fifty Largest Utility Companies

SOURCE: AS ABOVE: AT&T STATISTICAL REPORT, AND U.S.I.T.A. STATISTICS



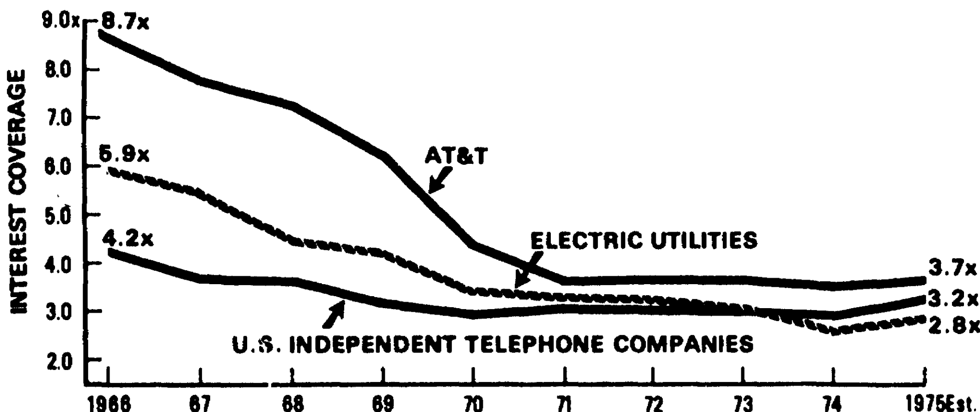
SOURCE: MOODY'S INVESTORS SERVICE

LONG-TERM DEBT INTEREST RATES NEW ISSUES VS. EMBEDDED RATE
(an example)



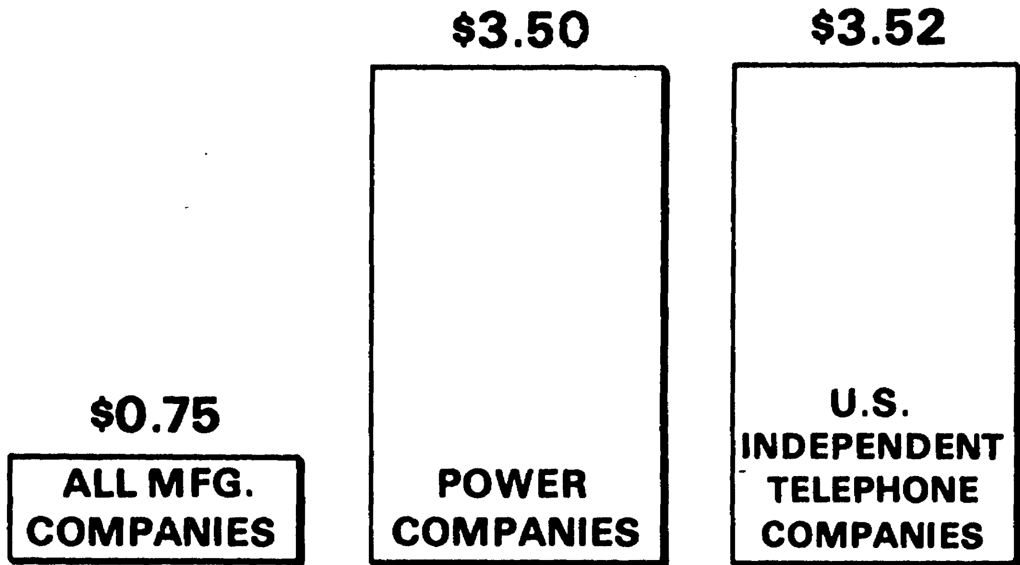
NOTE: The chart is based on actual interest rates experienced by GTE telephone companies and is reasonably representative of USITA experience.

COMPARISON OF PRE-TAX INTEREST COVERAGE
Telephone and Electric Utilities



SOURCE : U.S.I.T.A. STATISTICS, AT&T,
PACIFIC GAS & ELECTRIC'S 29 LARGEST STRAIGHT ELECTRICS IN
COMPARATIVE FINANCIAL DATA: FIFTY LARGEST UTILITY COMPANIES

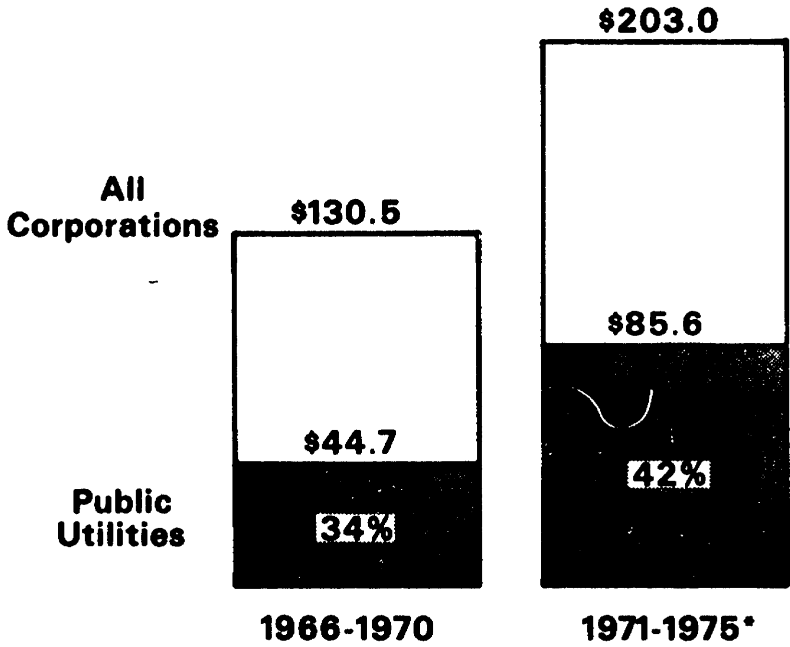
ASSETS REQUIRED TO GENERATE ONE DOLLAR OF SALES REVENUE



SOURCES: FORTUNE 500 — MAY 1975
FORTUNE 50 — JULY 1975
U.S.I.T.A.

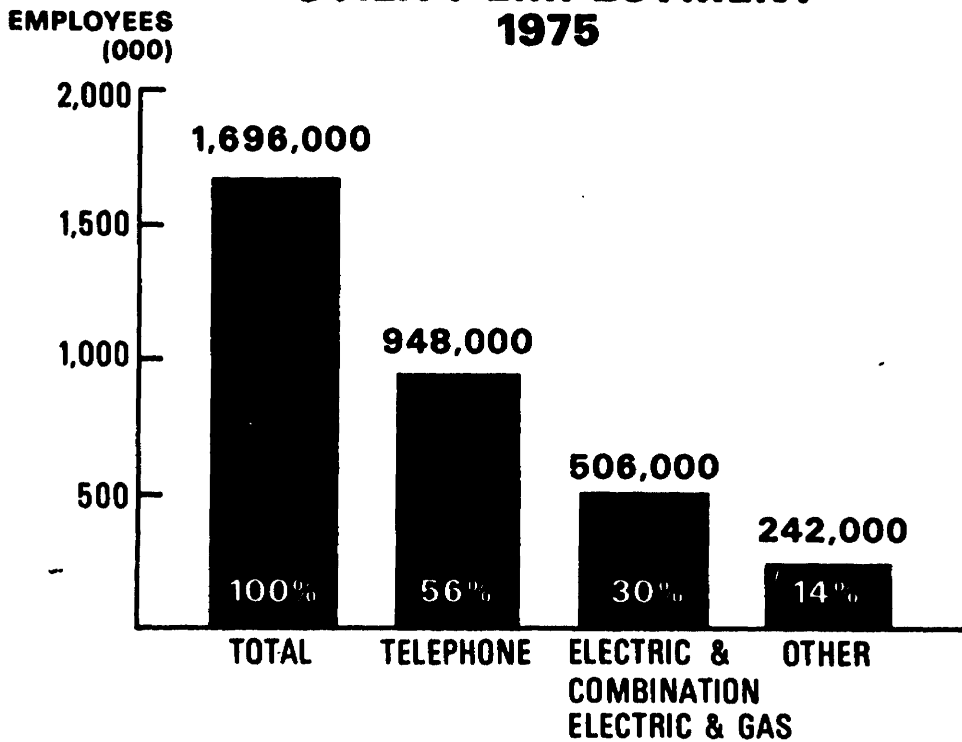
TOTAL NEW SECURITY ISSUES, 1966-1975 PUBLIC UTILITIES AS % OF TOTAL

($ BILLIONS)



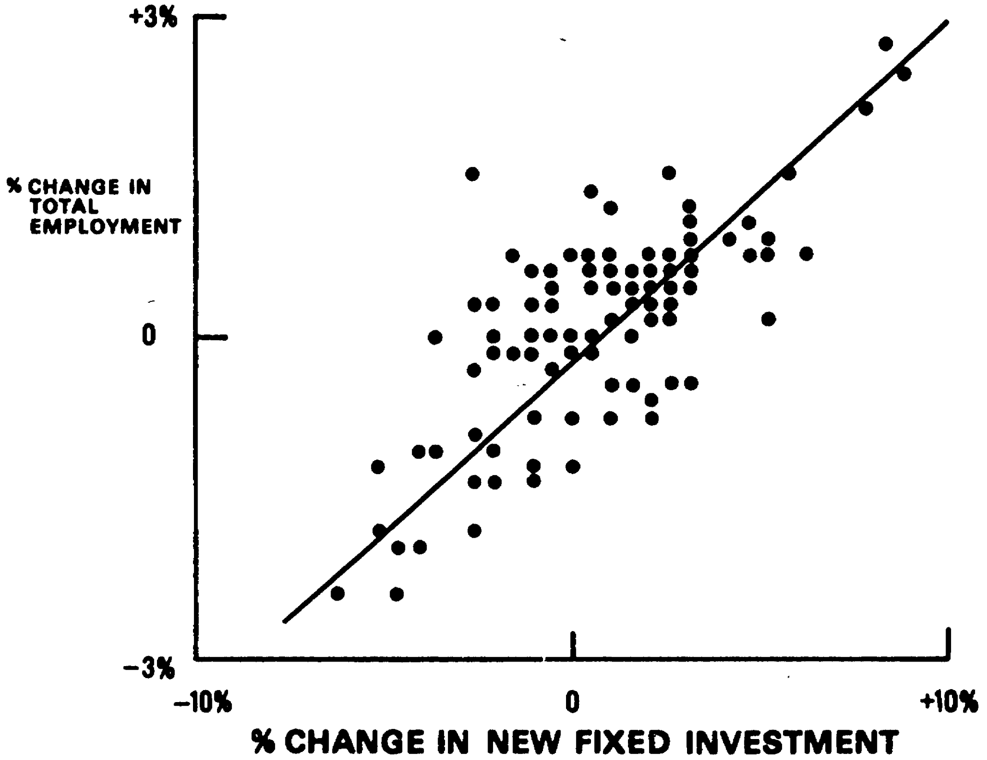
*1975 ESTIMATED

SOURCE: SALOMON BROTHERS

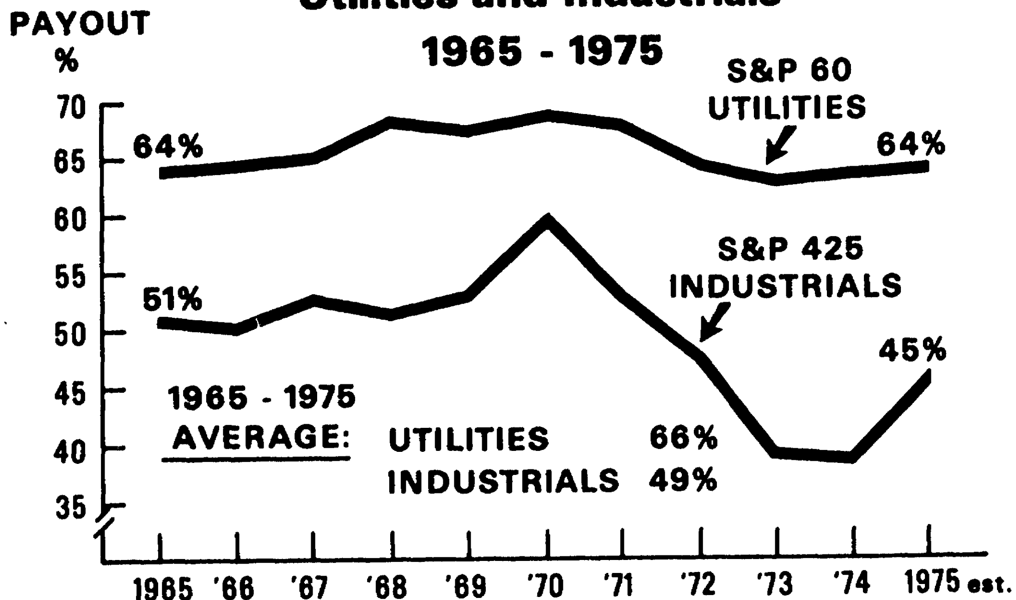

UTILITY EMPLOYMENT
1975
EMPLOYEES
(000)
2,000
1,500
1,000
500
1,696,000
948,000
506,000
242,000
100%
56%
30%
14%
TOTAL
TELEPHONE
ELECTRIC &
COMBINATION
ELECTRIC & GAS
OTHER
SOURCE: U.S. DEPARTMENT OF LABOR

CORRELATION BETWEEN CHANGES IN INVESTMENT AND EMPLOYMENT 1948-1975

CORRELATION = 69%



SOURCE : U.S. DEPARTMENT OF COMMERCE


DIVIDEND PAYOUT RATIOS
Utilities and Industrials
1965 - 1975
PAYOUT %
70
65
60
55
50
45
40
35
64%
S&P 60 UTILITIES
64%
51%
S&P 425 INDUSTRIALS
45%
1965 - 1975 AVERAGE: UTILITIES 66%
INDUSTRIALS 49%
1965 '66 '67 '68 '69 '70 '71 '72 '73 '74 1975 est.
SOURCE: STANDARD & POOR'S CORPORATION

TAX LAWS FAVOR HIGH GROWTH, LOW DIVIDEND INVESTMENTS OVER LOW GROWTH, HIGH DIVIDEND INVESTMENTS

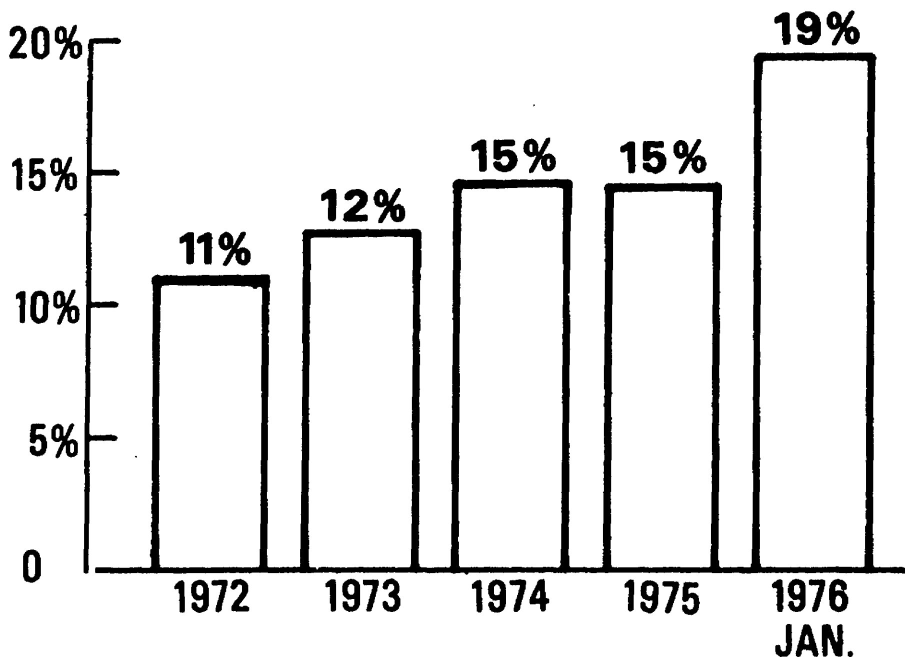
Assuming $100 Investment

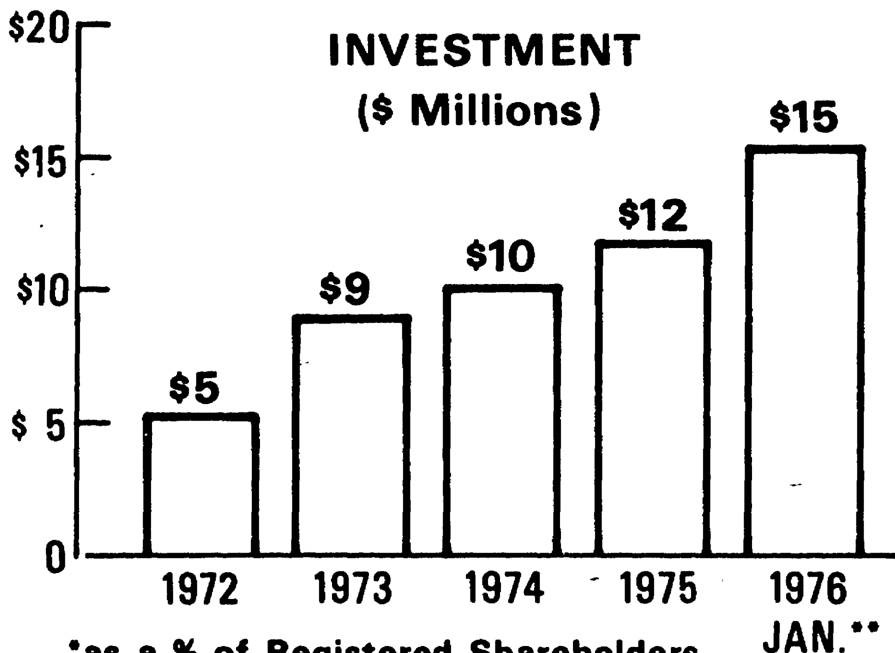
Type of Company	Market Price Appre–ciation	Dividend	Pre-Tax Total Return	After-Tax Dividend*	Total Return 1st Year	After-Tax Return Upon Sale After 7 Years**
	(1)	(2)	(3) (1)+(2)	(4)	(5) (1)+(4)	(6)
Non-Utility						
High Growth Low Dividend	$10.00	$2.00	$12.00	$1.40	$11.40	$97.51
Utility						
Low Growth High Dividend	$ 4.00	$8.00	$12.00	$5.60	$ 9.60	$83.43
			Net tax advantage afforded low dividend paying stocks		$ 1.80	$14.08

* Assumes a 30% tax bracket, and therefore a 15% capital gain tax
** Assumes reinvestment of appreciation and after tax dividends

GTE DIVIDEND REINVESTMENT PLAN

PARTICIPATION *

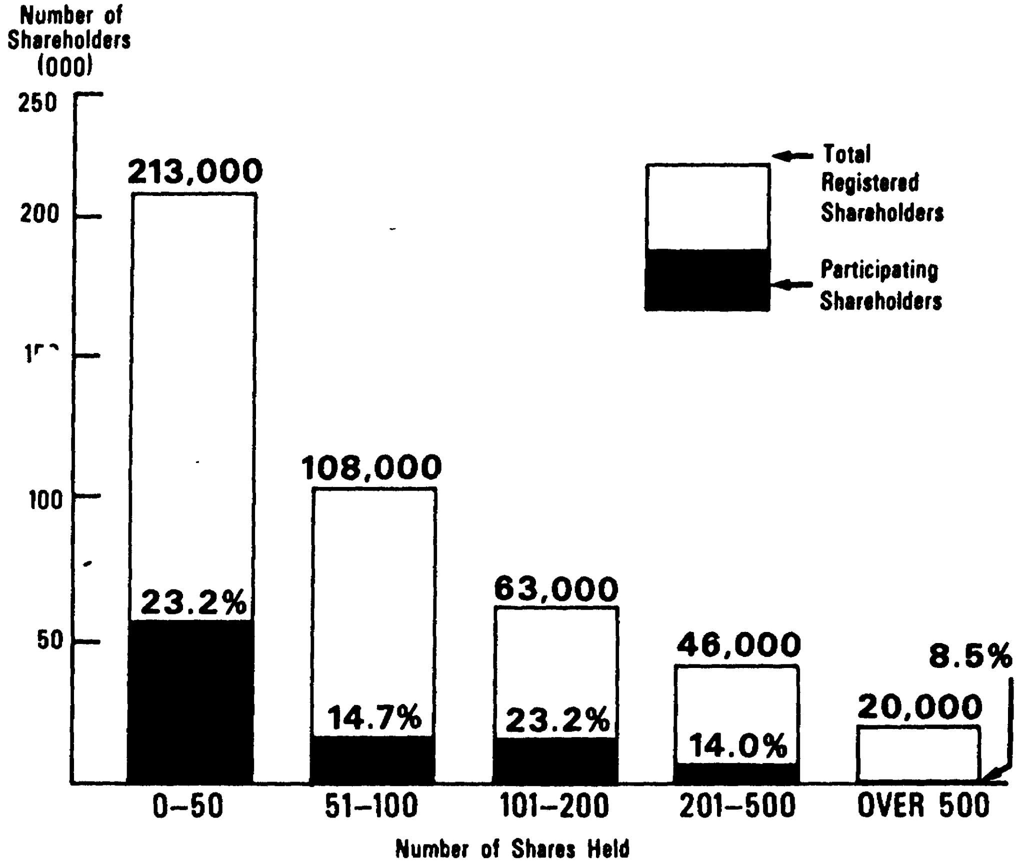




*as a % of Registered Shareholders

**Annual Rate

SHAREHOLDERS PARTICIPATING IN GTE'S DIVIDEND REINVESTMENT PLAN



74% OF PARTICIPANTS OWN 100 SHARES OR LESS

Appendix A

Five Technical Obstacles to Utilities' Implementation of the ESOP Provisions of the Tax Reduction Act of 1975

Aside from the question of adequate, long-term economic incentives, there are five technical problems which effectively foreclose the possibility of telephone utilities' instituting ITC-funded employee stock ownership plans (ESOP's) pursuant to the provisions of the Tax Reduction Act of 1975.

Remedial amendments are necessary to deal with these five obstacles.

1. *Normalization for regulatory purposes.*—Specific statutory provisions relating to normalization are necessary to preserve any financial benefits to regulated public utilities from the 1 percent-ITC contributions to ESOP's. If the 1 percent-ITC contributions were treated the same way for regulatory purposes as the regular 10 percent portion under Section 46(f) of the Code, a regulatory commission could treat the 1 percent credit as a cost reduction to be flowed through to utility customers, either immediately or over the life of the new plant. Such flow-through treatment would not be appropriate for the 1 percent credit allowed by Section 46(2)(1)(B), where the credit was used to acquire capital stock for employees. If the credit were flowed through to the ratepayers, the utility would have issued stock for which no permanent capital had been received. In effect the regulated utility would have paid twice for the 1 percent credit—once in stock to its employees and once in reduced rates to its customers. Not only would such a result be an economic disincentive, it would counter Congress' desire to strengthen the capital structures of the utilities.

Section 46 should be amended to provide specifically that the 1 percent tax credit be treated as a contribution to equity on behalf of the employees, with regulatory flow-through prohibited.

2. *Recapture of 1 percent tax credit.*—Although adjustments to the amount of ITC claimed may be later made pursuant to Section 47 of the Code on account of early retirement of plant, Section 301(d) of the 1975 Act appears to contemplate that no compensating adjustment be made in the amount contributed to an employee plan. This result would again put the employer in the position of having issued stock to its employees for which no permanent capital had been received.

Section 47 should be amended to prohibit the recapture of any portion of the ITC actually contributed to an ESOP, unless it could be shown that the original claim of credit had been made in bad faith.

3. *Redetermination of credit.*—Similarly, if the Service should determine on audit that the underlying property was ineligible for tax credit, the amount of the 1 percent-ITC would thus become subject to assessment as a deficiency liability. As with recapture, Section 301(d) of the 1975 Act does not appear to permit any corresponding adjustment in the 1 percent-ITC contribution to the employee plan. Again, the employer would be placed in the position of having issued stock to its employees for which no permanent capital had been received.

Section 301 should be amended to allow subsequent adjustments to ESOP contributions to reflect amounts subject to redetermination.

4. *Expenses of trust administration.*—The Service in T.I.R. 1413 has interpreted the 1975 Act to preclude charging the expenses of administering the employee trust to the trust. The effect of this prohibition is that expenses of the employee trust become an operating expense of the employer and, in effect, reduce the net benefit of the ESOP to the employer. Without remedial legislation, the burden of the administrative expense could discourage corporations from instituting such plans.

Section 301 should be amended to allow expenses attributable to trust administration of the 1 percent-ITC to be charged against the trust.

5. *80 percent affiliation requirement.*—Under the provisions of the 1975 Act, an employee trust can receive stock only of the employees' direct employer-corporation or of an affiliated corporation. The 1975 Act imposes the 80-percent-affiliation test of Section 368(c) of the Code. Specifically, the Section 368(c) test requires the parent to hold at least 80 percent of *each* class of stock in each subsidiary, a requirement that cannot be met by operating subsidiaries of most Independent telephone companies.

The consolidated return test, which is used in Section 407(d)(7) of the Employee Retirement Income Security Act of 1974 (ERISA), P.L. 93-406, should be substituted for the Section 368(c) test. This change will have the effect also of alleviating the potential problem created as to second- and lower-tier sub-

sidiaries which is identified by Mr. Robert N. Flint, AT&T's Vice President and Comptroller, in his letter to Chairman Long dated March 31, 1976, in the second paragraph under the heading, "Amendments to Employee Stock Ownership Plans (ESOP).

SUMMARY

If these five technical obstacles are not remedied by amendment, USITA does not believe the Independent telephone companies can practicably establish employee stock ownership plans.

APPENDIX B

AMENDMENT TO SECTION 305—ENCOURAGEMENT OF REINVESTMENT OF UTILITY DIVIDENDS

SECTION ——. ENCOURAGEMENT OF REINVESTMENT OF PUBLIC UTILITY DIVIDENDS

(a) *Amendment of Section 305.*—Section 305 (relating to distributions of stock and stock rights) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) *Dividend reinvestment in certain public utility common stock.*—

"(1) *In general.*—Notwithstanding any other provision of this section, subsection (a) shall apply to any distribution of eligible stock by an eligible public utility corporation pursuant to a qualified dividend reinvestment plan.

"(2) *Ordinary income on certain dispositions.*—If the amount of any distribution of stock was excluded from the gross income of any taxpayer under subsection (a) by reason of paragraph (1), and if the taxpayer disposes of such stock within 12 months of its distribution to him, then notwithstanding any provision of this subtitle other than section 116, an amount equal to the amount excluded from gross income under subsection (a) in respect of the stock so disposed of shall be included in the taxpayer's gross income for the taxable year in which such disposition occurs. Such amount shall be treated as a dividend for purposes of this title. The adjusted basis of such stock immediately before such disposition shall be an amount equal to the amount includible in gross income by reason of this paragraph. For purposes of this title any stock to which this paragraph applies upon the disposition thereof shall be deemed to be disposed of before any other stock of the same class.

"(3) *Definitions.*—For purposes of this section—

(A) *Qualified dividend reinvestment plan.*—The term 'qualified dividend reinvestment plan' means a written plan adopted by a corporation which is a regulated public utility or qualified parent corporation under which—

(i) its shareholders who so elect may receive any distribution otherwise payable in property only in shares (including fractional shares) of eligible stock equivalent in value (determined as of the record date of such distribution) to the dividends waived;

(ii) dividends waived in respect of any distribution must be used exclusively for the construction, reconstruction, erection or acquisition of public utility property; and

(iii) in the case of a qualified parent corporation, the value of eligible stock distributed under the plan (determined as of the record date of each distribution) during any taxable year of such corporation may not exceed the dividends received during such year from regulated public utilities which are members of the affiliated group of which such corporation is the common parent corporation.

A written plan of a qualified parent corporation shall be deemed to satisfy the requirements of subparagraph (ii) of this paragraph if the amount referred to in such subparagraph must be used exclusively for the purposes referred to in that subparagraph by such qualified parent corporation or by one or more of the regulated public utilities described in subparagraph (iii).

"(B) *Eligible public utility corporation.*—A domestic corporation which is a regulated public utility or qualified parent corporation shall qualify as an 'eligible public utility corporation' for any taxable year in which such corporation has complied with the requirements of its qualified dividend reinvestment plan, and has satisfied the requirements of subparagraphs (i) and (ii) of this paragraph.

(i) Such corporation's investment in public utility property at the end of the taxable year shall exceed its investment in public utility property at the begin-

ning of such year by at least an amount equal to the dividends waived during such year under its qualified dividend reinvestment plan.

(ii) Such corporation's investment in public utility property at the end of the taxable year shall exceed the amount of its investment in public utility property on January 1, 1976 by at least the amount of the dividends waived under its qualified dividend reinvestment plan from January 1, 1976 to the end of the taxable year.

The determination of amounts invested in public utility property shall be made under regulations prescribed by the Secretary or his delegate, provided that, in determining whether a qualified parent corporation has satisfied the requirements of subparagraphs (i) and (ii) of this paragraph, there shall be taken into account the aggregate amount of the investment in public utility property made by such qualified parent corporation and all regulated public utilities which are members of the affiliated group of which such qualified parent corporation is the common parent corporation.

"(C) *Dividends waived.*—The term 'dividends waived' means, with respect to any distribution, the amount which would have been distributed to shareholders electing to receive eligible stock pursuant to a qualified dividend reinvestment plan if such shareholders had received the same amount of property per share as shareholders of the same class not making such election.

"(D) *Eligible stock.*—The term 'eligible stock' means common stock of the same class as the stock with respect to which such stock is distributed.

"(E) *Public utility property.*—The term 'public utility property' means property described in section 46(c)(3)(B).

"(F) *Regulated public utility.*—The term 'regulated public utility' means a corporation engaged predominately in the trade or business of the furnishing or sale of services described in the first sentence of section 46(c)(3)(B).

"(G) *Qualified parent corporation.*—The term 'qualified parent corporation' means a common parent corporation of an affiliated group which includes one or more regulated public utilities.

"(H) *Affiliated group, etc.*—The term 'affiliated group' and 'common parent corporation' have the same meaning as when used in section 1504(a)."

Senator NELSON. The first witness was supposed to be Mr. Flint. He had not yet arrived when we started.

The CHAIRMAN. If Mr. Flint is not here, we will call on Mr. Larry Hobart, assistant general manager, American Public Power Association.

STATEMENT OF LARRY HOBART, ASSISTANT GENERAL MANAGER, AMERICAN PUBLIC POWER ASSOCIATION

Mr. HOBART. I have a prepared statement and I have a three-page summary which, with your permission, I will read.

The American Public Power Association is a national service organization representing some 1400 local public power systems—mainly municipal [illegible]tric utilities—in 48 States, Puerto Rico, the Virgin Islands, [illegible]nd G[illegible].

[illegible] urges that in its consideration of possible changes in Federal tax laws [illegible] Senate Finance Committee (a) reject further tax subsidizati[illegible]ivate power companies as proposed by the Ford administ[illegible]b) support termination of the use of pollution control bo[illegible]mended by the Treasury Department; and (c) oppose pro[illegible]which adversely affect municipal bond financing by units of State a[illegible] local governments.

UTILITY TAX AID

In testimony before this committee on March 17, Secretary of the Treasury Simon renewed the administration's 1975 request for con-

gressional approval of an electric utility tax program which would provide further benefits to private power companies. APPA has reviewed the administration's proposal and wishes to offer the following comments:

1. There is not unanimity within the Ford administration that the program is necessary. A recent ERDA analysis and statements by a high Treasury Department official conclude that the current financial condition of private power companies does not justify additional tax relief.

2. Market analysts report significant improvement in utility financing. As one publication reported, "The bicentennial bull market that has kicked off 1976 included healthy gains for most electric utility stocks. And most Wall Street analysts and underwriters who follow the industry believe that these increases, although benefiting from overall market strength, also reflect stronger utility finances that should lead to improved performance even beyond the current surge."

3. Private power company officials have given support to the belief that additional Federal financial aid is not required. The Edison Electric Institute has determined that Federal funding for conventional electric generating plants which might be available through the administration's proposed energy independence authority is neither wanted nor needed.

4. Any existing financing problems of utilities are not basically tax problems. As Secretary Simon has stated, "* * * the most fundamental problem with respect to electric utilities is the problem of adequate rates." This is a problem which must be handled by regulatory commissions.

5. Postponements and delays in bringing utility plants on line are frequently caused by factors other than financing, including siting, regulatory requirements, environmental procedures and litigation, jurisdictional conflicts of government agencies, equipment deliveries, and less-than-anticipated load growth. Alteration of the tax code will not change these factors.

6. The administration tax program would benefit those private power companies which are already in reasonably good financial health.

7. Benefits of the program would flow to only one segment of the electric utility industry—private power companies. No comparable assistance would be available for consumer-owned utilities.

8. The proposed tax benefits would be added to existing tax advantages which in 1974 permitted 35 percent of the Nation's major private power companies to pay no Federal income taxes at all.

9. Under the administration plan, State utility commissions would be required to accept Federal decisions on handling of certain regulatory matters.

10. While minimizing importation of foreign oil is one of the aims of the utility tax package, there already exist economic incentives to utilize nuclear and coal-fired generating facilities.

If Congress determines that new Federal programs of financial support for some utilities are desirable, APPA believe they should (a) use direct, open funding or backup help through a designated Federal agency as opposed to tax breaks, and (b) assure availability of assistance to all segments of the electric utility industry which demonstrates need.

POLLUTION CONTROL BONDS

APPA suggests that the market for tax-exempt bonds for financing of public services would be significantly improved by the elimination of so-called pollution control bonds. These bonds—issued for the benefit of private parties—have tightened the municipal bond market and pushed up interest costs. It is estimated that pollution control bond financing may have reached $7 billion this year, and accounted for a rise of about 80 to 85 basis points in municipal bond rates or two-fifths of the total rise in rates since the beginning of 1974.

Secretary of the Treasury Simon told the House Ways and Means Committee last year that the proliferation of pollution control issues has been a prime factor in increasing "drastically" the interest costs on municipal bonds and in causing cancellations and postponement of new issues. He called for repeal or restriction of such financing, a position shared by APPA.

OPTIONAL TAXABLE BOND

APPA believes that in its consideration of an optional taxable bond, as proposed by Secretary Simon in his March 17 testimony, Congress should not enact legislation which would (a) raise the cost of money to State and local governments, (b) adversely affect the ability of those units of government to market their bonds at the lowest possible cost, (c) create a Federal subsidy or State or local bond marketing system which would make the payment of such bonds dependent on Federal appropriations, (d) provide for Federal review of State and local projects and bond issues, or (e) alter the constitutionally-protected right to issue tax-exempt bonds.

The CHAIRMAN. Thank you very much.

Senator Hansen?

Senator HANSEN. I note that you oppose the use of pollution control bonds as recommended by the Treasury Department.

I have talked with a number of representatives of power companies private ones and a few public ones, and apparently the need to comply with pollution control laws has placed a very heavy burden upon utilities, but you do not feel that this device is any longer warranted as far as the private power companies are concerned?

Mr. HOBART. The original legislation imposing pollution control requirements was passed some time ago. We are today in an era when we expect they will be required across the board. There seems to be little justification for continuing a program whose major effect now seems to be to push up the cost of legitimate municipal financing.

Senator HANSEN. It will cost it up that way or push up the power rates. Is it your feeling power rates can be increased rather significantly without any other problems developing?

Mr. HOBART. The costs wil be reflected in rates, but we do not believe that in itself is a problem.

Senator HANSEN. Charlie Luce said his experience with Con Ed in New York 2 or 3 years ago was the regulatory agency in New York State did not authorize the passthrough of some of the increased fuel costs, which I think at that time were a real problem. As a consequence, Con Ed has to forego one stock divided and it severely affected the cost of its stock. I recognize that.

Do you feel that utilities wouldn't hesitate to permit rate increases to reflect the full cost to funding all of the pollution control that has been put on?

Mr. HOBART. You have covered a large number of points.

Senator HANSEN. In Wyoming we have a $3.1 billion proposal.

Mr. HOBART. The Laramie River plant.

Senator HANSEN. Yes. The State of Wyoming has a law which is six times as restrictive in sulfur dioxide emissions. Our State law is 0.2 percent. You don't think that poses any problem?

Mr. HOBART. It poses a problem, but I don't think it is necessarily a tax problem. I am familiar with the Laramie River project and the stringent standards in the State of Wyoming. Project participants consider the restrictions are more stringent than actually necessary to protect the public health and welfare within the State. The State, of course, has made a decision and the project will live with that decision and install the equipment necessary to meet the standards.

Senator HANSEN. One of the concerns the people out there have is whether this plant will pay taxes. Will it?

Mr. HOBART. I can't speak for that particular project. I can say the national experience in the aggregate is that the State and local taxes or payments in lieu of taxes made by publicly owned electric utilities are similar to what is paid by privately owned electric systems. Frequently, public agencies are not required to pay taxes but make payments in lieu of taxes.

Senator HANSEN. This plan out there is going to serve more than the area of southeastern Wyoming. It will serve several State areas and the costs of providing the services of government for those people who live there, who mine the coal to service the plant, I don't suppose, are going to be shared by the States of Nebraska or Colorado. Can you tell me how that $1.3 billion investment will be operated so as to make an adequate payment to State and county governments in lieu of taxes?

Mr. HOBART. I am afraid I don't have detailed familiarity with it.

Senator HANSEN. We are interested in the details.

Mr. Hobart, you can submit this information for the record.

[The following was subsequently supplied for the record:]

[Source: Basin Electric Report, in Platte County, January 1975]

TASK FORCE PLANS FOR MBPP IMPACT

On June 7, 1974, the five sponsors of the Missouri Basin Power Project (MBPP), announced a joint filling for a certificate of public convenience and necessity with the Wyoming Public Service Commission to construct and operate a large 1500 megawatt generating station in the Wheatland, Wyoming area.

The generating station was being planned to meet the joint power requirements of the small consumer-owned electric systems throughout the Missouri Basin region, the announcement said, and the first stage of the generating complex was scheduled for commercial operation in 1979.

Location of the power plant near Wheatland had been rumored for months and citizen interest and concern in the MBPP project in the area was running high. Wheatland, a small community of 2,500 people, is located on the Laramie River in southeast Wyoming and is a trade center for a ranching and farming area. A project of the magnitude of MBPP, requiring a large influx of workers during the construction period would bring unprecedented and sudden growth to Wheatland and would require essential public services beyond the community's present capabilities.

The MBPP power planners, in making their announcement, had said they would exert every effort to plan comprehensively for the social, economic and environmental impacts which would be associated with the project.

The participants in the regional power project had also pledged to work cooperatively with citizens in the area and indicated that citizen input and participation would be an essential part of planning for the development impact under an "open planning process."

The MBPP sponsors, sensitive to the concerns of the citizens, lost little time in demonstrating their willingness to begin the "open planning process", and in mid-July, more than 100 Wheatland area people packed Vimbo's Restaurant to hear the MBPP sponsors describe the aims and scope of the project.

The MBPP sponsors told the citizens that they represented a large number of small consumer-owned electric systems scattered over sparsely-populated areas of eight states of the Missouri Basin region. A number of these small systems were Wyoming rural electric systems. These small systems, located primarily in rural areas, had organized federations in the late 1950's and early 1960's to collectively meet their power requirement on an assured long-term basis. The MBPP project was being developed to meet 1979–1984 needs. The people who directed and operated these systems were from rural backgrounds, were familiar with the needs and problems of people in rural areas, rural communities. They had gained experience over the years in developing reasonably priced housing programs for rural areas, in developing water and sewage systems for small communities. And they were ready to begin immediately to work with area citizens in planning for the impact of the power plant construction . . .

The next day a meeting was held at the Wheatland Rural Electric Association offices with Lloyd Ernst, Manager of MBPP Wyoming Operations. There, MBPP representatives and several Platte County leaders decided that a working task force would be organized which would begin to collect information, conduct studies, establish needs and develop guidelines for orderly growth and development of the area. A formal organization meeting was planned for early August.

At the August meeting, a large group of area business leaders, representatives of citizens' groups and city, county, state and Federal government officials met with MBPP representatives. John Allen, Chairman of the Wheatland Planning Commission, was elected to head the Platte County Task Force and Russ Bovaird, a representative of Tri-State G & T Association, Northglenn, Colorado, was elected secretary. Tri-State is the power supplier for the majority of the rural electric systems in Wyoming and a major MBPP participant. Bill Schott, a community planner on the area development staff of Basin Electric Power Cooperative of Bismark, N.D., the project manager of MBPP, was designated as task force coordinator.

In late September, the MBPP sponsors announced that the exact location of the MBPP power plant was to be five miles northeast of Wheatland and that the plant was to be named the Laramie River Station. MBPP project planning was accelerating, but the Platte County Task Force was moving ahead too, organizing itself into seven working committees which would be concerned with specific areas of community impact. The task force also brought in representatives from state and federal agencies as well as other representatives from citizens' organizations to act as advisers to the working committees.

The committee and their members are:

City Government: Chuck Parsons, Mayor of Wheatland, Lawrence Larson, Mayor of Guernsey and Jack Eddlemen, a member of the Wheatland City Council.

County Government: Chet Frederick, Platte County Planning Commissioner and Claire Lou Johnson, Platte County Extension Agent.

Schools: Ed Hunter, Superintendent, Wheatland School System, Blaine Campbell, Superintendent, Guernsey School System and Bill Johnson, a member of the Wheatland Board of Education.

Housing: Elliot Graves, President of the Wheatland Ministerial Association, Dr. Gary Payne, Director of the Southeast Mental Health Center at Wheatland and Task Force Chairman Allen.

Day Care Center: Jill Holloway of the Department of Public Assistance and Social Services of Wheatland, Sue Payne, Wheatland civic leader and Chris Rogers, Wheatland, a representative of the U.S. Office of Economic Opportunity.

Transportation: State Senator Don Cundall, Don Purcell, Platte County Clerk and Glen Gorman, a member of the Guernsey Board of Education.

Airport: Jim Dunham, Wheatland City Clerk, Margaret Brown, a former member of the Wheatland City Council and Cecil Walthal, Wheatland auto dealer.

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Since the organization of the working committees, important strides have been made in planning for the development impact. The City of Wheatland is conducting a study of the water and sewage systems in order to develop plans for upgrading the capacity of the systems to meet the needs of an increased population. Grant applications have been submitted to the Environmental Protection Agency for upgrading the sewage system and letters of intent have been sent to the Farmers Home Administration and the Economic Development Administration for loan and grant funds to increase the capacity of the water system.

The City of Wheatland is also developing a comprehensive plan for zoning and traffic flow in cooperation with the Platte County Planning Commission. Another planning area being investigated by the task force is the need for increased law enforcement facilities and social services in Wheatland and Platte County.

Engineering studies are very nearly complete on a power study to establish requirements for upgrading Wheatland's municipal electric system. The Wheatland Municipal Power Board has placed on order materials for installation of a 69 KV line.

The Task Force Airport Committee is working with the Wheatland City Council and the Platte County Commission to prepare information to apply for funds from the Federal Aviation Administration to expand city airport facilities.

Meetings have also been held with federal agency officials to secure funding for housing projects. A Platte County Housing Authority has been formed to provide housing assistance for low-to-moderate income families and the elderly. Basin Electric Community Development Cordinator Schott, who has provided technical assistance in organizing numerous housing authorities throughout the Basin Electric service area, worked with the county officials to set up the authority.

The Day Care Committee has begun discussions with U.S. Department of Health, Education and Welfare officials to obtain funds for construction of a Day Care Center.

One of the concerns of the task force has been the matter of economic stability in the community after MBPP construction activity has ceased. Plans are now underway to develop an industrial park in Wheatland designed to attract small industries to the area. An application has been submitted to the Farmers Home Administration for a $25,000 grant to begin development of the park.

Of the progress made to date in MBPP impact planning, Wyoming MBPP Operations Manager Lloyd Ernst says, "The strides that the task force has made in the areas of housing, social services and many other areas thus far is most encouraging. We are very fortunate to be working from such a broad base of leaders in both the public and private sectors. The people of this area are vitally concerned with their future quality of life and are working actively to develop plans for orderly development. The task force and their advisers are to be commended for their cooperative efforts."

Task Force Chairman John Allen, in assessing planning efforts thus far, says, "I feel the task force is really working and is providing good local input into the MBPP project. We are as far along as we can be at the present time with the information and data available. We do appreciate all the help the MBPP sponsors are providing us in working to assure that we do not have any major problems with impact from the project. I feel we can maintain the quality of life in the area even considering the impact of MBPP. The task force has good rapport with both the city and county government agencies for they are as concerned as we are about the need for orderly planning for the impact of the project."

Mr. HOBART. I would like to point out that the problem is recognized by the proposers of the plant. They have worked with a group of citizens within the Wheatland community to form an impact committee. The utility, I understand, is going to make advance payments to help take care of the increased service problems, and there is in the works some mechanism to try to deal with the problem you are discussing.

Senator HANSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. I have no questions.

The CHAIRMAN. Senator Nelson?

Senator NELSON. I have no questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. In your summary, the very bottom paragraph, you say the following:

"If Congress determines that new Federal programs and financial support for some utilities are desirable, APPA believes they should (a) use direct, open funding or backup help through a designated Federal agency as opposed to tax breaks, and (b) assure availability of assistance to all segments of the electric utility industry which demonstrated need."

Separating your part (b) and, I understand, your concern about the public utilities, what is the advantage from Congress standpoint of going the direct funding route or setting up another agency to achieve the same tax advantage?

Mr. HOBART. I think the major advantage is it puts the whole thing up front where you can see it. Also, the administration has proposed blanket solutions to problems that may be specific in character. Not all privately owned private utility companies are in difficulty. Some are quite healthy.

If we are to use an overall approach, I would say the benefit of having a separate agency outside of the tax structure would be, No. 1, to make clearly visible the amount of Federal financial support going into the operation and, No. 2, to allow the Congress and the administration to pinpoint those particular entities that are in trouble.

Senator PACKWOOD. I have no other questions.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. In your statement you refer to the administration tax program extensively. It is my understanding the public power systems and rural cooperatives own 15 percent of the electric systems in the United States. Would these power companies receive the same benefits under the administration proposal?

Mr. HOBART. We think that is one of the defects. If there is a public interest in dealing with the difficulties public utilities have had in recent years, it seems to us Federal help should be available across the board, regardless of ownership, for any utility which can demonstrate it needs that kind of help. That is why we recommend—as I was discussing with Senator Packwood—a program which could be administered outside the tax code, and which could then be made available easily to all utilities in need.

Senator FANNIN. I am trying to tie together the type of assistance to be given by the Federal Government. Senator Hansen brought out one of the greatest problems we have today, which is the extent to which the companies must go in building facilities, sometimes without the need proven. Financing is a very serious problem.

Mr. HOBART. I think there are two points to make there, Senator Fannin.

One is the effect of pollution control bonds, the proceeds of which are made available to private parties. The bonds, of course, are issued by public entities. The proceeds then go to a private party, which repays that amount of money, through lease arrangements, plus the interest associated with those bonds. The private party, of course, is not involved in a public purpose. It is essentially a private operation. It is benefiting, however, from a device approved by Congress for the

financing of State and local government operations. It does not seem equitable or reasonable to continue this arrangement beyond the time it is actually needed, considering its adverse impact on governmental interest rates.

Secondly, while it is true the cost of pollution control facilities represents a significant part of the cost of building electric facilities, that is an accepted fact not only in the utility industry, but in other organizations' activities where air and water quality has to be taken into account. If there were a transitional need for such help, we think that transitional need has now disappeared, and the cost of this equipment has to be factored into normal business expenses.

Senator FANNIN. I understand some utility companies have amassed tax credits which they have been unable to use. Are you familiar with that? Do you have any figures?

Mr. HOBART. The Federal Power Commission has put together figures showing unused utility investment tax credits. At the end of 1974, the excess amounted to over $300 million. FPC experts, noting the increase from 4 percent to 10 percent, say the amount of unused credits will increase significantly in 1975. I can provide detailed figures for the record.

Senator FANNIN. I think it is important to know what is involved, so if you could provide the information, I would appreciate it.

[The following was subsequently received for the record:]

AMERICAN PUBLIC POWER ASSOCIATION,
Washington D.C., April 2, 1976.

Hon. PAUL J. FANNIN,
U.S. Senate,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR FANNIN: During my appearance before the Senate Finance Committee on April 1, you asked me for information on the amount of unused investment tax credits amassed by private power companies. I am enclosing for your information a table prepared at the Federal Power Commission which shows that at the end of 1974 the figure stood at $316 million. The table also provides a breakdown by year and company for the period 1970–1974.

As pointed out by Professor Jerome E. Hass of Cornell University, currently serving as Acting Chief of the Division of Economic Studies of the Office of Economics of the Federal Power Commission, in testimony before the Tax Expenditure Task Force of the House Budget Committee on February 24, there are three pertinent facts to note with respect to unused investment tax credits accumulated by utilities:

1. The unused balance has increased dramatically over the past five years, especially from 1973 to 1974.

2. While 1975 data is not yet available, the unused credits will surely be much higher since the investment tax credit rate was increased from 4 to 10 percent for utilities in early 1975.

3. Many of those firms with the deepest financial trouble have gained substantial unused credits even at the end of 1974, and further investment tax credits will be of no assistance to them.

I think you may also be interested in Professor Hass' finding that both the rate of return earned on total assets by private power companies and their real cash flow from operations increased dramatically in 1975. A table showing financial ratios from 1969 through the first 10 months of 1975 is also enclosed. Professor Haas attributed this improvement to "positive regulatory action."

Sincerely,

LARRY HOBART.

Enclosure.

FINANCIAL RATIOS—CLASS A AND B PRIVATELY OWNED ELECTRIC UTILITIES

	1969	1970	1971	1972	1973	1974	[1] 1975
Times interest earned [2]	3.45	2.79	2.58	2.53	2.40	2.03	2.10
Rate of return of assets (7) [3]	5.87	6.45	6.53	6.71	6.77	6.73	[4] 7.03
Real cash flow from operations [5]	6.79	6.80	7.00	7.43	7.90	7.50	8.64

[1] 12 months ended October 1975.
[2] Total utility operating income before Federal income taxes divided by interest payments.
[3] Total utility operating income plus net other income and deductions divided by total assets.
[4] Based on estimated total assets of $158,000,000,000 on Oct. 31, 1975.
[5] Total utility operating income plus depreciation, amortization and deferred income taxes (net) deflated by Handy-Whitman Index of Public Utility Construction Costs (July of each year with 1969—100). Billions of dollars.

UNUSED INVESTMENT TAX CREDITS AVAILABLE, DEC. 31, 1970-74

[In millions of dollars]

Company	1970	1971	1972	1973	1974
Alabama Power Co	0	0	0	0	9.46
Arizona Public Service Co	0	0	0	0.19	4.33
Boston Edison	0	0	0	11.04	13.87
Carolina Power & Light	0	0	0	.66	9.82
Columbus & Southern Ohio Electric Co	0	0	0	1.50	4.62
Consolidated Edison Co. (New York)	0	4.19	43.10	60.40	46.56
Detroit Edison Co	0	0	4.68	8.99	20.01
Duke Power Co	0	0	4.22	17.93	35.66
Georgia Power Corp	0	0	0	0	20.06
Hartford Electric Light	0	0	.70	3.50	4.04
Iowa Electric Light & Power Co	0	0	0	0	7.20
Maine Yankee Atomic Power	0	0	0	7.50	7.37
Niagara Mohawk Power Corp	0	0	0	Neg.	18.00
Orange & Rockland Utilities, Inc	0	0	2.86	3.96	6.23
Public Service Electric & Gas Co	0	0	0	7.50	27.29
South Carolina Electric & Gas Co	0	0	0	4.33	4.10
Tucson Gas & Electric Co	0	0	0	.67	8.32
Vermont Yankee Nuclear Power Corp	0	0	4.96	5.82	6.00
Virginia Electric & Power Co	0	19.81	4.38	15.65	29.86
All other class A & B utilities	6.20	8.08	6.77	18.18	58.65
Total unused ITC available	6.20	32.08	71.67	167.82	316.45
Total taxes paid	1,117.94	953.06	889.06	850.45	530.51
Unused ITC as percent of taxes paid	0.06	3.04	8.01	19.07	59.07

Senator FANNIN. You refer to the problem of adequate rates and that has been brought out in many instances. I know in Tucson, Ariz., the Tucson Gas & Electric is practically bankrupt because they could not get a rate increase. Since this is a problem that has to be handled by regulatory commissions, I agree with that.

We pass through tax incentives that are utilized. Is there some way we could provide some help to seeing that the regulatory agencies do respond?

Mr. HOBART. In 1974, private power companies rates increased by approximately $2.2 billion. In 1975, the figure jumped by $3.1 billion. Analysts looking at the problem of regulatory lag have concluded in numerous cases there is increasing recognition on the part of commissions that they have to speed up the consideration of rate increases. The nature of the problem and its magnitude both seem to be altering with time.

I do not see that there is an opportunity through changes in the tax code to really effectively deal with that problem.

Senator FANNIN. I don't like interfering with the State actions, but at the same time I think it is a serious problem.

Thank you very much.

The CHAIRMAN. Senator Byrd?

Senator BYRD. No questions.

[The prepared statement of Mr. Hobart follows:]

STATEMENT OF LARRY HOBART, ASSISTANT EXECUTIVE DIRECTOR, AMERICAN PUBLIC POWER ASSOCIATION

American Public Power Association is a national service organization representing some 1,400 local public power systems—mainly municipal electric utilities—in 48 States, Puerto Rico, the Virgin Islands, and Guam.

APPA urges that in its consideration of possible changes in Federal tax laws the Senate Finance Committee (a) reject further tax subsidization of private power companies as proposed by the Ford Administration; (b) support termination of the use of pollution control bonds as recommended by the Treasury Department; and (c) oppose proposals which adversely affect municipal bond financing by units of state and local government.

UTILITY TAX AID

On March 17, Secretary of the Treasury Simon renewed the Administration's 1975 request for Congressional approval of an electric utility tax program which includes a permanent increase in the investment tax credit to 12 percent (except for generating facilities fueled by petroleum products) and its immediate application to progress payments for long-leadtime projects; extension of five-year fast tax writeoffs for certain pollution control equipment and allowances of similar rapid amortization for conversion or replacement of petroleum-fueled generation; permission for use of depreciation for tax purposes on non-petroleum burning plant construction expenditures as made; and opportunity for shareholders to postpone and reduce tax on common stock dividends when paid in stock.

APPA has reviewed the Administrations utility tax proposals and wishes to offer the following comments for the consideration of the Senate Finance Committee:

1. There is not unanimity within the Ford Administration that the program is neccessary

A paper on "Energy Requirements and Federal Policy Actions" presented by Richard H. Williamson and Edward J. Hanrahan of the U.S. Energy Research and Development Administration on November 19, 1975, at the winter meeting of the American Nuclear Society in San Francisco, California, observed that: "It is true that new plants are far more costly than previously experienced so that continued pressure is exerted on the financing capabilities of the utilities. However, the financial and cash-flow positions of most utilities have improved substantially in recent months. Though much delayed, rate increases over and above fuel escalation clauses are being regularly granted by state public utility commissions. Investor confidence is returning as evidenced by the regular marketing of securities and the upward rise in stock prices. The reduced construction programs caused by the lower growth is assisting the management of cash-flow problems. Even if inflation continues to escalate plant costs, one must recognize that rate increases will be granted to keep pace with the inflation although time lags will occur."

After reviewing "a number of potential policy or legislative changes to improve the financial health of electric utilities", including the Electric Power Facility Construction Incentive Act of 1975, and considering their impact, the authors concluded that: ". . . it is not entirely clear that adoption of Federal proposals will really have a great effect today. It appears that the financial health of the utilities is steadily improving, even in the almost total absence of Federal assistance. It also appears that the forces of the energy-economic system have worked to remove a large part of the capital requirements problem in little more than a year since the financial difficulties of the utilities became widely known."

More recently, in February of this year, Assistant Treasury Secretary Sidney L. Jones reportedly told a conference sponsored by the University of Florida's Public Utility Research Center in Gainesville, Florida, that electric utility earn-

ings had "come back too fast" for utilities or investors to expect a tax break for those re-investing their dividends in utility stocks. According to the trade publication Electrical Week:

"He said that much of the concern that the Administration and Congress had last year for financially strapped utilities 'has been dissipated' by the 'generally improved financial showing' of the industry. Asked later if the Administration would push President Ford's six-point, $600-million tax-relief plan for utilities, Jones said only: 'That remains a part of the program.' "

2. Market analysts report significant improvement in utility financing

"The profits of most of the nation's big electric utilities are healthier than they have been in some time," the New York Times reported on November 12. Rate increases were the principal factor in the improved profit picture, the Times stated. Earnings by electric utilities were described as "spectacular".

The February 9 issue of Electrical Week carried a headline reporting that "Utility Stock Market Has the Bull by the Horns". The accompanying story declared:

"The bicentennial bull market that has kicked off 1976 has included healthy gains for most lectric utility stocks. And most Wall Street analysts and underwrtiers who follow the industry believe that these increases, although benefiting from overall market strength, also reflect stronger utility finances that should lead to improved performance even beyond the current surge. One result of the higher common stock prices will likely be heavier sales of utility equity, especially early in the year. This also may mean greater financing flexibility if a need is seen to restore some construction cutbacks later in 1976."

3. Private power company officials have given support to the belief that additional Federal financial aid is not needed

The board of directors of the Edison Electric Institute, the national association for privately-owned electric utilities, at a meeting in January in Phoenix, Arizona, agreed that Federal funding for conventional electric generating plants which might be available through the Administration's proposed Energy Independence Authority is neither wanted nor needed. EEI asked for elimination from the EIA proposal of any suggestion that Federal money would be used to finance conventional nuclear or fossil facilities. "There's just no need for that." W. Donham Crawford, EEI president, asserted. EEI reported in February that the electric utility industry raised $12 billion in capital—a financing record—in 1975, and that state regulatory commissions approved a record-high of $3.1 billion in rate increases last year (up from $2.2 billion in 1974).

4. Financing problems of utilities are not basically tax problems

Secretary of the Treasury William Simon told the Ways and Means Committee last year that: "We have said that the most fundamental problem with respect to electric utilities is the problem of adequate rates." He said that: "So long as rate commissions refuse to approve rates sufficient to provide an adequate return to capital, investors will be unwilling to invest in the industry, regardless of the rate of capital formation or the aggregate amount of capital available." He pointed out that certain utilities are experiencing problems of cash flow, high interest rates, and debt-equity ratios, and reiterated: "Again, these problems are not basically tax problems." If this is so, why attempt to treat them by amending the Internal Revenue Code?

5. Postponements and delays of utility plants are caused by factors other than financing

Secretary Simon did not discuss other major—and perhaps primary—reasons for postponement or cancellation of generating plants, which include, according to the National Electric Reliability Council, "the numerous problems associated with siting, regulatory requirements, environmental procedures and litigations, jurisdictional conflicts of governmental agencies, and equipment deliveries." Furthermore, for many utilities, electrical load has not grown as swiftly as anticipated. Alteration of the Federal tax code will not change these facts.

6. The administration program would benefit those in "reasonably fair health"

The program may not benefit those companies which are probably in the greatest need of financial assistance. Aid would be supplied primarily in the form of Federal tax relief, despite the fact that, according to the Federal Power Commission, privately owned electric utilities in 1974, the most recent year for

which Federal Power Commission statistics are available, paid only 1.8 percent of their total electric operating revenues in Federal income taxes, and 76 power companies—35 percent of the Nation's major power companies—paid no Federal income taxes at all. (In 1974, net after-tax profit of the 215 major private power companies was 12.6 percent of revenue.)

Furthermore, it would appear that if financial assistance for private companies is needed, it should be applied on a case-by-base basis, rather than "blanket" relief which provides assistance for those who are not in need as well as those in need.

The necessity of a case-by-case analysis is apparent in a comment by Gordon Corey, Vice Chairman of Commonwealth Edison Co. and Chairman of the Federal Power Commission's Technical Advisory Committee on Finance.

Indicating "enthusiastic" support for tax relief for private power companies, Mr. Corey observed to Energy Finance Week that the proposals advanced by Secretary Simon will help only companies "in reasonably fair health." It would seem questionable public policy to embark upon a long-range tax program which awards unique advantages to a section within a selected industry which is "in reasonably fair health."

Secretary Simon has said that: "The increase in the investment tax credit will be a cash contribution by the Federal government for the construction of additional electric power plants." If such special transfer payments in the form of tax relief are to be made, clearly each case should be examined to insure that financial aid is justified. Federal welfare programs available to low-income families impose means tests or qualification requirements. It would seem that no less scrutiny should be paid to utility clients of the government which seek income maintenance programs.

7. The program is discriminatory

As previously indicated, some—but not all—privately and publicly owned electric utilities have reported financial difficulties which have adversely affected acquisition of new plant and equipment that may be important in supplying future electric demand.

As a remedy to this situation, the Administration has recommended a number of new tax breaks for all private power companies—regardless of need. No comparable program has been proposed by the Administration to assist any publicly-owned power systems, which serve 18.5 percent of the nation's electric consumers, although similar problems may exist in this segment of the utility industry. The Administration plan is therefore discriminatory.

Furthermore, the Secretary has proposed special tax benefits for one sector of private business which enjoys unique protective devices. As then-Secretary of the Treasury Douglas Dillon pointed out in 1962 in arguing against availability of the investment tax credit to utilities: "This recommendation was made with full recognition of the great contribution that utilities make to the American economy. It was based on the fact that public utilities are regulated monopolies with substantial assurance of a given rate of return on investment after tax. Moreover, investment in public utility facilities is based largely on demand, government by public requirements." The Department of the Treasury noted at that time that: "In return for their authorization to operate as regulated service corporations, they are assured consumer rate charges which will cover their costs of operation, including Federal income taxes, plus a just and reasonable rate of return on investment. This rate of return is so set as to attract the capital needed to serve the public conveniences and necessity. For the vast majority of utilities the rate of return presently available, when adjusted for the lack of risk on that investment, equals or exceeds the rate of return presently available, when adjusted for the lack of risk on that investment, equals or exceeds the rate of return in other industries. Furthermore, the rate of return is gauged to enable the utility to obtain adequate capital at whatever cost is required."

While private power companies may disagree with specific decisions of regulatory commissions, there is no question than they operate within a protective framework which is not available to a host of other businesses—many of whom would undoubtedly argue that they are more logical candidates for tax relief than utilities.

8. Contributions to employment may be marginal

Another stated goal of the utility tax package promoted by the Administration is creation of jobs. However, a 1972 subsidy study prepared for the Joint Economic

Committee to determine the usefulness of the 7 percent investment tax credit in reducing high unemployment concluded that the credit does not correct this market deficiency as proponents originally argued. The study estimated that the credit would reduce unemployment by 0.1 percent in one year and 0.3 percent over a 2½ year period.

Leonard Woodcock, President of the United Auto Workers Union, in testimony last year before the Ways and Means Committee, pointed out with respect to the investment tax credit that:

"As representatives of the UAW have stated before Congress many times, while described as incentives, investment tax credits are in reality windfalls. They are available for investment that would have been made in any event as well as for any—inevitably relatively small—amount of additional investment that might be attributable to it. (In fact, the credit is available even to a firm that responds to the incentive by reducing the amounts of its investment below previous levels.) Thus, in the unlikely event that the credit stimulates an investment increase of as much as 10 percent, more than 90 percent (100 divided by 110) of the credit will represent tax revenues wasted in paying business for investment made for reasons that have absolutely nothing to do with the credit.

"Tax breaks for business are usually sold as a spur to savings and investment, which will ultimately provide more jobs. It is obvious, however, that the effect of the credit on the level of investment marginal, at best, its contribution to employment must also be marginal."

Mr. Woodcock also told the committee that:

"Our recommendation to let the corporate tax cuts in the Tax Reduction Act expire at the end of 1975 extends to those cuts favoring the private power companies. Similarly, we do not support any of the other subsidies for the industry that the Administration is actively pursuing. These again are examples of blanket solutions which fail to distinguish between utilities in need and those which do not require aid. If enacted, these loopholes would continue to generate tax privileges and lost revenues long after the need for them, if there ever was one, has passed.

"As I stated above, the 'by case' approach is the only efficient and equitable way of dealing with this problem."

9. Power companies could be eliminated as taxpayers

Adoption of the Administration's utility tax package would reportedly reduce tax revenues by $1 billion by October, 1977 and by an increasing amount in subsequent years. This amount of tax relief is nearly twice as much as the $521 million in Federal income taxes paid by all private power companies in 1974.

Congress has already increased the investment tax credit for private companies by 250 percent for the years 1975 and 1976, and liberalized its availability. This subsidy is in addition to other tax advantages previously made available to private power companies, including use of municipal bond financing for pollution control equipment and ability to issue tax-free dividends. The additional tax favors requested by the Administration not only would discriminate against other ownership segments of the electric utility industry and other kinds of business organizations (which may have financial problems that are more pronounced than utilities), but could eliminate private power companies as Federal income taxpayers—even though they might continue to collect such taxes from their consumers.

10. The program would mandate policies by State commissions

Administration proposals for eliminating tax liabilities of private power companies are conditional on regulatory agency "normalization" of the tax benefits and inclusion of construction work in progress in rate base. This approach seeks to use the Internal Revenue Code to stimulate so-called "mandated reforms" in utility regulation which the Administration has previously proposed. Congress has thus far declined to approve these suggestions for Federal preemption of regulation by state commissions, which are responsible for scrutiny of retail rates and certification of new plant. The Administration is proposing that the Congress second-guess regulatory commissions on the merits of particular rate making policies. This would be done by attempting to prevent further rate base deductions or flow-through of tax benefits and to compel consumers to pay for plants which are not providing them with electricity.

11. Tax incentives not essential to encourage non-petroleum conversions or replacement

While minimizing importation of foreign oil is one of the alleged aims of the utility tax program outlined by the Administration, it is not clear that tax incentives are essential, in most instances, to encourage non-petroleum generation conversions or replacements. The high price of oil coupled with legislation passed or pending in Congress to require coal conversion or capability for generating stations moves utilities in this direction without benefit of new tax breaks, although some forms of aid may be needed in specific cases.

It is of interest to note a March 19, 1976 Atomic Industrial Forum report which showed that the average total cost of a kilowatt-hour produced by nuclear energy last year was 12.27 mills, the cost with coal was 17.54 mills, and the cost with oil was 33.45 mills.

AIF found that the nuclear contribution in 1975 provided nearly nine percent of all electricity generated in the United States and represented fossil fuel savings of over 10-billion gallons of oil or more than 55-million tons of coal and resulted in cost savings of over $2 billion.

Commonwealth Edison, a private power company with a strong commitment to nuclear power (roughly one-third of its electrical generation was produced by nuclear energy in 1975), estimated in December that the bus-bar advantage of nuclear over coal is 23 percent to 25 percent.

12. Improvement in utility operations also could improve financial picture

Frank Zarb, Administrator of the Federal Energy Administration, has emphasized that improvement of utility operations could improve significantly the utility financial picture.

The Federal Energy Administration has pointed out that the electric utility industry could save capital—and fuel—by improving availability of major generating units and increasing their capacity factor. FEA stated in a March, 1975 report on "Improving the Productivity of Electric Powerplants":

"On average, the Nation's nuclear and large fossil-fueled units are forced out of service more than 15 percent of the time, are unavailable for service more than 25 percent of the time, and operate at less than a 60 percent capacity factor. Improvements in capacity and availability factors and reductions in forced outage would yield near-term and long-term benefits for ameliorating the effects of such severe industry problems as financing, high fuel costs, siting and licensing.

"The potential financial benefits of improved productivity are large. By 1980, an industrywide reduction in the average forced outage rate of just 1 percentage point could reduce the Nation's installed capacity requirements by up to 6,800 MW and capital requirements by as much as $1.8 billion (1974 dollars). Over this same period, a capacity factor increase of 8 percentage points for nuclear units and several percentage points for 400 MW and larger coal-fired units would permit an increase in output from these units equivalent to the electric energy produced by burning more than 500,000 barrels of oil per day. At projected costs for oil, coal, and nuclear fuel, this could reduce the utility industry's total fuel costs in 1980 by approximately $3 million per day (1974 dollars)."

FEA's views on this subject were further expounded by Administrator Zarb at a June load management conference in which he said his agency will seek to cut power plant expansion one-third (70,000,000 kw) by 1985, at a capital saving of $49 billion. A key to reaching the reduction is to boost the utility industry's average plant capacity factor from 49 percent to 57 percent.

13. Principles for any new financial aid program should be enunciated

If Congress determines that new Federal programs of financial support for some utilities are desirable, APPA believes they should (a) use direct, open funding or backup help through a designated Federal agency as opposed to tax breaks, and (b) assure availability of assistance to all segments of the electric utility industry — public and private — which demonstrate need.

As far as emergency situations are concerned, a Federal program of this type already exists in the Federal Reserve Act. The Federal Reserve System has a general contingency plan which encompasses lending to electric utilities. Authorization for the program was approved by Congress in the 1930s. Aid can be granted in unusual and exigent circumstances, as determined by the FRS Board of Governors. The plan is applicable to both public and private utilities.

Should Congress determine that additional aid is needed for selected utilities which can demonstrate a need for assistance, an agency with the power to make or guarantee borrowings might perform this function. But creation of such an agency is not a tax matter.

POLLUTION CONTROL BONDS

As you know, in 1968 Congress restricted the issuance of industrial development bonds, where state and local governments issue tax-exempt bonds to be utilized by private businesses. However, Congress did permit industrial development bond financing for certain purposes, including pollution control.

In his testimony before the Ways and Means Committee last year, Secretary Simon noted the rapid growth of tax-exempt financing for pollution control facilities, and indicated that such revenue bonds may currently account for about 15 percent of the new issue exempt market. He pointed out that the impact of these issues is to tighten the municipal bond market and push up interest costs, and also observed that:

"The emphasis on environmental protection has caused major changes in modern technology and the adoption of new manufacturing processes designed to minimize pollution. The attempt to segregate the cost of such facilities as between the cost of the basic technology and the cost of pollution control has become an administrative nightmare and is, in fact, well nigh impossible."

Because of their adverse market and administrative features, Secretary Simon recommended that indusrtial development bond financing be further limited by permitting tax-exempt pollution control financing only for separate facilities added to plants in operation before January 1, 1975. "This proposal would help reduce the cost of upgrading existing properties but recognizes that in new plants pollution control and production usually can't be separated," he said.

An analysis prepared by the Municipal Finance Officers Association suggests that if Congress does not act, pollution control issues could grow through the decade to $6 billion or more in annual sales, and that their volume will increase relative to other tax-exempts. "As the volume of pollution bonds grows, their added volume and higher yields drive up rates on all tax-exempt bonds, anywhere from 5 to 20 basis points (at a 20-year maturity) per billion of annual pollution bond financings, depending on market conditions," the MFOA study states. "Pollution control bonds are most directly competitive with other long maturity, term-structure and lower quality tax-exempt bonds and, therefore, they force up rates on these bonds to an even greater extent—an estimated 25 basis points or more under tight credit conditions."

The problem posed by pollution control bonds was analyzed in a December, 1975, article in Fortune which reported:

"The pollution-control bond gives the corporations a triple or, in some cases, a quadruple subsidy. The company gets the benefit of the state's lower borrowing costs. It can also treat the pollution facility as its own property, and so depreciate it on an accelerated basis. And, under certain conditions, it may even be able to deduct a part of the lease payments as business expenses. As if that were not enough, in most states, pollution-control facilities are exempt from local property taxes.

"Pollution-control revenue bonds represent a discriminatory handout, in that small companies usually cannot get states to authorize such bond issues, and even if they could, investors might be reluctant to buy the bonds. Perhaps most important, the ready availability of long-term subsidized borrowing for pollution control tends to produce a bias in favor of highly capital-intensive waste treatment as opposed to alternative methods, such as adjustments in production processes, that might achieve the same results as lower capital costs. Hence, the pollution-control bond leads to a profligate use of capital.

"The volume of pollution-control issues has increased phenomenally in the past few years. According to the Securities Industry Association, pollution-control bonds totaled slightly over $1 billion in the first half of 1975. But most bonds of this kind are privately placed, and the S.I.A. data pick up only a small proportion of private placements. Robert Gerard, a deputy assistant secretary of the Treasury in charge of capital-market policy, thinks the amount of pollution-control financing—public and private—has already reached somewhere between $4 billion and $7 billion this year.

"George Petersen, an economist with the Urban Institute, calculates that, if the larger of these estimates is correct, the pollution-control bond probably accounted for a rise of about 80 to 85 basis points in municipal-bond interest rates. That would represent almost two-fifths of the total rise in rates since the beginning of 1975.

"Anguished protests against pollution-control bonds have come from enlightened municipal finance officers as well as from many members of the

underwriting community. Says Lennox Moak, the tart-tongued but highly respected finance director of Philadelphia: "In 1974 Pennsylvania authorized about $1.9 billion in pollution-control revenue bonds. That is only $200 million less than the total amount of traditional municipal issues sold by both the state and its local subdivisions throughout the year. I have told the advocates of pollution-contronl bonds just one thing: 'Get the hell out of my market! You are ruining it!'" Recognizing the dislocations caused by pollution-control bonds, the Municipal Finance Officers Association is now advocating an end to their tax-exempt status ad the substitution of a system of tax credits for corporations undertaking cleanup campaigns."

In 1974, out of a total of $1.6 billion in pollution control bond sales reported by the Daily Bond Buyer, $928 million were issued for the benefit of private power companies. The paper reports that: "In 1974, electric utilities were the most frequent and largest users of the IDBs. Of the 114 reported transactions, 47 were for electric utilities or 41.2 percent. They consumed 56.8 percent of the total dollar amount." While the private power companies share of such financing was down in the first half of 1975 (17.3 percent of the financings and 24.2 percent of the dollar total), it still totaled $240 million. In addition, a list of pending pollution control issues published by the Daily Bond Buyer showed that private power companies would be the beneficiaries of nearly $2 billion in additional tax-exempt pollution control bonds—a sum almost twice as large as all the revenue bonds issued by the municipal electric utilities in 1974.

Secretary Simon has told the Ways and Means Committee that the Treasury Department views the proliferation of pollution control issues as a prime factor in increasing "drastically" the interest costs on municipal bonds and in causing cancellations and postponement of new issues. He has called for repeal or restriction of such financing. APA commends the Secretary for his recognition of this problem, and urges that the Congress take action to terminate use of pollution control bonds.

OPTIONAL TAXABLE BOND

Municipal bonds will be employed to fund a large portion of the estimated $4.5 billion in capital expenditures budgeted by non-Federal public power systems for 1976. The marketability and price of these and subsequent municipal bonds will have a significant effect on future power supply and rates for consumers of such systems.

APPA wishes to make the following points regarding proposals for a taxable bond for state and local governments.

1. APPA is opposed to any attempt to terminate the ability of state and local governments to issue tax exempt bonds to finance essential public services, including electric power. This financing device is an accepted and workable approach to funding of construction programs, provides community independence in the raising of needed monies, and helps keep down consumer costs of using the service supported by the bonds.

2. APPA does not support the substitution of a taxable municipal bond with a Federal subsidy for tax exempt municipal bonds. Such an action would replace a financing technique of demonstrated viability with a new and untested security of unknown value.

3. APPA believes that in its consideration of an optional taxable bond, as proposed by Secretary Simon in his March 17 testimony, Congress should not enact legislation which would (a) raise the cost of money to state and local governments, (b) adversely affect the ability of those units of government to market their bonds at the lowest possible cost, (c) create a Federal subsidy or state or local bond marketing system which would make the payment of such bonds dependent on Federal appropriations, (d) provide for Federal review of state and local projects and bond issues, or (e) alter the Constitutionally-protected right to issue tax exempt bonds.

The CHAIRMAN. Next we will call on Mr. E. B. Leisenring, chairman of the Tax Committee of the National Coal Association, accompanied by Mr. Robert Stauffer, general counsel.

Senator PACKWOOD. Did I miss Mr. O'Connor or is he not here?

The CHAIRMAN. I am very sorry, I missed Mr. O'Connor. I will call him after this witness.

STATEMENT OF E. B. LEISENRING, JR., CHAIRMAN, TAX COMMITTEE, NATIONAL COAL ASSOCIATION, ACCOMPANIED BY ROBERT F. STAUFFER, GENERAL COUNSEL, AND LARRY ZALKIN, TREASURER OF WESTMORELAND COAL CO.

Mr. LEISENRING. Mr. Chairman and members of the Finance Committee, I am E. B. Leisenring, chairman of the National Coal Association's tax committee and a former chairman of its board of directors. I am also president of Westmoreland Coal Co. of Philadelphia, Pa. I am accompanied by Robert F. Stauffer, general counsel of the National Coal Association, and by Larry Zalkin, treasurer of Westmoreland Coal Co.

The membership of the National Coal Association consists primarily of producing coal companies, the operations of which comprise more than half of the commercial production in the United States. We appreciate this opportunity to present our views.

THE NEED FOR CAPITAL FORMATION

By conservative estimate, the coal industry will require $18 to $22 billion between now and 1985 to meet capital investment requirements. Some energy economists place the figure above $25 billion. Regardless of what ultimate figure eventually develops, it is many times the current total industry capitalization of about $5 billion. These requirements are based on 1975 dollars. If we project a low compounded 5-percent inflation factor over that period, the dollar requirements are increased by over 60 percent.

If the coal industry could draw on a blank check from the financial community there would be no problem. However, coal is not the only industry that will require a huge infusion of capital over the next 10 years.

Coal must compete for its investment funds. To do so successfully it must be an attractive investment opportunity with a competitive short- and long-range rate of return. Currently, in spite of profitable years in 1973 through 1975 the industry simply does not have a proven rate of return commensurate with the risk, and the risk is great. Thus the potential for development remains only that—a potential.

Coal production in 1975 was 640 million tons. This represents a 6-percent increase over 603 million tons produced in 1974. Today we are producing at an average annual rate of only 600 million tons, which is 6 percent below last year. Tragically coal's productive capacity has remained essentially stagnant for over 20 years. We can produce little more coal today than we could shortly after World War II. This static condition cannot be permitted to continue. The industry must substantially increase production, and the cost will be high.

While capital costs may vary according to the terrain and the depth of the seam, it is generally accepted in the coal industry that the capital cost of installing a new deep mine is $35 to $40 per ton of annual production. This does not include the substantial administrative costs prior to startup, such as securing permits, surveys, feasibility studies, and other related costs. Thus, a medium-large mine, with a capacity of 1 million tons a year, represents $35 million to $40 million investment by the time it begins commercial production. For a surface

mine the costs vary widely, but on the average run from $15 to $20 per annual ton of production. Here, too, administrative costs such as environmental impact statements and permits are not considered.

Actually our recent experience verified the cost of mine development. My company, Westmoreland Coal, last year announced that we are committed to open two new mines, costing $20 million and $35 million respectively. If it were claimed that the industry's rate of profitability is excessive, remember that a $35 million mine alone will consume the equivalent of over half of all Westmoreland's 1975 earnings. The coal industry is beginning to generate some of the capital needed to increase production at the rate called for by the Federal Government. But we are far from being in a position of financial self-reliance.

Since the industry must replace about 3 percent of its capacity every year simply to replace mines that are worked out, it must open new mines with about 15 million tons of capacity annually just to stay even, much less make headway toward offsetting our Nation's suicidal dependence on foreign oil.

With this background let me turn to specifics. The data set forth below reflects the best estimates of our economists if the coal industry were to double production over the next 10 years.

CAPITAL REQUIREMENTS

	Annual production, end of period (million tons)	Total capital investment required during period (billions)
1976 to 1980	890	$8.8–$10.7
1981 to 1985	1,200	9.4–11.4
Total		18.2–22.1

For the 5 years from 1976 to 1980 in order to bring production up to 890 million tons, we will need between $8.8 and $10.7 billion. In the next 5 years, 1981–85, to double the current production and bring it up to the 1.2 billion tons, we will need another $9 to $11.4 billion.

This illustrates the magnitude of financing facing the industry; $18 to $22 billions of new dollars will be required by 1985 to reach a production rate of 1,200 million tons per year. Of this amount we estimate that approximately 50 to 60 percent, or in the neighborhood of $12 billion, can be generated internally barring unforeseen negative factors.

Fortunately for the coal industry the promise of the future was recognized by a few farsighted corporate planners many years ago when profitable companies bought into the industry. For the most part the industry has not maintained production with coal profits. Rather, it has been able to maintain the current rate of production primarily with the infusion of capital from the profitable corporate parents of some coal producing companies.

However, I doubt that even the parent companies, backed by relatively strong internal financing, can meet the capital demands of the future. It will be necessary to turn to the financial community for investment capital. To be favorably received, there must be the assurance of an acceptable return on investments.

TAX INCENTIVES

To be assured of the availability of capital, both that which is internally generated and that originating in the financial market, a favorable tax climate is absolutely necessary. Summarized below are our views on tax legislation which would contribute to the expansion of the coal industry over the near term, and ultimately to our country's energy independence. While many tax incentives might be discussed, I will focus on those which we believe would have a major influence on the capital formation requirements of the coal industry.

A. *Investment tax credit*

To encourage the purchase and construction of business assets and equipment, the Tax Reduction Act of 1975 raised the investment tax credit rate to 10 percent for the years 1975 through 1976. The House Ways and Means Committee had included in its Energy Conservation and Conversion Act of 1975 the extension of this rate for coal mining equipment for 3 additional years, 1977 through 1979. Thus, that committee recognized the need for large capital expenditures in coal mines and the desirability of encouraging such expenditures.

The coal industry, like many other industries, cannot maximize the use of an investment credit, the duration of which is speculative at best. I know that nothing is permanent with respect to the tax code except its continued existence. However, a greater measure of certainty exists when a provision does not have a specific cutoff date, which must be renewed periodically.

From the time a contract for its purchase is signed, it now takes 4 to 6 years before a major surface dragline is ready to go into operation, which costs $30 to $40 million. It is essential that we know for proper corporate planning whether or not we can rely on the permanency of those sections of the code that impact so heavily on our future plans.

Therefore, to make the investment credit provision fully effective in accomplishing the objectives desired we suggest the following:

1. The investment tax credit be made a permanent part of our income tax structure.
2. The rate be increased to at least 12 percent, and that any portion of the credit to be tied into employee stock ownership plans—ESOP's—should be over and above the 12 percent figure.

NOTE.—An ESOP would be considered a negotiable benefit under the coal industry's contract with the United Mine Workers of America. It is improbable that any coal producers covered by the contract could establish an ESOP without its inclusion in contract renegotiation, the next of which occurs in 1977.

B. *Black lung benefits trust*

No greater area of uncertainty exists in the coal industry than that related to contingent black lung benefit payments. We know now that the cost will probably total some $5 billion over the next 10 years alone. Precise future costs are impossible to compute at this point in time.

This particular problem faced by the industry is an outgrowth of the Federal black lung legislation which was enacted into law in 1969 and amended in 1972.

Under that law coal producers must now pay black lung benefits to all coal miners that contract the disease. These obligations could con-

tinue for 50 to 75 years after a mine is closed, because the benefits apply to a miner's dependents. Estimates vary, but actuaries calculate it will require about $1.35 to $5 per ton of coal mined, depending on the life expectancy of the mine, and the age complement of the work force to fund each claim.

Insurance to cover this liability is extremely difficult to obtain because the obligation is a new one, the liability is almost impossible to evaluate, and cancellation by the insurer is a possibility if the risk proves too great. Therefore, we propose that the operator be allowed to establish a tax-exempt irrevocable trust into which he makes payments.

The payments into the trust would be deductible at the time the payments are made to the trust. This would provide an incentive for the creation of the trust fund and could result in a twofold increase in current contributions to the trust because of the tax benefits derived from the contribution. Any income earned by the trust would be exempt from taxes, thereby maximizing the accumulation of funds, and payments to the miner could be excluded from the miner's tax liability.

The corpus of the trust could never revert to the creator of the trust. It could not be used as a tax shelter device by the mine owner with the funds to be recaptured at a later date. Legislation to permit such trusts has been introduced in the House of Representatives.

There are advantages to both the miner and the operator. First, the miner working in the mine today, should he qualify for benefits in the future, would know that his black lung disability compensation is being funded on a current basis. Irrespective of the future, there would be money in the fund. The employer, funding on a current basis, would be in a better financial position to meet his future obligation, rather than wait 20 years from now when a claim is registered, at which time the money would hopefully be available.

Simply stated, we recognize the obligation to compensate the miner disabled by black lung. What we seek is a legal vehicle to carry the funds so that today's coal production pays for the obligations arising as a result of current production.

There is another very real problem that could arise in the future if these obligations are not current funded. State public service commissions would have difficulty approving utility rate increases based on increased coal costs resulting from obligations incurred in years past.

Never in the history of the country has an industry been singled out in the manner of the coal industry with respect to black lung legislation, and faced with a financial obligation of this magnitude. We ask this committee to provide a vehicle to implement this requirement of the law.

C. Accelerated depreciation rate

The promulgation of the accelerated depreciation rate—ADR—system by Treasury, as quoted from Treasury Department release of June 22, 1971, was intended to produce the following results:

> . . . the uncertainty and complexity of the application of the depreciation provisions of the Internal Revenue Code will be significantly reduced and substantial administrative benefits will be achieved;
>
> The establishment of the Office of Industrial Economics in conjunction with the ADR system will, for the first time, permit useful lives for each asset class to be as current and as accurate a reflection of a "reasonable allowance" as possible,

based upon a broad spectrum of up-to-date information reflecting both the trend of past experience and what may be anticipated for the short run future;

Increased investment resulting from ADR will produce economic growth which will increase our Gross National Product and reduce unemployment;

Additional investment in more modern productive equipment stimulated by ADR will increase productivity and dampen inflation; and

The competitive position of American producers in world markets will be greatly strengthened.

The ADR system still far exceeds the depreciation periods of most industrialized nations. U.S. businesses must compete with foreign competitors for both limited natural resources and available markets. Capital recovery is one of the significant factors which affects our ability to maintain our share of the world market and also expand the Nation's industrial base.

A stable and favorable depreciation policy is a vital ingredient in justifying and encouraging current and future capital outlays in the coal industry. Congress should consider liberalizing the existing ADR allowances by at least twice the current rate.

The coal industry strongly supports an increase in allowances made under the ADR system. To repeal ADR as advocated by some would prove a serious deterrent to the economy of this country, which is only now emerging from a severe recession.

In addition, the benefits of accelerated depreciation have a substantial negative effect on the computation of percentage depletion under the 50 percent of net income limitation. While providing cash flow for the replacement of plants and equipment, accelerated depreciation can eliminate cash flow necessary to replace depleted mineral properties. Therefore, we suggest that section 613(a) of the Internal Revenue Code should be amended to provide that tax depreciation in excess of book depreciation attributable to individual properties or aggregations shall not be included as a deduction for the purpose of determining the 50 percent of net income limitation for percentage depletion.

D. Valuation point for coal processed into low-pollutant fuel

Under present law if coal is processed to produce oil, gas, or solid low-sulfur fuel, such processing is considered beyond the valuation point for percentage-depletion purposes. That is, for percentage-depletion purposes the coal must be valued before it is converted to low-sulfur fuel. Existing law, however, does permit the processing of oil shale to the point where it is equivalent in value to crude petroleum.

S. 2109 introduced last year by Senator Hansen would permit, for percentage-depletion purposes, processing of coal into low-pollutant fuel—synthetic gas, synthetic oil, or low-sulfur, solid fuel. Thus, the same depletion valuation would apply to natural gas, natural petroleum, synthetic fuels from oil shale and synthetic fuels from coal. If coal is processed to remove pollutants, the valuation for depletion purposes would occur after such processing.

Coal and oil shale constitute such a huge part of our total energy reserves that inevitably they must be used to satisfy future deficiencies in supplies of natural gas and oil. Coal represents over 80 percent of known total U.S. fuel reserves, including uranium, and 74 percent of all of our ultimately recoverable fuel reserves.

The only question is, how soon before coal must meet its potential? The conversion of coal to low-pollutant fuels should be encouraged to

the extent possible because only when such conversion becomes a commercial reality will the United States be assured of an adequate energy supply which can be used without damage to the quality of the ambient air.

Congress has already provided, in section 613(c)(4)(A) of the code, that processes to convert oil shale to the equivalent of crude petroleum retorting shall be considered as taking place prior to the depletion "cutoff point." Such treatment increases the incentive for investment in oil shale conversion plants since it increases the possible future percentage depletion deduction. Similar treatment should be provided for coal which is converted to low-sulfur fuel, not merely as a matter of equity, but, far more important, because the Nation needs additional sources of clean fuel, and synthetic fuel from coal appears closer to reality than is true with respect to oil shale.

Senator Hansen's bill would also cover processing of coal to produce a low-sulfur, solid fuel—a process currently in the research stage. This should be encouraged because many of the smaller industrial plants have need for solid fuel but are not large enough to warrant building a chemical plant to remove pollutants from the boiler stack. With the increasing demand for a clean environment, such plants may wind up with no source of energy unless industry is encouraged to invest in these processes.

E. Interest expense should not be included as a deduction when determining net income limitation

Section 613(a) of the Internal Revenue Code should be amended to provide that interest expense allowable to individual properties or aggregations shall not be included as a deduction for the purpose of determining the 50 percent of net income limitation for percentage depletion. This would create a moderate incentive for coal development, as well as provide a means of neutralizing the disincentive to use debt, rather than equity capital, to finance new mine development or expand existing mines.

Relatively few coal producers have adequate internal capital to finance a new mine without recourse to some considerable use of debt capital. Unfortunately the interest expense thus incurred must then be allocated to the cost of developing or operating the mining properties, and is added to other deductible items for the purpose of determining the 50 percent of net income limitation for percentage depletion. Thus, if an operator deferred development until he had accumulated sufficient funds to pay for the new mine out of cash resources, he has a distinct tax advantage, in allowance for depletion, as opposed to another producer who goes into debt financing for a new development.

The differential treatment serves as a deterrent to orderly and expeditious development of coal reserves and is a factor in delaying new development until substantial cash reserves have been retained out of earnings.

F. Reclaimed mineral depletion

Literally millions and millions of tons of coal and other minerals lie abandoned in gob piles, slag heaps, and settling basins throughout the United States. With respect to coal this is a valuable fuel source, a part of a finite reserve that should be utilized.

In years past coal processing was a costly and tedious process. Because of its abundance only, the coal with the most desirable qualities was used. Mountains of waste, or gob piles, are scattered throughout coal mining areas.

Under existing law the mining company which originally mined the coal is entitled to depletion allowance if it seeks to reclaim the coal from the waste piles. No other party is permitted the allowance. This restricts reclaiming for three reasons:

First: Many of the original coal producers are no longer in business. The companies were simply dissolved when mining of the property was no longer profitable.

Second: If one company purchased another coal company, the successor company cannot take depletion if it reclaims.

Third: If the original mining company is still in business it may be more concerned with mining coal and not getting involved with the chemical and engineering processes necessary to retrieve the coal from the slate and other refuse.

In many instances then, the financial incentive does not exist to undertake the reclaiming process. If the normal depletion allowance for coal—10 percent—were allowed all reclaimers, the added dollar return could well be sufficient to encourage the undertaking of reclamation efforts.

The benefits are twofold: First, a valuable natural resource, now abandoned, would be utilized; second, many of the unsightly piles of waste would be eliminated or substantially reduced.

We ask that consideration be given to amending the Internal Revenue Code to allow depletion to any party reclaiming coal—or any other mineral for that matter—from waste deposits. The proposal is based in logic and precedent: that a coal producer is entitled to percentage depletion when he engages in removing coal from the other minerals in which it is found.

Coal comprises over 80 percent of our total recoverable energy reserves. The energy content of coal in the United States far exceeds that of all the known oil reserves in the Mideast, a fact that is provable, but so dramatic that it seems to be little recognized. Coal, even with its recent increased costs, is much less expensive than oil and unregulated natural gas.

Use of indigenous coal instead of foreign oil keeps our dollars at home. Yet we are still the stepchild of the energy family.

Every recent energy-related study—and there must be dozens of them—conclude that the Nation must turn to coal in the very near future. And we will have to use coal until the promise of fusion and the dream of solar power are realities.

If coal is to meet the challenge, the antagonistic attitude of some agencies of the Government must be changed. Until the financial community feels that mining coal is something more than a high-risk investment venture, we cannot approach our potential. While this committee may not be able to amend all the restrictive legislation, or change the attitude of the bureaucrat in many areas, it can help develop an attractive investment atmosphere by initiating changes in the Tax Code of the nature set forth in this statement.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. If the coal industry was able to survive financially during the 1960's when profits were so low, why can't you generate

all the capital you need now when coal prices are substantially higher?

Mr. LEISENRING. During the 1960's we survived, but only barely. The return on investment for the industry was somewhere in the range of 3 to 6 percent. It is true coal prices have increased substantially. By the same token, the coal industry is a capital incentive industry, one of the most capital intensive, and the cost for putting in new mines has accelerated at least as much as the price for coal.

As I have attempted to show in my testimony, if we are to double the production of the industry for the Nation's needs, we are going to need to borrow a great deal more money on top of the internally generated capital in order to do so.

Senator HANSEN. Would a higher depreciation allowance be helpful to your industry?

Mr. LEISENRING. Yes, it would.

Senator HANSEN. With reference to the Bureau of Mines and the Bureau of Reclamation, can you give us an estimate of reclaimable coal lying in waste heaps throughout the country?

Mr. LEISENRING. The Bureau of Mines does not have an official figure for the entire industry, but the State of Illinois has some 100 million tons of waste material on the ground from which it is estimated a total of 27 million tons of coal could be extracted. For the entire country and all the mining, anthracite and bituminous done over the last 150 years, there are probably in excess of 1 billion tons minimum that could be recovered from these piles.

Senator HANSEN. One billion?

Mr. LEISENRING. Yes.

The CHAIRMAN. Senator Nelson.

Senator NELSON. No questions.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. How much was your coal production in 1975 over 1974? Did you say 6 percent?

Mr. LEISENRING. Yes.

Senator PACKWOOD. On an accumulated basis, you will come close to doubling coal production at that rate.

Mr. LEISENRING. Seven and one-half percent compounded annually would bring us up, I think, to close to 1 billion.

Senator PACKWOOD. So assuming you can hold a minimum of 6 percent and prices go up, you will not need much in the way of tax incentives to double in 10 years.

Mr. LEISENRING. The 6 percent was an anomaly because in 1974, there was a strike in the industry during contract negotiations which lasted 6 to 7 weeks. A great deal of the increase in 1975 was compared to an abnormally low 1974.

Senator PACKWOOD. There was no stockpiling prior to the strike?

Mr. LEISENRING. There had been some stockpiling prior to the strike, yes.

Senator PACKWOOD. No further questions.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

In your conclusion, Mr. Leisenring, you refer to the energy reserves we have on coal if we are going to have indigenous resources for our energy program. I agree with your statement on the use of indigenous coal. It says increased costs. Isn't it true that you have not been able

to do more conversion because regulated natural gas prices have been so low that conversion is not competitive?

Mr. LEISENRING. Natural gas prices have been held down, but coal has not been given the use in the utility industry it might have due to a number of factors, the most important of which is the enforcement of the Clean Air Act which rules out a lot of coal that is 1 percent of sulfur or higher.

Senator FANNIN. When we are talking about the doubling of production of coal, will we need to double the production of coal if we do not make some changes in our antipollution laws and make it possible for this coal to be utilized?

Mr. LEISENRING. I believe that coal of higher sulfur will over the next 10 years be usable under the law because of the technology that is going forward with stack scrubbers and other methods and technologies of removing sulfur from the coal and removing sulfur compounds from the effluents, but it is hoped that while these technologies are being perfected, that some easing of the enforcement of the Clean Air Act by EPA will come about.

Senator FANNIN. Do you feel we are doing enough in research and technology? I notice we have powdered coal now and we are trying to utilize it in burners. Is there sufficient technology going forward on such alternatives as gas utilization?

Mr. LEISENRING. Yes, now there is more research in utilization going forward but it has only been in the last 2 or 3 years with the formation of ERDA and the hundreds of millions of dollars that are now being spent for coal utilization and coal technology. But in years before that, coal was the stepchild in the fuel industry and had only a small fraction spent in research as compared to atomic energy, for instance.

Senator FANNIN. From your testimony, I assume you are still having problems, serious problems on capital formation. Is that true in the coal industry?

Mr. LEISENRING. That is true, sir. If we get some of the additional tax incentives we have put before you today, it will help develop the tremendous increased capital needs that are facing us.

Senator FANNIN. You talk about depletion allowances and Senator Hansen was mentioning that. What is your recommendation in that regard as far as depletion allowance?

Mr. LEISENRING. We think the coal industry especially, with the needs that are facing us, should have accelerated depreciation rates approximately double what they are.

Senator FANNIN. You know the problems we have had as far as depletion is concerned in the oil industry. I just wondered what approach could be made to give you the benefits that are needed for your forward production that we can get through the Congress. That is one of the great problems we face.

Mr. LEISENRING. I misunderstood you. I thought you said depreciation. You are speaking of depletion allowance.

Senator FANNIN. Yes.

Mr. LEISENRING. I believe coal should get a 15 percent depletion rate which would be half again as much as we now have and it would bring us up equal with uranium, oil shale and some other energy-producing minerals.

Senator FANNIN. You need the combination of the increased depletion, you say double the depreciation rate schedule.

Thank you very much.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Leisenring, there are two aspects of your testimony I want to comment on, first in regard to the investment tax credit and your suggestion that it be made permanent. As to what the figures should be; whether it should be 7, 10, or 12 percent or what have you, I think that you make a mighty good point that the Congress ought to decide whether it is prepared to keep the investment tax credit as a permanent part of the tax code or eliminate it. It keeps business up in the air, it seems to me. A business has no way of knowing whether this is a permanent part of the code or whether it will be taken off in 6 months or a couple of months. I like that aspect of your testimony. I am not prepared to say what the rate should be but I do think Congress ought to make up its mind and get away from this off-again, on-again program in regard to the tax credit.

With respect now to the black lung benefits trust, do I understand your proposal correctly that under this, the operators would be permitted to establish a tax exempt irrevocable trust. I assume what you mean by tax exempt is that the mine operators would be able to pay into that trust each year to whatever extent they felt they would be desirable and then that would be a tax deduction as a business expense in the year it is paid?

Mr. LEISENRING. That is correct, Senator.

Senator BYRD. Would this trust be setup in connection with the new legislation which is now before the Congress which has passed the House which is now in the Senate committee or would it apply to past legislation as well as the obligations of the mine operators under the black lung legislation?

Mr. LEISENRING. We certainly hope it would be a part of the legislation now before the House and the Senate and that it would apply to those trusts already constituted and any trusts constiuted by coal producers prospectively. It should apply to both past and future obligations.

Senator BYRD. Is it your idea that the trust would be administered by the Government like the Social Security Trust Fund or would it be administered by the coal industry as such?

Mr. LEISENRING. It would be administered by an independent trustee. In the case of Westmoreland Coal Co., we have already set up a trust with the bank. It is an irrevocable trust. There are no benefits flowing to the company but only to the beneficiaries receiving black lung benefits.

Senator BYRD. I gather from your testimony there is no way it can be considered a tax shelter for the company because the money never comes back to the company.

Mr. LEISENRING. That is correct. It is irrevocable. The only benefit to the company is the normal business deduction.

Senator BYRD. Can't you do that now?

Mr. LEISENRING. There is no provision for it under the law. We are doing it and it is now before the Internal Revenue Service. We are seeking their approval of this but it is a very uncertain area unless it is covered by legislation.

Senator BYRD. It seems to me it is clearly a business deduction. It is the same as paying wages to a miner. You are paying benefits to a miner who has been injured in the mines. Is there any questions that being a deductible expense now?

Mr. LEISENRING. It is my understanding the Internal Revenue Service is holding hearings on these trusts—of which I believe there are three or four in existence—to find out just what tax status they have as to the deductibility of the company on the one hand and the income to the beneficiary on the other hand.

Senator BYRD. I guess it is also a question of how much you can deduct in a particular year and how you determine the amount to be deducted.

Mr. LEISENRING. That is correct.

Senator BYRD. Under the legislation you have proposed, the companies would determine how much they could or wished to pay into the fund in a particular year.

Mr. LEISENRING. That is correct. Although they cannot put an inordinate amount into the fund or I am sure the IRS would not approve it.

Senator BYRD. Offhand, without knowing all the details of it, it would seem to me that would be a proposal that would be helpful to the miner and to the company and the disadvantage to the Government would probably be very little from the point of view of tax revenue.

Mr. LEISENRING. I am glad you apparently agree with our position.

Senator BYRD. The staff is interested in knowing whether this is in lieu of the House-passed bill now before the Senate Labor Committee. As I understand, you want it to be a part of that bill, is that correct?

Mr. LEISENRING. It would be in lieu of the House-passed legislation on the subject.

Senator BYRD. It would take the place of the House-passed legislation?

Mr. LEISENRING. That is correct. The funding would take the place of that area covered by the House-passed legislation.

Senator BYRD. It would not take the place of the entire bill but it would take the place of one section of the House-passed bill; is that correct?

Mr. LEISENRING. That is correct.

Senator BYRD. My time has expired but if the chairman would let me ask another question to find out where the House proposal differs with this proposal.

Mr. LEISENRING. May I defer to Mr. Stauffer for an answer.

Mr. STAUFFER. I am not expert on the Black Lung bill in the House but I do believe the House-passed bill would have the Treasury Department set up and administer the fund to pay the benefits to the miner. Our proposal would be strictly a private endeavor operated by the company and paid out to the miner.

Senator BYRD. What the witness is advocating would be a private trust.

Mr. STAUFFER. Yes.

Senator BYRD. What the House approved is not a private trust?

Mr. STAUFFER. I do not believe so.

Senator BYRD. That is a trust established by the Government?

Mr. STAUFFER. Yes.

Senator BYRD. Your proposal is to take the place of that.

Mr. STAUFFER. Yes, or on the assumption the House-passed bill did not become law.

Senator BYRD. The coal industry, at one point, approved the House-passed bill, did they not?

Mr. STAUFFER. I do not know the answer to that. Can we submit that for the record?

Senator BYRD. Yes, you may.

[The following was subsequently received for the record:]

We oppose the bill in the form it passed the House. Basically the legislation is a pension bill to be funded by a Federal severance tax. It is a pension bill because there would be an irrebuttable presumption that a miner has contracted the disease, after he worked in the mines for a stipulated period. Medical documentation would not be required. Further we oppose the nature of the funding provided in the bill. A 'premium' based on tons produced would be levied against the producer in an amount sufficient to pay for claims not found to be the responsibility of individual coal operators. The Department of Treasury would administer the fund. This is purely and simply a Federal severance tax and should be a subject of hearings before the Senate Finance Committee since in reality the bill imposes a Federal tax on coal to be administered by Treasury.

Senator NELSON. I notice in your statement you say that "it is generally accepted in the coal industry that the capital cost of installing a new deep mine is $35 to $40 per ton of annual production."

I don't understand that. Coal is not selling for that, is it?

Mr. LEISENRING. The mine would cost $30 to $40 million.

Senator NELSON. Is that $30 to $40 for every ton of coal produced?

Mr. LEISENRING. You consider the size of the mine on the million tons a year it produces. If it produces 1 million tons that figure means for every ton we must expend $35 to $40, so you multiply the 35 or 40 times a million tons and the mine costs you $35 to $40 million.

Senator NELSON. That is just for 1 year, not the life of the mine.

Mr. LEISENRING. The cost of constructing the mine and then the mine will last for 20 to 30 years. The mine will cost $35 to $40 million and if you divide it by the number of tons produced annually, 1 million tons, you come to the $35 to $40 per annual ton.

Senator NELSON. You are not saying that the capital cost starting a new mine adds $30 to $40 to each ton of coal produced during the life of the mine?

Mr. LEISENRING. No, sir, it is a yardstick used by the coal industry to measure how many dollars per annual ton a mine costs. If it is a million tons a year, then it is $35 to $40 per annual tons totaling $35 to $40 million for the mine.

Senator NELSON. Even though the mine is producing that amount for the next 30 years?

Mr. LEISENRING. That is correct.

Senator NELSON. On the question of depreciation or investment tax credit depreciation, what would be your view of the Canadian system, for example? Supposing you eliminated all schedules on depreciation, eliminate the investment tax credit, and then allow depreciation on capital investment as the Canadians do of 50 percent of the capital investment the first year and the balance the second?

Mr. LEISENRING. In other words, you would depreciate the investment in 2 years?

Senator NELSON. That is right.

Mr. LEISENRING. I am not familiar with the Canadian tax law.

Senator NELSON. Well, that is what it is.

Mr. LEISENRING. I don't think we have put our pencil to the results which might flow from such an arrangement.

Senator NELSON. I think it is the national chamber of commerce or the Coal Association jointly that has a proposal—I don't know if anybody has introduced it—I assume they have—they have a proposal for a 5-year depreciation on capital investment. They also throw in buildings. So, you don't have an opinion as to whether it would be more beneficial for the purposes of accumulating capital if you could write off in 2 years or 50 percent the first year and whatever option you wanted for the second, third, fourth, fifth year as against other provisions in the statute, schedules, investment tax credit, and the rest?

Mr. LEISENRING. I am not aware any calculations have been made by the coal industry in that regard but I would like to have such calculations made and enter them for the record.

Senator NELSON. I would appreciate seeing them.

Mr. LEISENRING. We will submit that information.

[The following was subsequently supplied for the record:]

I am not familiar with the Canadian system. As you explain it, it would simply involve a two-year write-off of depreciable assets. I am very tempted to say that we would support such a change. However, I feel certain this would not reflect the unanimous position of the coal industry. For instance, some companies have signed long-term, cost-plus contracts. These arrangements provide the coal producer with substantial security in exchange for which he realizes a much smaller profit margin. In these instances there probably is not sufficient profit generated to offset the large losses due to the two-year depreciation.

I believe a far better alternative would be to leave the credit and the ADR in the system, add the two-year depreciation allowance, and make the choice optional with the taxpayers. This would permit both the low profit producer and the higher profit producer the chance to select those provisions which would best provide the sorely needed investment capital for his company.

The CHAIRMAN. I was late in getting here this morning because I appeared on behalf of the committee to discuss what may develop into a point of difference with the members of the Budget Committee. Some of them seem to take the view that you owe a certain amount of taxes to the Government whether the law says so or not. If the top tax rate is 70 percent, then anything in the law that permits you to keep more than 30 percent in a tax expenditure to an individual. They have their own view of tax uniformity; which is not always consistent. Basically it works out to the theory that anything that fails to tax one taxpayer on exactly the same basis as all other taxpayers departs from tax uniformity. So the proposal that you are advocating here would fall in that category almost entirely.

I don't quite buy that theory. It seems to me that the taxes you own are what the law says you owe. In raising revenue for this Government, those of us who vote on taxes should take a look at what the situation is with regard to the entire economy and ask ourselves the question: How can we best raise the amount of money we need for the support of this Government? We might decide that somebody in the coal business can afford to pay more, or maybe he cannot afford to pay that much if we expect him to do what the Nation's economy requires. Maybe it would be better to raise funds through an excise tax rather than an income tax.

Do you buy this theory that it is a tax expenditure when the Government permits you to plow some of your own money back into building

your business, that the Government has in effect made you a gift by letting you plow some of your earnings back into trying to earn more and to put more people to work?

Mr. LEISENRING. No, I do not. I think the tax incentives which exist for the coal industry give the coal industry a somewhat lower overall tax rate than some other industries, espeically manufacturing where I think the tax rate is 45 to 50 percent. Our tax rate is probably 30 to 40 percent. I can only say that in summarizing my whole testimony that if we are to generate the funds and have the rate of return to borrow money to increase production as the Government has asked us to do, we are going to need a tax rate which is more favorable in order to achieve it.

I would say this, Senator Long. My company is expending in new production over 90 percent of our cash flow this year, last year and next year. We are paying out in dividends, 6 or 7 or 8 percent of our cash flow to the shareholders. I think the percentage of reinvestment is very high and I think it should be high and we intend to keep it high in order to put in new mines to the utmost extent that we can.

The CHAIRMAN. Should we decide that in the national interest we should only tax away half of your net earnings rather than all of them, would you think that is a bounty or a gratuity from the Government that you are permitted to plow back some of your earnings to earn more for your workers, your company and for the benefit of society?

Mr. LEISENRING. I would not characterize it as a bounty or gift. I would characterize it as a policy. If you ask us to substantially increase our production, we have to have the funds to do it.

Senator BYRD. I would like to get back to this black lung trust fund. I must say in my earlier comments, I did not realize that you were advocating that your program take the place of what the House passed. I think that your program has some advantages over the House proposal but I would not be prepared at this time to make a judgment because I am not familiar enough with the details of each.

May I ask you this. Could you submit for the record what might be done in regard to your proposal in placing a requirement for a minimum contribution to that trust.

You mentioned in your testimony that the cost would be from $1.35 to $5 a ton, I believe. Could legislation be written which would make it a minimum of $1.35 a ton or some such minimum if you are going to take this approach over the House approach?

Mr. LEISENRING. What we are doing now is covered by the existing tax law. We are making contributions into our existing private trust fund which is irrevocable to cover the present and past liabilities for the beneficiaries who will receive the fund income. That comes under the jurisdiction of the Internal Revenue Service as to whether or not we are funding an adequate amount and to make certain that we are not funding an excessive amount. We would like to study some exact language further, if you will, and I will be glad to submit it to you for the record.

[The following was subsequently received for the record:]

With essentially no actuarial experience to rely upon, the question is difficult to answer. The total amount needed to fund all the valid claims from a given mine would depend to some extent on the disease incidence of a particular company, the nature of the mine, the age complement of the work force, and other factors. I would say that under-funding would not be a problem. Rather, if the

incentive were present there might be a tendency to over-fund initially—at least until a record was developed to give the grantor-producer some idea of the magnitude of the liability. Right now, estimates—and they are only estimates—place the cost of supporting the Black Lung benefits under the existing law at $1.35 to $5.00 per ton of coal mined. With this kind of spread you can understand why I hestitate to suggest a minimum figure based on tonnage.

Also, please bear in mind that these trusts would be individually funded by each company. They would not be mandatory, and many companies would most likely rely on buying insurance to cover their contingent liability. This legislation would benefit those which are currently self-insuring or that are undecided as to how to face this problem.

Senator BYRD. I think that would be helpful in trying to work out a proposal along the lines you are recommending. Yours is a voluntary plan, as I understand it.

Mr. LEISENRING. That is correct.

Senator BYRD. And the House proposal is a compulsory plan.

Mr. LEISENRING. Our plan is voluntary but it meets a compulsory requirement of paying benefits which are clearly spelled out to our employees and former employees.

Senator BYRD. So it is compulsory in that sense?

Mr. LEISENRING. That is right.

Senator BYRD. In your testimony, you say "the miner working in the mines today, should he qualify for benefits in the future, would know that his black lung disability compensation would be funded on a current basis."

Do you not fund it on a current basis now?

Mr. LEISENRING. We do but it is not certain under the law——

Senator BYRD. It gets back to the interpretation of the Internal Revenue.

Mr. LEISENRING. That is correct.

Senator BYRD. What you want to do is write into law the assertion that you can fund it on a current basis.

Mr. LEISENRING. That is correct.

Senator NELSON. May I ask one more question on this point?

The CHAIRMAN. Yes.

Senator NELSON. On the black lung bill that came over from the House, the mark up is planned at an early date. I am not sure whether the chairman will try to mark it up before April recess, but I think it will be within a month or so.

Was the proposal you have made here for funding this obligation presented yet at hearings by the coal association on either the House or Senate side?

Mr. LEISENRING. It is my understanding that this bill is before the Labor Committee of the Senate right now, and I believe tomorrow or in the very near future, the National Coal Association will present its views in some detail. I am not a specialist on the subject but the Labor Committee will be hearing the National Coal Association's views on this legislation.

Senator NELSON. I am on that committee. I did not know they were scheduled.

Do you know if this proposal was presented on the House side during hearings for consideration when the House drafted the bill?

Mr. LEISENRING. It is my understanding Congressman Duncan of Tennessee has proposed parts of the bill which are parallel to or the

same as what we are proposing to this committee today for the House side of that bill.

Senator NELSON. But this precise proposal is going to be presented to the Labor Committee as a substitute for the House bill. Is that what you are telling me?

Mr. LEISENRING. It will certainly be discussed.

Senator BYRD. Congressman Duncan's proposal was made after the House committee handled the black lung bill, wasn't it, but not during the hearings?

Mr. LEISENRING. That is correct. It was not timely enough.

The CHAIRMAN. Are there further questions, gentlemen? Thank you very much.

I want to extend my apology to Mr. James O'Connor. I will call him now. In shifting from one presiding officer to another this morning, we overlooked his place on our list. I want to offer my apologies. I am happy to see you have Mr. Reid Thompson with you.

STATEMENT OF JAMES J. O'CONNOR, EXECUTIVE VICE PRESIDENT, COMMONWEALTH EDISON CO., ACCOMPANIED BY REID THOMPSON, CHAIRMAN OF THE BOARD AND PRESIDENT, POTOMAC ELECTRIC POWER CO., AND AL NOLTZ, COMMONWEALTH EDISON OF CHICAGO

Mr. O'CONNOR. My name is Jim O'Connor. I am executive vice president of Commonwealth Edison Co.

The CHAIRMAN. Please identify the others with you.

Mr. O'CONNOR. On my left is Mr. W. Reid Thompson, chairman and chief executive officer of the Potomac Electric Power Co. On my right is Al Noltz, Commonwealth Edison, Chicago.

Senator, gentlemen, we have prepared a rather lengthy statement for the record. It has been presented to the staff of the committee. Rather than read that on behalf of EEI, I would like to summarize the statement.

First of all, the organization that I am representing today, the Edison Electric Institute, represents about 99 percent of all the customers of the investor-owned utilities in the country.

In adition to that, the privately owned sector of the electric industry represented by EEI serves 77 percent of all the electric customers in the country.

My comments today will center on two areas, first, the financial problems of our industry and second, steps that we think that can be taken and should be taken which would aid significantly in restoring the financial integrity of the electric utility industry.

In 1975, the Edison Electric Institute completed a major study which concluded that economic growth is desirable to improve the standard of living. In the course of that study, they determined that economic growth is absolutely commensurate with energy growth.

In projecting for the years ahead, they determined we would need electricity growth on the order of 5.3 to 5.8 to sustain even moderate economic growth in this Nation.

But to have a 5.5-percent growth in the amount of electricity will require very substantial new capital resources. Our industry has been

particularly hard hit by inflation. For example, the fuel that we buy today, on the average, is four times more expensive than it was 10 years ago. The plant we are building today is four times more expensive on a per kilowatt installed capacity than it was 10 years ago.

Our interest rates for long-term debt, which were 4½ percent in 1964, run upward of 10 percent in 1974–75.

The bond ratings of 35 of 50 of the largest electric power companies in the Nation have been reduced in the last 36 months.

Twenty-five or one-half of the 50 largest electric utility companies in the Nation have had to sell common stock at below book value in the last couple of years.

I think part of this problem is reflected in the fact that 10 years ago, in 1964–65, our industry was able to generate roughly 65 percent of the funds that they require for expanding generating capacity through internally generated sources—depreciation, deferred taxes and retained earnings. Today we are able to generate only one-third internally of our needs for expansion.

We are the most capital-intensive industry in the country. It takes us $4 of expenditures to produce roughly $1 of revenue. We compare that against the industries traditionally thought of as capital intensive, oil and gas, $1 of expenditures for every dollar of revenue; for the auto industry it is 56 cents to achieve $1 of revenue. In our case, $4 of plant expenditure to get $1 of revenue.

To give you some idea of how large our capital requirements are going to be in the years ahead, the Technical Advisory Committee on Finance to the Federal Power Commission last year completed a report that estimated up to the year 1989, or during the next 15 years, our industry, the privately owned sector alone would have to spend roughly $500 billion, and that is in current dollars, to finance plant expansion.

The difficulty that we have experienced in raising capital for new generating facilities has been responsible largely for the delay or the cancellation of new plant construction by the electric utility industry.

During the 1½-year period that extended from April 1, 1974, to October 1 of last year, our industry either deferred or cancelled projected new generating capacity of 181,000 megawatts of new capacity. Of that total roughly two-thirds or 125,000 megawatts was in nuclear capacity.

To give you some idea of what that represents, just the amount of deferrals and cancellations that took place during that period is equal to a little over one-third the total capacity now in existence by the electric utility industry in this country.

Another perspective on that problem is in terms of jobs. The deferrals and cancellations that we experienced during that 1½-year period equate to the loss of roughly 100,000 construction jobs. These are only the jobs that are directly related to the construction of these plants, not to the jobs related to the secondary activities conducted offsite.

We feel that the principal solution to these problems is really twofold:

First: As has been mentioned earlier today, is the need for rate relief on the State level. Yet, we all know utilities have experienced delays in getting the necessary relief to go forward.

Second: A number of changes in the Internal Revenue Code could be most helpful in solving our problems. These proposals were contained in the President's labor-management proposals sent to Congress last year and we support each and every one of them.

We support and urge that the investment tax credit for utilities be raised to at least 12 percent and we urge also that it apply indefinitely for the reasons stated earlier by Senator Byrd—the on-again, off-again thing which makes it so difficult for our industry to contend with when we need leadtime of 5 years for fossil fuel and coal and gas and up to 10 years or more for nuclear powerplants. This need creates gyrations in our financial programs that are very difficult to contend with.

We urge also there be removed the limitation on the amount of investment credit that can be taken. As you know, there is a transitional period that provides for the lessening of the amount of credit that can be taken as it goes down from 100 percent. We urge the level be restored to 100 percent.

Also, we urge any extension include permission to take credit on qualified construction expenditures or progress expenditures. This is a new aspect of the treatment on investment tax credit that we find to be very, very important and we urge that extension.

Finally, we think it advisable that the Finance Committee and others consider the provisions adopted last year which provide for an additional 1 percent for the employee stock-ownership program.

We urge that these provisions be extended so that we can go into those programs and make them worthwhile for an industry as a means of raising equity capital. In surveys conducted throughout our industry, we know better than 90 percent of our companies would participate and have indicated a desire to participate if the regulations to be arrived at provide some degree of permanency.

Next, there is the tax deferred treatment of income that is reinvested in the common stock in an electric utility company. This provides for simply a tax deferral. This is not a loss in tax revenue. It will be made up someday. It is particularly important in our case because in the next 5 years we estimate we will have to be raising $3 billion in new equity capital each year. The dividend investment program would assist materially in aiding our industry in the formation of new capital.

In December of 1975, the average utility stock was selling at 47 percent of its level 10 years prior to that. When somebody says our financial problems have eased, it is like a patient with a 105-degree temperature, give him an aspirin and it goes to 104, then telling him he is in good health. He is not in good health. We need this assistance.

The investment program would be a means to encourage this investment. This proposal is even less favorable than that which deals with stock dividends. Our industry for the most part, because our stockholders buy our stock primarily on a yield basis, cannot take advantage of the kind of treatment that is provided for stock dividends.

The third item in the President's program that we consider to be very important and we urge the adoption of concerns tax depreciation and that it be permitted on qualified progress expenditures——

The CHAIRMAN. I will have to ask you to end your oral statement at this point. I have read your statement and I think most of the others

have. I want to ask some questions about it. You will get a chance to elaborate further on what you have to say as the questions go along.

Senator Nelson.

Senator NELSON. I have no questions.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions, Mr. Chairman.

The CHAIRMAN. It is my understanding your industry has not taken advantage of the 1-percent-tax-investment credit for employee stock ownership, which would have brought more capital to your industry, because of some of the technical problems involved similar to those that American Telephone & Telegraph Co. has pointed out. Is that correct?

Mr. O'CONNOR. Yes.

The CHAIRMAN. Let me tell you what you are asking us to consider. I think I could go along with everything in your program with one exception. If we are going to raise the investment tax credit above 10 percent, I think that the additional 2 percent should be for the benefit of the employees. I think we ought to take the wraps off of it, and I would be happy to have your suggestions along that line. You have Mr. Reid Thompson sitting beside you. As a matter of fact, he is an old soldier in stock ownership. He put such plans into effect in his company before. I discussed with him from time to time what some of the technical problems would be.

It seems to me we could work together on a plan where you would take that additional 2 percent. We will continue, I am confident, if I have my way, the 1 percent that is there already, and you can borrow against that to get more capital, as these Kelso plans do, where they set up a trustee, borrow money, buy convertible debentures and convert them as they can. We might need to change the law so that, if need be, you can sell stock at book rather than at market value in some cases.

I would like to have your suggestions along that line. If we can work out a package where we could make that one change, do you think you could support that package if this committee recommends it?

Mr. O'CONNOR. We certainly do. As I mentioned in my remarks, the item you alluded to is in the change of regulations or clarifications of the regulations so we know where we are headed. This is terribly important.

The other item is the permanency aspect of it. Once we have adopted a program, having to go out 2, 3, 5, years, we think it is important that that be resolved.

The CHAIRMAN. I was very disappointed that some companies such as yours did not take full advantage of the option of 1 percent. They explained to me the many problems involved which for the most part were our fault, since in some respects the provision was drawn too tightly. It left you with some hazards that we should not expect you to assume. Some of those were pointed out by American Telephone and Telegraph. There are some others we should consider. But if we gave you the flexibility it took so that your company could have what would be one of the best employee stock ownership arrangements in America, I would just like to know if you think your people would take full advantage of it.

Mr. O'CONNOR. Let me speak for my company first, if I may, and give you my ideas.

We would adopt an employees stock ownership plan. We have until September 15 of 1976 to make that decision. We have already prepared the documentation necessary. We are waiting for clarification of the regulations concerning that.

Mr. Thompson's company is going ahead and adopting it. Our only concern is the clarification.

The CHAIRMAN. The public service commissioners in California told me that there were companies coming in asking for a rate increase to provide for more adequate service. They asked them the question why they don't take full advantage of what is available to them now. It was pointed out this 1 percent was available. I know it has some technical shortcomings, and I know the regulations are too restrictive. We will do what needs to be done to take care of that aspect of it. I don't expect you just to go on conversation and promises.

One of those pollsters talked to a Democratic lady and said that one reason Mr. Carter is running so well is he is not making any promises. People are sick and tired of promises from people running for public office. If we actually take care of it so that your people can be protected from the uncertainties that have plagued you up to this point, I hope your people can assure us they will take full advantage of the employee stock ownership plan.

Senator Fannin?

Senator FANNIN. One of our most serious problems today is unemployment, and this is especially true in industry.

How will the tax proposal as set forth alleviate the unemployment problem in the construction industry?

Mr. O'CONNOR. We estimate—and this is a very conservative estimate—about 104,000 jobs are lost because of cancellations. Of course, we talk about the lead time in constructing a plant, 5 years for fossil fuel and 10 years for a nuclear plant. Those are jobs lost for a long, long time. So, it is a very serious impact on our industry.

I can tell you that perhaps no greater priority is placed on the subject than by Bob Georgine president of the Building and Construction Trades Department, AFL-CIO, who has spoken many times of getting these plants back into construction. It is the top priority as far as their union leadership is concerned. So, there is a real impact on the labor market.

Senator FANNIN. You mentioned the construction of nuclear generator plants. We know there are problems today that face us. We do not know what the vote is going to be in California and elsewhere, but does the construction of nuclear generating plants result in an advantage to rates charged the average consumer?

Mr. O'CONNOR. May I preface my reply with a reference to a U.S. News and World Report for 1975 which points out that we have gone from 100 percent U.S. oil production back to 44 percent. Of the utilities' oil for generation, 50 percent now comes from facilities that are offshore. We see this trend continuing and if these projections are correct, it is going to come primarily from the Middle East. We regard nuclear power as extremely important and an economical source of power also.

The Atomic Industrial Forum made a calculation, using 1975 figures, and they estimated the operation of nuclear powerplants in this country were responsible for reducing the ultimate cost to consumers

by about $8 to $10 billion contrasted to what it would have been had they used fossil fuels.

We feel that while the cost of nuclear powerplant construction is higher than traditional construction, the operating costs are significantly lower.

The company that I work for, Commonwealth Edison, has the largest commitment to nuclear power in the United States. We estimate we can produce a kilowatt-hour from a nuclear plant 28 to 34 percent less depending on the fuel. We feel there is a major advantage from an economic standpoint.

Senator FANNIN. If we do not go forward with these programs, are we going to have blackouts or brownouts, or problems of that nature?

Mr. O'CONNOR. Presently the industry has a good reserve margin, possibly because of 1975 experience. Perhaps through the next 3 or 4 years, we will be all right but, beyond that point, there is a very serious threat of problems providing energy throughout the Nation if we do not get on with the construction of nuclear plants and other types of plants because of the leadtime involved. The decisions we make today will affect our customers throughout the 1980's and beyond. We have to plan for tomorrow's needs. The turnaround time in our industry is so long, we have to make these decisions at an earlier date.

Senator FANNIN. You have emphasized the dividend reinvestment programs. How much would that be? Do you have any idea of percentages?

Mr. O'CONNOR. If we assume roughly 15 percent of the stockholders of our industry were to take advantage of this, and last year the dividends on collective utility common stocks were about $3.75 billion, we expect we can raise $500 million.

Senator CURTIS. I have no questions. I have followed your testimony.

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

[The prepared statement of Mr. O'Connor follows:]

STATEMENT OF JAMES J O'CONNOR ON BEHALF OF EDISON ELECTRIC INSTITUTE

My name is James J O'Connor. I am Executive Vice-President of the Commonwealth Edison Company which provides electricity to Chicago and the northern one-third of Illinois. Today I appear on behalf of the Edison Electric Institute. The Institute is the principal national association of investor-owned electric light and power companies in his country. Is member companies represent 99 percent of all customers of the investor-owned segment of the electric utility industry, and 77.5 percent of the nation's electricity users. We appreciate the opportunity of appearing here today to present our views on pending tax legislation.

CAPITAL NEEDED TO MEET ELECTRIC ENERGY GROWTH DEMANDS

In 1975 the Institute completed a major study which concludes that moderate, continuing economic growth is desirable to improve the "quality of life" and the standard of living of the American people and that growth can be sustained by the United States for the foreseeable future. Improved productivity is essential to growth and this means capital investment—buying more and better tools to produce more per manhour, which effectively curtails inflation, and building new facilities to provide employment for the nation's growing work force. While other factors are important, the key to increased productivity is the formation of capital.

The Institute estimates that under conditions of moderate economic growth electric energy consumption will grow at an average rate of 5.3 to 5.8 percent per year. (In 1975 growth was below the anticipated average due to the depressed

condition of the economy. Although residential and commercial sales increased, 6.2 percent and 7.0 percent respectively, industrial sales declined 4.5 percent, resulting in an overall growth of only 2 percent.)

The electric utility industry has encountered difficult problems in raising the capital necessary to finance the power plants and associated facilities required to supply the anticipated growth in electric energy consumption. The problems result from drastically increased costs—particuarly the cost of fuel, the cost of new plant facilities, and the cost of capital required to finance the facilities—together with an inability to obtain prompt authorization for increased rates to cover these increased costs. For some companies this has led to inadequate "coverage" of interest and dividends, which, under indenture covenants, limits or prevents the sale of senior securities. Despite improvement during the past year, market prices of many electric utility stocks are still below book value. Accordingly, as it becomes necessary to sell additional common stock, there is a dilution of the value of existing shares. Because such a dilution shrinks their earning power, investors become increasingly reluctant to purchase utility equity securities.

In 1964, electric utilities were able to provide about 64 percent of the funds needed for new plant investment with internally generated funds, principally retained earnings, depreciation, and deferred taxes. By 1974, declining earnings and rising prices for the equipment needed to serve utility customers made it possible to finance only 33 percent of capital expenditures in this way.

The electric utility industry is by far the most capital-intensive industry in the country. For every $1 of revenue, about $4 must be invested in plant facilities. In contrast, the steel and oil industries, generally considered to be capital-intensive themselves, need only about $1 of investment for every $1 of revenue and the automobile industry requires only about 50 cents of investment for each $1 of revenue.

In a study concluded in 1975, the Technical Advisory Committee on Finance to the Federal Power Commission estimated that construction expenditures of the electric power industry will increase from an annual rate of $16½ billion in the first half of the 1970's to about $23 billion in the last half. From 1976 through 1989, construction expenditures of the investor-owned utilities are expected to total in excess of $500 billion in current dollars; this is four times the expenditure during the preceding comparable period. (See attached chart showing breakdown by year.) As a result, the need for financing from outside sources will increase more than proportionately, and the investor-owned electric industry will have to raise over $300 billion in the outside market during this time.

Difficulties experienced by most electric utility companies in raising capital have been a major reason for deferrals and cancellations of new generating facilities. Currently, our figures show that between April 1, 1974 and October 1, 1975, a total of 181.000 megawatts of capacity have been delayed or removed from the schedule. Of this total, 125,000 megawatts were in nuclear units, most of which were due to be completed in 1980 or later. This is equal to roughly 35 percent of the total present installed generating capacity. It is estimated that the projects deferred or removed involve approximately 100,000 construction jobs annually. Of course, deferrals and removals have an immediate deterring effect on employment and the current economy. Even more important are the implications for the national economy in the future if there is then a significant shortage of electric power. In all likelihood, there will be shortages of electricity if action is not taken promptly to restore the deferred and cancelled projects.

The principal solution to this serious problem is adequate and expeditious authorization for rates to cover increased costs and attract new capital. However, changes in the Internal Revenue Code are a necessary concomitant in the overall capital picture because existing tax laws impose a severe burden on capital investment.

RECOMMENDATIONS OF THE PRESIDENT'S LABOR-MANAGEMENT COMMITTEE

The President's Labor-Management Committee has recommended a number of changes in the Internal Revenue Code that would help to solve our industry's financial problems and thus stimulate construction of urgently needed electric facilities.

We strongly endorse their recommendations and urge early and favorable consideration by the Congress.

Investment tax credit

We support the recommendation of the President's Labor-Management Committee that the investment tax credit be increased to 12 percent for electric utilities, that it apply indefinitely and that it be applicable in full to qualified progress expenditures without the transitional adjustment. Also, we urge that normalization accounting and rate treatment be required for additional investment credits under any new legislation.

Since 1962, the investment tax credit has been authorized, suspended, restored. terminated, and then authorized again. Because of the long lead time necessary for the construction of large generating plants and transmission lines, there is a need for assurance that the credit will be allowed for an indefinite period. On the average, it takes over five years to place a coal-fired generating unit in operation and ten or more years for a nuclear facility. Large amounts of capital are tied up during these extended periods, which serves to strain the financial position of utility companies. Allowance of the investment credit at a 12 percent rate would provide important capital funds and significantly ease the strain.

In order to receive full advantage of the increased cash flow resulting from the additional investment credit, the limitation for electric utilities, which is scheduled to fall ten percent per year until it reaches 50% in 1981, should be maintained for an indefinite period at 100% of an electric utility company's pre-credit income tax liability.

Also, allowing the investment credit on the full amount of qualified progress expenditures without regard to the transitional adjustment should reduce the lag between incurring the expenditure and realizing the credit.

The increase in investment credit should apply to generating facilities in which petroleum products (including natural gas) are to be used where the utility was committed to the construction of the facilities prior to recognition of the energy crisis. Denial of the investment tax credit on such facilities would cause an undue burden on companies which have acted reasonably and in good faith.

Finally, it should be pointed out that provision of the current one percent investment tax credit to finance Employee Stock Ownership Plans (ESOP) should be extended. The proposal of the Labor-Management Committee to increase the present 10 percent investment tax credit to 12 percent does not appear to contemplate a loss of the ESOP credit but does not provide for its extension.

Dividend reinvestment

One of the principal recommendations of the President's Labor-Management Committee concerns the deferral of current income taxes on dividends immediately reinvested by a shareholder of an electric utility company into stock of the paying company under a qualified dividend reinvestment plan.

This proposal is of considerable importance to the industry. Our industry's needs for new common equity financing are expected to be over $8 billion a year during the next five years. These requirements are 50 percent higher than those in each of the past five years.

The dividend reinvestment proposal would assist materially in encouraging investment in utility common stock and aiding in the formation of capital for utility investment. In December, 1975 the average utility stock was trading at about 47 percent of its level ten years earlier. Even with overall market conditions improving in recent months, many utility stocks are still valued below book value and with the financing needs of the industry some means to encourage investment in utility common stocks is essential. We strongly urge this proposal because the primary effect of tax deferral on dividends reinvested would be to provide needed equity capital.

This would merely provide a treatment similar to that now provided conventional stock dividends. Many utility stockholders purchase their stock for the cash yield and it is therefore not practical for utilities to change their dividend policy to provide for lower cash dividends to be supplemented by stock dividends. Under the language preivously suggested by the Treasury Department, the proposal results only in a deferral of ordinary income taxes which is even less favorable than the treatment accorded stock dividends.

Taxes will be recouped by the Treasury at ordinary income rates when the stock is disposed of by the shareholder. Hence, there is no permanent loss of tax revenues to the Treasury.

It should be pointed out that the public service obligation of utilities distinguishes our fund-raising needs from those of other industries. Our industry must raise capital on terms that are, at times, highly uneconomical because we must construct required plant to meet customer demand. Common stock is the foundation of our capital structure and, to continue construction, stock must often be sold even when market conditions make such issues uneconomical. Since utilities do not have the investment discretion enjoyed by other industries, the dividend investment proposal offers an important and needed way to make electric utility stock more attractive.

The results of a survey made last spring of Institute members which presently have a dividend reinvestment plan indicate that the deferral of taxation on reinvested dividends primarily would help the small stockholder. The results of the survey are as follows:

	Companies using outstanding shares	Companies using unissued shares
Percent of total common shareholders participating	5.4	9.6
Percent of total common shares held by those participating	1.8	4.9
Average common shares held by those participating	95.0	125.0

Depreciation

In view of the long lead time necessary to bring major generation and transmission facilities into operation, the Institute urges that qualified progress expenditures included in the base for ratemaking purposes be eligible for tax depreciation. Normalization accounting and rate treatment should be required in order to obtain this tax benefit. The combined effects of additional tax depreciation and inclusion of qualified progress expenditures in rate base will add materially to the internal cash generation of an electric utility.

Many regulatory commissions have already recognized that some or all construction work in progress (CWIP) should be included in rate base. By allowing qualified progress expenditure property to be eligible for tax depreciation only if the regulatory body allows the utility to include the same property in the rate base and to normalize the tax effect of the depreciation, the internal cash generation problems of electric utilities would be materially alleviated. With major generating plants now taking five to ten or more years to construct, the need for additional internal generation of capital is obvious. With CWIP in the rate base utilities will be replacing bookkeeping earnings with real earnings, and normalization of rate treatment will assure that the cash remains available to the utility for use in acquiring needed facilities. This results in a tax deferral not a permanent loss in taxes to the Treasury.

For the reasons stated above under the investment credit heading and where long standing commitments have already been made, qualified progress expenditures relating to generating facilities in which petroleum products are to be burned should be eligible for tax depreciation when incurred.

Amortization of pollution control and fuel conversion generating facilities

The President's Labor-Management Committee recommends extension of the provision for rapid amortization of pollution control facilities and also recommends that rapid amortization of the cost of fuel conversion generating facilities to use fuels other than oil or gas be permitted. Our economic studies show that this proposal would not achieve the goals intended unless the investment tax credit also is available with respect to such facilities. Loss of the investment tax credit would nullify the advantage of rapid amortization because it would be more advantageous for a taxpayer to elect an accelerated method of depreciation, the ADR system, and a 12 percent invesment tax credit rather than rapid amortization with no investment tax credit. Of course, the 60-month amortization period would limit the amount of the investment tax credit to two-thirds of the amount otherwise available.

The right to amortize fuel conversion costs should include as eligible costs those associated with conversion from gas to oil. Boilers in plants which were designed to burn natural gas could rarely, if ever, be converted to burn coal. Because of the differences in the nature of the two fuels, esentially a new boiler with storage and handling equipment would be required. Because natural gas-fired plants are the least costly to construct, the cost of converting one to burn coal, together with the cost of adding coal handling equipment, would probably be as much as or more than the original cost of the entire gas-fired plant. Further, many natural gas-fired plant sites do not have the physical space to stockpile coal, making an adaptation to coal impossible.

A conversion to burn residual oil would be entirely consistent with the national energy program for the best usage of natural resources. Residual oil (the product existing after refining crude oil into gasoline and distiliate oil) has only industrial uses, with the most common being used as industrial boiler fuel. If rapid amortization for the costs of converting a gas-fired plant to burn residual oil is denied, many companies' conversion efforts will be impaired, which would not be in furtherance of the national energy program of the most prudent usage of natural resources.

Estimated tax revenue impact

In recent testimony before the Budget Committee, Assistant Secretary of the Treasury Charles Walker estimated that the enactment of these recommendations would reduce electric utility income tax liabilities in future years.

A breakdown for fiscal year 1977 indicates that a $800 million temporary loss would result from the deferral of taxes under dividend reinvestment, and while the proposal generates cash for the utilities, the tax deferral would be to the benefit of utility company stockholders rather than reducing the electric companies' income tax bill. Also, as previously mentioned, the tax deferral would not be a permanent loss to the Treasury.

Tax savings of $200 million to the electric utilities are attributed to depreciation of qualified progress expenditures. The savings again are only temporary in nature because the total depreciation deductions applicable to such facilities over the lives of those facilities would be the same as those allowed by current law. The tax benefits are accelerated but not increased.

Consequently, the increase in the investment credit, estimated by Secretary Walker to amount to $70 million in fiscal year 1977, would be the only permanent tax benefit to the electric utilities, assuming that limitations relative to the credit would currently or eventually allow use of the credit.

ADDITIONAL TAX PROPOSALS

Integration of the corporate and individual income tax

In recent statements, Treasury Secretary Simon, Ways and Means Chairman Ullman, Securities and Exchange Commission Chairman Hills and others have focused on the growing problem of capital formation in the United States. They agree that our present tax system is biased against capital formation. By taxing corporate profits twice—once at the corporate level and again at the shareholder level—the system inhibits the flow of capital in the economy. Because the capital needs of the electric utility industry are so great, it is particularly affected.

Double taxation obviously encourages the retention of earnings so as to avoid the second tax. But traditionally many purchasers of utility stock have acquired such stocks on the basis of yield and utilities which therefore have a high percentage of earnings are placed at a substantial disadvantage when compared to those corporations which retain a much greater portion of their earnings. Elimination of the second tax would greatly assist utilities in raising equity money.

Many plans have been suggested for alleviating these problems by integrating corporate and individual income taxes. We fully support the underlying principles and objectives of such proposals.

Carryover and carryback modifications

Section 172 of the Internal Revenue Code currently provides for net operating loss carryover and carryback periods for taxpaying businesses of five and three years, respectively. Because those electric utilities currently experiencing the most severe financial problems have little or no taxable income, the granting

of additional incentives which further reduce taxable income would have little or no meaning because little or none of such incentives could be utilized within the current statutory carryover and carryback periods. However, these utilities have paid substantial income taxes in the past and will undoubtedly find themselves in this position once again in the future.

We recommend, therefore, that Section 172 of the Code be amended to provide for electric utilities maximum periods of 7 years for carryover and 10 years for carryback of net operating losses, with an increase in the carryback period to be available only if the taxpayer reduces the carryover period by an equal number of years.

Congress has in the past recognized the special needs of particular classes of taxpayers and has provided several modifications to the general rule, such as the 10 year carryback period applicable to "Financial Institutions" and the 7 year carryover period provided for "Regulated Transportation."

Analogous modifications of investment credit carryover and carryback provisions would be similarly helpful to companies that would gain little or nothing from the grant of additional current tax deductions and investment tax credits.

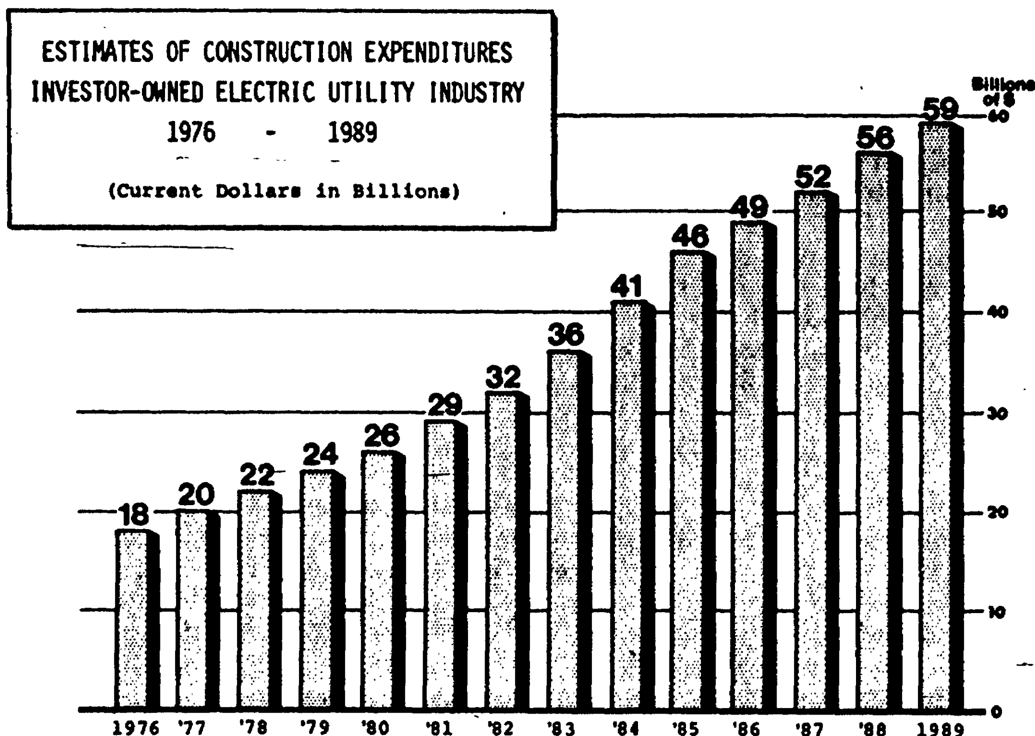
Costs of meeting national environmental standards

The meeting of reasonable national environmental standards, a goal which the electric utility industry fully supports, accounts for a substantial part of the industry's capital needs in coming years. Our latest estimates are that in the years 1976 through 1980 the investor-owned electric companies must invest over $10 billion for this purpose. This is intimately tied in with attainment of national energy goals, since a substantial part of the environmental concerns result from the switch to nuclear and coal from oil and gas as energy sources.

Two particular income tax provisions could be of immense value in helping the industry meet its capital requirements in this area. First, 5-year amortization of all pollution control facilities, not just facilities retrofitted on existing plants, should be permitted. Essential elements of such a provision would be that the investment credit be allowed and that fast amortization not be permitted unless the resulting tax deferral is normalized for rate making purposes. As previously pointed out allowance of the investment credit is necessary because little, if any, tax advantage results from use of 5-year amortization without the credit instead of accelerated depreciation over asset depreciation range lives with a ten percent or higher credit. Normalization is necessary both because it is sound economically and because if the tax deferrals are flowed through in rates no capital is provided to help finance the required facilities.

Second, there should be incorporated in the tax law provisions which make effective the existing provision of Section 103(c) (F) relating to industrial development bond financing of air or water pollution control facilities. We believe that the Internal Revenue Service and the Treasury Department have largely nullified this provision by means of highly restrictive interpretation and unconscionable delays in responding to requests for ruling. There should be included in the statute a definition of "air or water pollution control facilities" that expresses the intent of Congress specifically enough that Section 103(c) (4) (F) will become truly effective as a means of helping in the financing of pollution control facilities. This is a vitally important matter for at least two reasons. First, because interests rates are lower on tax-exempt than on taxable borrowings, tax-exempt financing exerts a lesser upward, inflationary pressure on electric rates. Second, the market for tax-exempt obligations is in the main distinct from the market in which most utility debt financing is done, and access to this other market should significantly enhance the industry's ability to raise needed capital.

We suggest as an additional measure to assure that the intent of Congress in enacting Section 103(c) (4) (F) is given effect that it be made possible to sue to obtain a declaratory judgment when IRS acts adversely or fails to act with respect to a request for ruling on a proposed financing. The provision should closely parallel Section 7476, declaratory judgment relating to qualifications of retirement plans, which was enacted as a part of the Pension Reform Act of 1974. Pollution control financings and qualifications of retirement plans have the common attribute that when IRS acts adversely or fails to act, the affected parties are virtually helpless.



Source: 1976-1979 Edison Electric Institute (For these years it is estimated 60% of total funds must be obtained on the open market); 1980-1989 Derived from the National Power Survey Technical Advisory Committee on Finance Report. December 1974.

The CHAIRMAN. Our next witness is Mr. Robert N. Flint, vice president and comptroller, American Telephone & Telegraph Co.

Mr. Flint was to testify earlier but he was unavoidably delayed, so we will hear from you now, Mr. Flint.

STATEMENT OF ROBERT N. FLINT, VICE PRESIDENT AND COMPTROLLER, AMERICAN TELEPHONE & TELEGRAPH CO., NEW YORK CITY, N.Y.

Mr. FLINT. Mr. Chairman, let me apologize for being late. The weather in New York is very bad, and we just went round and round.

I have a statement I would like to file for the record.

I would also like to very briefly summarize the more important points, some of which have been covered, so I will be brief.

I do appreciate the opportunity to be here. I am going to be speaking on behalf of the American Telephone & Telegraph Co. and the operating telephone companies that constitute the Bell System.

My remarks will relate to primarily three areas.

One would be the investment tax credit. A second item will be the taxation of dividends or the deferral dividends, and the third one has been alluded to, and that is the amendments we feel are essential in order to be able to remove the obstacles to adoption of the additional 1 percent investment tax credit.

I would like to address these remarks in light of the massive difficulties the telephone communications industry is experiencing.

In the last 10 years, we have gone from 76 million to 118 million telephones. This meant we had to have some additional plants, from $34.3 billion up to over $84.6 billion.

During this 10-year period, in order to do this, we had construction programs which amounted to about $71 billion, and this put a tremendous burden on our ability to be able to raise capital. About $29 to $30 billion for those construction programs during this 10-year period was raised by the sale of new securities to investors. As a result, over the last 10 years, our debt has increased over threefold. Our debt ratio has increased from 33 percent to almost 50 percent.

Our annual interest charges have increased 6-fold. We are now carrying about a $2.3 billion amount of interest annually.

Most significantly, post-tax interest coverage, which is the measure of the quality of a security and the ability to be able to borrow as to the terms and amounts, has plummeted from well over 6 times in the last 10 years to now where it is only 2.5 times. We have had 2 of our major operating telephone companies, in fact, downgraded, and if we do not show improvement, others will be in risk. As a matter of fact, A.T. & T. could be in jeopardy.

In looking to the future, we see we could have an entirely different situation than we had 10 years ago. We had borrowing margins 10 years ago. With the 33 percent debt ratio, there was a lot of cutting room. We have now reached what I would consider to be above the normally prudent level of debt. So we are going to have to do something about encouraging the equity investors to come back into the marketplace.

What I am suggesting here is the tax laws be as neutral as possible. This would be of the greatest possible benefit. At the present time, I feel there is a bias against the equity investment. That is a subject all unto itself, but let me comment on the 3 proposals which I wanted to discuss.

The first, of course, is the investment tax credit. Stated very simply, we also believe that the investment tax credit should be made permanent. We think the rate should be at least 10 percent for the very reasons earlier cited.

We also are very much in favor of having the tax deferral on dividends reinvested in our stock. We already have a reinvestment plan in which people do reinvest their dividends. It is particularly helpful to the smaller investor because he is able to get his stock easily and without transaction cost. Unfortunately, the tax has to come out of other earnings or savings.

Therefore, we feel if they had the deferral, it would be an extremely helpful thing, and it would be good to accumulate additional equity dollars.

The final one relates to the obstacles we discussed before the committee when I appeared before it on December 9 and, Mr. Chairman, I submitted a letter on December 5, a copy of which is attached to my written statement.

The CHAIRMAN. We voted for it, but, unfortunately, it got bogged down with all of the other good things we wanted to pass before the Congress adjourned. If you try to do too many good things at a time,

they call it a Christmas tree bill and you have to wait until the next year.

Mr. FLINT. I am acquainted with that term.

We are anxious to have the issue settled. We have some 1 million employees, and in order to go through the paperwork, and so forth, for setting up appropriate accounts, it is a massive job. We do have a 6 months' extension for filing our consolidated returns, which is September 15. As you can well imagine, it takes quite awhile to put together a consolidated return of some 6 volumes. We would like to have the wheels put under the vehicle so that we can make our decision.

I would like to say one other thing which I have mentioned in my prepared testimony, which I think is an inadvertence in the investment tax credit law. That is, as I read it, a second- or third-tier structure corporations' employees would be disqualified. I don't think this was intended. It is not an impediment from AT&T's standpoint to go ahead, but I doubt if, due to the circumstances, an employee not being in the right tier should be disqualified.

The CHAIRMAN. We will try to take care of that.

Mr. FLINT. We were not aware of it last time, Mr. Chairman. That is all I have to say, and I thank you for the opportunity.

The CHAIRMAN. Senator Nelson.

Senator NELSON. I have no question, Mr. Chairman.

The CHAIRMAN. I will yield to Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

In the attachment to your statement, you refer to the employee stock ownership plan. If the 1 percent ESOP were modified, how many employees would be affected?

Mr. FLINT. We have 940,000 employees, Senator. There would be some employees with very short service who would not be included.

For example, we would take a cutoff period of 3 years or something like that, but it would be my view we would have all employees, whether union represented or otherwise absent there being something in the labor-relations area that would be an impediment.

The CHAIRMAN. I would hope that we could have it so that even though it is negotiable—and I understand this was a ruling of the National Labor Relations Board—you could offer to all employees the opportunity to come in, whether the business agent is for it or not. Any time one turns down some stock coming to an employee at no cost to himself, I think that employee's decision would be he would like to have the stock.

Mr. FLINT. My reluctance here, Mr. Chairman, is not knowing the laws and regulations and requirements in the labor area; I feel I would be unwise to make any kind of commitment. I can give you the sense of that.

Senator FANNIN. Personally, I feel this has such great benefits to the rank and file union member that they will tell their officials to support the program—at least I would hope so—because I think it is certainly essential for good labor-management relations.

Going on to another subject, you talk about the investment tax credit should be made permanent. Certainly I agree. We have this on-again-off-again thing which has been very detrimental as brought

out by Senator Byrd today. But how is the investment tax credit to be treated in the industry?

Mr. FLINT. The way we do it in the communications business is like this, Senator, and I think an example is the easiest way to do it.

If we invested $1,000 in a plant that had a 10-year life, the 10 percent investment tax credit would apply, and we would be entitled to $100 investment tax credit. That $100 would be set up in a reserve, and over the 10-year life of that property, that $100 would be amortized at the rate of $10 a year to your earnings so that the customer over the service life of the plant will receive the money but, in the meantime, we have the money in the reserve and earn on it, and it is a source of capital. As I said, you get a double bang for your dollar. We get the use of the money for our capital requirements, and the telephone customer gets the final dollars' benefit over the life of the plant.

Senator FANNIN. There has been substantial discussion regarding dividend reinvestment proposals. In your opinion, who would benefit from the adoption of such provision?

Mr. FLINT. I think a lot of people would benefit. First of all, I think the investor himself would have a benefit because, at the present time, he has the burden of—if he does care to reinvest his dividends—of coming up from external sources to pay the tax. If the company declared a stock dividend, there would not be the same result. So, the investor could defer the tax until he had realized economic gains through the sale of stock.

The corporation would benefit in that, as you would have this encouragement for people who would want to invest in their common stock, it would be a source of equity, and we need all the equity money that can be made available. I think that if this happens, you are getting people to save money rather than using it for something else, and that is probably good for the economy. It is a winner all the way around.

Senator FANNIN. The utilities have been talking about the regulatory agencies of the States and the problems they have as far as the States are concerned, and they could not get rates increased to make investments, and so on.

Has that been a serious problem with the telephone company?

Mr. FLINT. It has not been but the fact that we have not gotten as much rates as we need has depressed our earnings, and by depressing the earnings, it has depressed the value of our stock. Therefore, it is more difficult to do equity financing.

However, we feel we have met the customers' requirements. We see to it that there is proper management of the business, and if the tax laws would be detrimental to us, we might fall into that position, but we are AAA, by and large, and we do have the ability to raise money when money is available.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Mr. Flint, will the House bill add to the complexity of the tax laws?

I was impressed by your illustration as to the size of your company's tax. If the House-passed bill were enacted, would that simplify or complicate things?

Mr. FLINT. I am trying to draw back into my mind, Senator, what the provisions would be that would apply.

Senator CURTIS. For example, the LAL rules.

Mr. FLINT. We would not have any problem. I think I can best answer you this way: We have in my view a very competent staff of people who know how to accommodate to the various kinds of complications we have, with quite sophisticated computer programing, and I would say we would be more concerned about the economic consequences. If you do something about the overall paperwork problem, that would be extremely helpful to us.

Senator CURTIS. How would the proposed dividend deferral work? How long would the tax be deferred if the investor-owner of stock used his dividends to buy more stock?

Mr. FLINT. In my view, you would not recognize the tax until such time as he disposed of the stock which was paid for by the dividend. As to whether that would be ordinary income or capital gain, I think, would be a matter for the Congress to consider. If you wanted to draw a very close parallel to what it would have been had it been a stock dividend, it would be capital gains.

However, if, instead, you merely say it is a postponement of ordinary income, then it would be taxed as ordinary income.

Senator CURTIS. In a sense, it would be treated somewhat like a stock dividend.

Mr. FLINT. It would essentially if you taxed it as a capital gain.

Senator CURTIS. Would the effect on the investor be about the same as if he received a stock dividend?

Mr. FLINT. That is right, sir.

Senator CURTIS. You are now allowed, I guess, to retain the earnings. In a sense, however, the individual is in the same position as if the earnings were retained and the stock increased in value?

Mr. FLINT. That is correct, and then he would have capital gains.

The CHAIRMAN. I would like to explore one matter with you.

I never thought about this when I first became a Member of the Senate, but I have come to think that Secretary Simon was probably right when he said that corporations do not pay taxes; people pay taxes.

In the last analysis, insofar as we put more taxes on your company, aren't you going to have to pass them on to the public if you are going to continue to attract capital and to provide the service that is expected of you?

Mr. FLINT. I would say theoretically that is certainly true. I think as a practical matter that is true. That would mean we would have an operating expense that would be larger than it would otherwise have been, and it would be reflected in the cost of service. Absent our ability to do it, it comes out of the shareowner's hide because you have to look elsewhere for expenses.

The CHAIRMAN. If you take it out of the shareholder, he is going to shift his money to something else.

You have to be able to pay your people a dividend or interest for the use of their money. If you don't do it, you cannot attract more, and the money you have is going to start getting away from you in one way or the other, and they will get their money out of your company and go to some other endeavor.

In the last analysis, your company has to earn a certain amount of money in order to build new equipment, to stay modern, and you have to be able to earn enough to attract capital in competition with other people who have investments available to the public.

When we put a big tax on your company, while in the short run you might be able to take it out of what you pay to the shareholders, in the long run, if you are going to do what you have been doing and render a modern service in the future, does it not mean you are going to have to pass the taxes on to the consumer as a part of the cost of the service?

Mr. FLINT. I agree.

The CHAIRMAN. Thank you very much, sir. I appreciate your testimony today.

[The prepared statement of Mr. Flint follows:]

STATEMENT OF ROBERT N. FLINT

This statement is submitted on behalf of the Amreican Telephone and Telegraph Company for the Bell System Companies listed on Table I of this statement.

We appreciate the opportunity to appear before this Committee in connection with its hearings on tax reform. My remarks relate to the capital formation requirements of the telecommunications industry, with particular reference directed to three policy proposals before the Committee. These proposals are (1) the investment tax credit, (2) certain amendments to Section 301 of the Tax Reduction Act of 1975 needed to remove obstacles to adoption of the additional 1 percent investment tax credit provided by I.R.C. Sec. 46(a)(1)(B), and (3) the proposal to defer the taxation of dividends reinvested in utility expansion programs.

I wish to address these proposals in the light of, first, the massive requirements for additional capital facing the telecommunications industry, and second, the financial constraints within which the telecommunications industry must raise the required capital.

During the 10-year period ended December 31, 1975, the number of Bell System telephones increased from 76 million to 118 million, and telephone plant in service (consisting of central offices, switching centers, outside distribution facilities, etc.) increased from $34.3 billion to $84.6 billion, an increase of over $50 billion. This pattern of sustained growth has been essential to meet the communications requirements of the American economy.

During this 10-year period, the principal Bell System telephone companies have met the communications requirements of their customers through construction programs totalling almost $71 billion (Table II, Col. A). These results have been obtained at the cost of placing an enormous burden on the capital formation capacity of the Bell System. Almost $30 billion of the $71 billion construction programs have been raised through the sale of new securities to investors (Table II, Col. B). As a consequence, since 1965:

Debt has increased over three-fold, to $31.8 billion.

Debt ratio has increased from 33 percent to almost 50 percent.

Annual interest charges have increased six-fold, to $2.3 billion.

And most significantly, post-tax interest coverage, which is a measure of the quality of debt securities—and thus the measure of the ability to raise future capital—has plummeted from well over 6 times in 1965 to under 2½ times coverage today. The dangers of downgradings in credit standings are real. The Pacific Telephone and Telegraph Company and the New England Telephone and Telegraph Company have been downgraded and, absent improvement, other Bell System Companies including AT&T itself are in jeopardy.

Thus, looking to the future, the Bell System must meet its capital needs under conditions which are radically different from those prevailing 10 years ago. The borrowing margins which existed in the 1960's have been used, and competition for capital in the financial markets is intense. The ability of the Bell System to compete, and compete effectively, for the formation of new capital will determine whether we will have a communications system which will continue to contribute to the Nation's economic growth. The penalty for failure must impede the Nation's overall productivity.

Against this background, it is essential that our tax laws be neutral with respect to capital formation efforts, and provide the opportunity to undertake

new construction commitments on equal terms for the entire business community. Also, it is clear that the Bell System will require substantial infusions of new equity capital over the coming years.

The proposals which I wish to discuss are directed toward accomplishing these goals:

INVESTMENT TAX CREDIT

Last year, in the Tax Reduction Act of 1975, a general increase in the investment tax credit to a uniform rate of 10 percent was provided. The uniform 10 percent rate under that Act is limited, however, to new construction undertaken in 1975 and 1976. Thereafter, the investment tax credit is scheduled to revert automatically to a two-tier structure of 4 percent for utilities and 7 percent for other businesses, unless new legislation is provided.

The investment tax credit has proven itself a powerful and efficient tool. We urge that H.R. 10612 as passed by the House, which would extend the 10 percent investment tax credit to all taxpayers for an additional four years, be amended to make the credit universally and permanently available at a rate of at least 10 percent. This is consistent with the view expressed in this Committee's Report No. 94–36 which accompanied the Tax Reduction Act of 1975.

AMENDMENTS TO EMPLOYEE STOCK OWNERSHIP PLANS (ESOP)

On December 9 of last year, I had the privilege of appearing before this Committee to outline problem areas that require legislative attention before AT&T can adopt the additional 1 percent ESOP investment tax credit provided by I.R.C. Sec. 46(a)(1)(B). Those problems involve the questions of regulatory treatment of the ESOP credit, application of "recapture" and "redetermination" of that credit, and the cost of ESOP administration. A copy of my statement, dated December 5, 1975, which specifies these problems in greater detail, is appended to this statement at Attachment A. Considering that we have an employee body of almost one million, we urge that these matters be considered as quickly as possible to afford us the time needed to complete the work which would be required if we are to establish a plan and set up separate accounts for eligible employees.

An additional problem in this area has come to our attention since last December. Section 301(d)(9)(A) of the Tax Reduction Act of 1975 defines "employer securities" as common stock of a corporation in direct control of 80 percent of the stock of the employer. This effectively precludes employees of second and lower tier subsidiaries from participation in the investment credit ESOP. This certainly would not appear to have been the intent of the Act and is contrary to the intent expressed by this Committee. (See S. Rep. No. 94–36, at p. 60.) We urge that the definition of "employer securities" be changed by making reference to I.R.C. Sec. 1563.

UTILITY DIVIDEND REINVESTMENT TAX INCENTIVE

Earlier in my testimony I mentioned that AT&T will require substantial amounts of new equity capital over the next several years. This, of course, is a problem facing all utilities. There is an obvious need to stimulate greater investor interest in equity capital.

We urge that favorable consideration be given to the proposal to defer the Federal income tax on dividends which shareowners reinvest in utility common stock. The tax would be postponed until the shareholder disposes of that stock, and at the time of such disposition the dividend amount would be subject to tax.

This is the same basic proposal recommended by the President's Labor-Management Committee which was appointed to study the special problems facing the electric utility industry, and which was explained to the Committee by Treasury Secretary Simon in his testimony given here on March 17. We are confident that if such a proposal were enacted, it would be a powerful stimulant to encourage equity investment. We urge that such a provision should be extended equally to the telecommunications industry which, like the electric utilities, must raise massive amounts of new equity capital, and which must compete in the same marketplace for new capital.

In summary:

1. The Bell System urges that the investment tax credit be permanently and uniformly extended for years after 1976 at a rate which is at least 10 percent.

2. The Bell System urges that certain amendments to the Tax Reduction Act of 1975 be adopted, to enable it (and other similarly situated taxpayers) to establish investment credit ESOP's.

3. The Bell System urges that taxation of common dividends reinvested in public utilities be deferred until the time that the common equity investors dispose of their dividend stock. Such a provision should enhance common equity accumulation, which is critically needed in the utility sector.

TABLE I—BELL SYSTEM COMPANIES

American Telephone and Telegraph Company.
The Bell Telephone Company of Pennsylvania.
Bell Telephone Laboratories, Incorporated.
The Chesapeake and Potomac Telephone Companies.
Cincinnati Bell, Inc.
Illinois Bell Telephone Company.
Indiana Bell Telephone Company, Incorporated.
Michigan Bell Telephone Company.
The Mountain States Telephone and Telegraph Company.
New England Telephone and Telegraph Company.
New Jersey Bell Telephone Company.
New York Telephone Company.
Northwestern Bell Telephone Company.
The Ohio Bell Telephone Company.
Pacific Northwest Bell Telephone Company.
The Pacific Telephone and Telegraph Company.
South Central Bell Telephone Company.
Southern Bell Telephone and Telegraph Company.
The Southern New England Telephone Company.
Southwestern Bell Telephone Company.
Western Electric Company, Incorporated.
Wisconsin Telephone Company.

TABLE II.—BELL SYSTEM CONSTRUCTION AND FINANCING (1966–75)

[In millions of dollars]

	Construction expenditures (col. A)	External financing (col. B)
1966	4,193	1,446
1967	4,310	1,624
1968	4,742	1,625
1969	5,731	2,459
1970	7,159	4,592
1971	7,564	3,807
1972	8,306	3,862
1973	9,322	3,460
1974	10,074	4,153
1975	9,329	2,764
Total	70,730	29,792

ATTACHMENT A

AMERICAN TELEPHONE AND TELEGRAPH CO.,
New York, N.Y., December 5, 1975.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This statement is submitted by American Telephone and Telegraph Company in connection with the hearings of the Senate Finance Committee on H.R. 10612, the Tax Reform Act of 1975, which was passed by the House on December 4, 1975.

My comments relate to four obstacles we have encountered in considering the establishment of an employee stock ownership plan utilizing the additional 1% investment tax credit, as provided by Section 46(a)(1)(B) of the Internal Revenue Code. These obstacles, which are essentially technical in nature, are enumerated below.

1. Special problem for Utilities: Under present law (i.e., Section 46(f) of the Internal Revenue Code) a regulatory commission may treat the investment tax credit as a cost reduction to be flowed through to utility customers, in some cases immediately and, in others, over the life of new business plant associated with the tax credit. This is a reasonable treatment for the 10% tax credit (allowed by Section 46(a)(1)(A)), where the benefit is intended to be shared by a utility's existing shareholders and its customers. But this would not be appropriate treatment for the ESOP credit allowed by 46(a)(1)(B) where the additional 1% tax credit is intended to be used to acquire capital stock for employees. If a regulatory commission were to seek to flow through the additional 1% ESOP tax credit in reduced rates to customers, the utility company would find itself in the position of not having issued stock for which no permanent capital was received. In other words, the utility company would be paying out the ESOP credit twice, once to its employees and once to its customers. This situation would be injurious to existing shareholders whose interest would eventually be diluted by the full amount of these new shares.

Legislation should be enacted to provide specifically that the portion of the tax credit going to the ESOP be treated as equity capital for the employees, with regulatory flow-through prohibited.

2. "Recapture" of Additional 1% ESOP Tax Credit: Section 301(d) of the Tax Reduction Act of 1975 sets out several conditions relative to eligibility for the ESOP tax credit. One of these conditions appears to be that a corporation should make its contribution to an ESOP at the time it files its return based on the amount of qualified investment claimed at the time it files its return, but that no adjustment may be thereafter made to ESOP contributions even though the amount of the tax credit to which the corporation ultimately is determined to be entitled may be lower than the amount claimed on its return if business plant happens to be removed from service prior to its initially anticipated life. In such a case, a portion of the tax credit would be subject to the "recapture" provisions of Section 47 of the Internal Revenue Code, but the employer would not be allowed to make a compensating adjustment in the amount contributed to an ESOP plan. See paragraphs (6) and (8) of Section 301(d) of the Tax Reduction Act of 1975. This would put the company in the position of having issued stock to its employees for which no equity capital was received, and would result in a corresponding dilution of the interests of existing shareholders.

The law should be changed to prohibit the recapture of any portion of the investment tax credit actually contributed to the ESOP, unless bad faith on the part of the taxpayer can be demonstrated.

3. Audit Redetermination of Additional 1% ESOP Tax Credit: A similar problem is created by the possibility that, on audit of the corporate return, the Internal Revenue Service will determine that property is ineligible for the tax credit which the taxpayer believed to be eligible when the return was initially filed. The amount of the related 1% ESOP tax credit would thus be subject to assessment as a deficiency liability. However, Section 301(d) of the Tax Reduction Act of 1975 fails to provide for any adjustment ain the treatment of ESOP contributions in such a case. Here again, the company would be put in the position of having issued stock without receiving equity capital for it.

The law should be changed to allow subsequent adjustments to ESOP contributions to reflect amounts subject to redetermination.

4. Costs of Administrating Tax Credit ESOP's: The Internal Revenue Service has interpreted the Tax Reduction Act of 1975 to require that the expenses of managing the additional 1% ESOP tax credit, held in trust for employees, cannot be charged to the trust. This means that such expenses must be absorbed by the company, with the ultimate effect borne by existing non-employee shareowners. Without remedial legislation, the burden of the administrative expense could discourage corporations from adopting these plans.

The law should be changed to allow a recovery from the ESOP trust of those expenses which are attributable to trust administration of this 1% tax credit.

If these four problem areas are not corrected by remedial legislation, American Telephone and Telegraph Company does not believe it is practical to elect the ESOP tax credit.

Respectfully submitted.

R. N. Flint,
Vice President and Comptroller.

The Chairman. Last but not least by any means, we would like to hear from Mr. Charles Moeller, Jr., senior vice president and economist

of the Metropolitan Life Insurance Co. We are pleased to have you with us today.

STATEMENT OF DR. CHARLES MOELLER, JR., SENIOR VICE PRESIDENT AND ECONOMIST, METROPOLITAN LIFE INSURANCE CO.

Mr. MOELLER. Thank you very much.

As you indicated, Mr. Chairman, my name is Charles Moeller, Jr., senior vice president and economist of the Metropolitan Life Insurance Co.

I welcome this opportunity to summarize my observations on capital formation as a problem and to make recommendations regarding tax changes that might help to alleviate this shortage.

I shall try to hold this summary down to the allotted time of 10 minutes; however, a full copy of my prepared remarks is available for the record.

With regard to the need for capital formation, our detailed 5-year forecast on the supply and demand for funds provides numerous indications that the demand for investment funds will be large. Reasons for this expectation are:

1. Inflation causes a rapid rise in the price for new plant and equipment and the proportion of funds financed externally.

2. Huge capital outlays are needed for expansionary and innovational demands, to replace outmoded facilities, to improve our international competitiveness, to develop new less readily accessible raw material sources, to ease the energy problem, to eliminate pollution, to improve worker safety, and to provide for an expanding labor force.

3. Continued large outlays are needed to increase the quantity and quality of housing, and to meet the pressures of rising land costs, and to mitigate the whole complex of problems associated with urban communities.

4. We expect continued rapid growth of spending and debt financing by Government, swollen by current massive efforts to stimulate the economy.

On the other hand, the supply of funds over the next 5 years is expected to remain relatively tight because of:

1. An easing in the rate of personal saving.

2. The continuation of large dollar gaps bewteen business investment and internal cash flow.

3. A tax structure which shifts saving from the private sectors to the Government sectors during period of rapid inflation.

4. A reluctance on the part of lenders to provide funds unless adequately compensated for inflation.

5. Occasional flareups of disintermediation pressures.

Thus, the Nation is in an era when investment demands will be high relative to the supply of saving. This 5-year gap, over 1976–80, may be in the range of $150 to $200 billion—and will impact heavily upon the private sectors of the economy.

Given the need for stimulating capital formation, I urge you to view all the recommendations being made, not segmentally, but in the context of the total economy and the effects upon the entire capital and money markets. Probably the most effective step would be to curb inflation. This would reduce the investment-saving gap and eliminate

the distortions of progressive tax structure in period of rapid inflation. Closely allied to bring inflation under better control is the need to halt the steady upward trend of Government outlays relative to the total economy.

Among the tax actions that should be considered are the following:

1. Make the investment tax credit permanent at 12 percent.

2. Shorten depreciable lives of assets and accelerate depreciation for pollution control, worker safety, and energy conservation outlays.

3. Reduce the corporate tax rate per se rather than make dividend payments deductible to either corporations or recipients.

4. Graduate the capital gains tax downward based upon holding periods, raise the allowable capital loss deduction, and allow full offset against capital gains.

5. Increase the dividend income exemption and add a similar exemption for interest income.

6. Raise the $60,000 exemption on Federal estate taxes.

7. Make more frequent adjustments in the income tax schedules.

8. Encourage individual initiative in saving for retirement very similar to ESOP.

Although these recommendations would result in temporary erosion of the tax base, in the longer run the advantage of greater economic growth would increase this base. The amount of erosion, of course, would be dependent upon the number of changes finally adopted. In general, it is recommended that this temporarily reduced level of taxes should be made up via a combination of slower growth in Government spending and the resultant faster pace of expansion in the private sector, and that offsets should not be sought among other tax bases.

The CHAIRMAN. Thank you.

Senator Fannin.

Senator FANNIN. Mr. Moeller, on page 2, item 4, "A reluctance on the part of lenders to provide funds unless adequately compensated for inflation," and then you go ahead and cover the items that would help as far as inflation is concerned.

One of the problems is the individual investor. What can be done that is going to bring him back to the investment market?

Mr. MOELLER. I think the individual investor is in the area of providing debt capital. He is buying debt instruments.

One of the major concerns seems to be the individual investor in the equity markets. There, I would say the elimination of double taxation would be a tremendous help to bringing the little man back in to buying common stock.

Senator FANNIN. Of course, you are referring to the dividends and what can be done to make the investments more attractive.

Mr. MOELLER. Yes. I think one of the major problems at the present time, too, is that, as a result of inflation, we have many alternatives for the individual investor in the debt side at 8 and 9 percent return. If we look at the stock market over the last 10 years, the stock market in terms of price has done absolutely nothing. That is, it has peaked out at 1,000 in all given instances since 1965. Thus, in common stocks, all the individual investor has received has been yield which has been in the area of 3 to 4 percent.

Consequently, something must be done to encourage individuals to make equity investments which I think are just as important as debt investments.

Senator FANNIN. That is one of our recommendations, to encourage individuals to save for retirement.

As you were making your statement, you mentioned ESOP. Would you want to elaborate on that? This is a program I give the chairman credit for in bringing it to the attention of the American people.

The CHAIRMAN. The Senator from Arizona introduced the first bill.

Mr. MOELLER. I would strongly encourage ESOP. I think my remarks come from the other side of the table; that is, as an employee of a financial intermediary rather than the employee of a manufacturing company. Where we see ESOP arrangements very often is in profit-sharing, and in savings and investment plans which are becoming very popular.

Invariably, there are a number of alternatives available to employees; that is, they may buy the stock of the individual company itself, which is ESOP, and perhaps have two other alternatives of a general, fixed fund, or a general equity fund.

I think this is a great way to add capital—investment capital—to the stream, investment capital that we need so badly, and I would in full circle come right back to the fact that I think this is a fine idea.

Senator FANNIN. Do you not agree one of the great advantages with ESOP is that it does give the worker, of course, like the Prudential Insurance Co. advertisement "piece of the rock," it does give them a way of having a part of the business activity.

Mr. MOELLER. I would endorse this very strongly. It is a great incentive mechanism. It does give the individual employee an interest in the management and ownership of the company.

I guess I would have to withdraw with respect to my competitor's "piece of the rock."

Senator FANNIN. I hesitated to bring that up.

Mr. MOELLER. Nevertheless, the concept is a very valid one.

Senator FANNIN. I apologize for mentioning a competitive organization, but they have utilized that quite beneficially. Maybe you have a better idea on that.

I do feel that the encouragement by people like you, Doctor, would certainly be tremendously helpful.

The general opinion seems to exist, that among company officials, ESOP is a program that should be looked into, but they have not followed through as we had expected.

I think as far as the union officials are concerned, they need a great deal of education in regard to this program.

Mr. MOELLER. If I might comment on this just a minute further, since we are talking about the Metropolitan Life Insurance Co., unfortunately as a mutual company we cannot buy stock in our own company. But we did develop in May of 1970 a savings and investment plan that has in concept the same thought as ESOP.

It is just gratifying to see the number of employees and the amounts that employees have been putting into the savings and investment plan and the amounts that have been added to the capital stream for investment in our economy.

Senator FANNIN. Thank you, Doctor.

The CHAIRMAN. Doctor, when workers choose to take some of their compensation as an interest in a company or as an investment, as you have suggested, is that inflationary or deflationary, or neutral?

Mr. MOELLER. I would say this is deflationary because it is a program for encouraging savings. It adds to the savings stream and over the long run this would very definitely be deflationary and good for the economy.

The CHAIRMAN. It does tend to cause the employee to receive some of his compensation in terms of investment in tools and machinery and plants which can produce more. In doing that, it is a form of compensation that is probably less inflationary than others we might consider in that if he goes out and spends compensation on a better quality of beefsteak, that is inflationary. But insofar as he saves for tomorrow by having a piece of the action, then that is something that will see him through hard times and, at the same time, it increases production and tends to hold down or shift expenditures into productive means rather than into means where more and more people are simply bidding up the price of a product.

Mr. MOELLER. I agree with everything you have said.

As a life insurance executive, we are very aware of the demographics of the future of our Nation. By that, I mean we see the older groups and the younger groups accounting for a larger share of the total population. Consequently, the worker groups tend to be taking a lesser share. I think this is very important as regards something like saving; that is, to increase the productive capacity of the Nation so that we can afford to provide livings for the older and younger people.

The CHAIRMAN. Let me explore one thing I do not see in your recommendations but I think we should consider in voting on this bill.

Inflation is becoming more and more of a problem, which we see it seems when a man buys a piece of real estate or even if he is buying some stocks or equity investment. Say he buys something for $100,000 and you move down the road about 20 years; at that time it would take $300,000 to make good what he paid $100,000 for to begin with.

It seems to me it is most unfair to tax that $200,000 difference as though it were a gain when in the last analysis it is not worth a bit more than it was in the beginning in terms of constant dollars.

In other words, just to get back the same dollars in terms of what they would buy, he has to pay a tax of 25 percent plus the 10 percent that has been added on, which gets up to 35 percent and then, if we take the view of some reformers, it would be pushed to 42 percent. I think it is very unfair to tax a man in a way that tends to be a penalty for the fact that the Government did not maintain the purchasing power of his currency, something he was powerless to do anything about.

Mr. MOELLER. This is precisely correct.

In the tables we have supporting the testimony, we have brought this point out by adjusting corporate profits for inventory valuation and plant and equipment for inflation that has taken place. The end result is that the rate, that is, the tax load on corporations, more than doubles.

The CHAIRMAN. It also tends to keep that property from being developed. If he is on the outskirts of a large city, for example, by now it is appropriate that the property should be developed into a housing development or an office building or shopping center should go there. The tax tends to make that person feel that he cannot afford to separate

himself from it. He must find some way to continue to hold on to it, maybe to lease it rather than to sell it so as to avoid a very heavy penalty of tax consequences.

I have been thinking of proposing that we simply have what we might call an inflation basis adjustment for those who have held something for a period of years to ease the tax burden on people when you really are just taxing them as a penalty for the Government failing to maintain the purchasing power of their money.

I wonder if that concept would have some appeal to you?

Mr. MOELLER. I think this is very important, and I believe we are addressing ourselves to capital gains taxes. I cannot see taxing, shall we say, capital gains or profits that come just out of inflation. I think this is unsound.

The CHAIRMAN. I wonder if you have given some thought to the philosophical problem I have raised about this matter of regarding it as a tax expenditure that the Government, looking at the needs of a businessman or industry such as yours, sees fit to tax you on a somewhat different basis than it taxes someone else. Do you subscribe to the theory that everybody owes *x* amount of taxes whether the law says so or not?

Mr. MOELLER. No; I believe people owe taxes because of the tax laws.

The CHAIRMAN. It seems to me when we write a tax law, we should look at everybody's problems. That is how I learned to do it from the State level on up. We take a look to see how we can raise money. Maybe we should do it with an inheritance tax or income tax; but however we want to do it, if we must raise taxes, it seems to me we should do it in a way that tends to look to where we can best do it in terms of justice, equity, fairness and, at the same time, do it to where it won't slow down the economy and put people out of work, but rather do it in ways that will move the economy. It is not a tax expenditure just because one fellow is better able to pay taxes than someone else, or we approve of someone making contributions to charitable organizations. It is not a bounty just because we write tax laws to reward someone for doing something that we feel is very good for the Nation and society and fail to do the same thing for somebody else that we do not think that is engaging in that kind of conduct to the same degree. Personally, I bristle a bit when someone suggests the Government owns everything a man makes and anything he is permitted to keep is a tax expenditure. That is the ultimate of that philosophy, and I just cannot buy it.

When I look at what those people call a tax expenditure, they tend to leave out of the pet tax advantages they have recommended down over the years. It has seemed to me we should look upon those things purely as a matter of relative merit—all things considered, what would be the best way to raise *x* amount of money, or would it be better to cut spending instead of raising taxes?

I think we have to consider all that.

Mr. MOELLER. I think that would be the alternative I would suggest in my package.

I tried to put this down philosophically as a package and, rather than trying to shift the tax to someone else, pick up the slack by either reducing the expenditures for the immediate slack or letting the economy grow faster as a result of higher individual income and corporate income and resultant higher taxes over the long run.

The CHAIRMAN. If I go along with the suggestions you have made, you won't need to come back and forever thank me for a gratuity at the expense of the Treasury. You should pay *x* amount rather than *y* amount of taxes because I think it is good for the country, not because I am trying to make a gratuity to you or anyone else.

Mr. MOELLER. We are all out to serve the Nation's interests, and I hope my contributions have helped along those lines.

The CHAIRMAN. I want you to know I feel whatever you earn is yours, and it does not belong to the Government first. We will tax away from you whatever we think is your fair share to pay the expenses of Government.

Thank you very much.

[The prepared statement of Dr. Moeller follows:]

STATEMENT OF CHARLES MOELLER, JR., PH. D., SENIOR VICE PRESIDENT AND ECONOMIST, METROPOLITAN LIFE INSURANCE CO.

THE NEED FOR CAPITAL FORMATION AND SAVING IN THE U.S. ECONOMY AND SOME RECOMMENDED POLICIES TO STIMULATE THEIR GROWTH

The basic need

A detailed analysis of real investment requirements for the economy relative to the saving that may be expected to take place over the next five years or so, strongly suggests that the needs for capital will substantially exceed the volume of saving generated. This gap between investment and saving has serious implications for the economy with regard to future ability to grow, to provide job opportunities for an expanding workforce, and to provide rising standards of living for the working and nonworking populations.

The reasons for the short-fall in the volume of real saving, that is the foregoing of current consumption by any group within the economy, can best be described in terms of supplies and demands for funds. With regard to demands for funds, these are expected to be very large for the following reasons:

1. The deleterious effect of inflation causes a rapid rise in real asset prices and increases significantly the proportion of purchase prices for these assets that must be financed externally. In the case of business corporations, it is estimated that over the past five years their depreciation allowances as reported for tax purposes based upon historical costs ran more than $150 billion below actual replacement cost. Moreover, their inventory profits totaled another $80 billion over the 1971–1975 period. Thus, due to inflation, profits were overstated by roughly $230 billion or an average of $46 billion per year. This gap between real and reported profits, however, is taxed at the full corporate income tax rate which, for a viable corporation, results in the need for periodic injections of external funds to merely maintain existing business investment. Similarly, families accumulating funds for the purchase of a home suffer an erosion in the purchasing power of their savings and require larger mortgages.

2. There is a great need for a high level of business investment to meet expansionary and innovational demands, to modernize and replace outmoded facilities, and to improve our competitiveness in international markets. While current operating rates are still low due to the recent recession, as the economy moves into the expansion phase of the cycle, the pressures of high operating rates above optimum will be felt in a number of industries. More than a tenth of all business fixed investment is considered to be technologically outmoded and about one-sixth is more than 20 years old. In many industries, comparable figures are substantially higher.

3. Our enterprise system must generate about 1½ million or so net new jobs per year to assure good employment opportunities for the bright young people coming out of our high schools, colleges, and graduate schools. Based upon the experience of the past decade, the cost of adding one new job while maintaining the existing workforce runs in the area of $70,000. In fact this can be viewed as a conservative estimate. If an adjustment is made for inflation, the required investment is more nearly $90,000 per worker or over $135 billion in total.

4. In addition to the basic business investment requirements mentioned above, other relatively new forces have raised the dollar needs for capital investment—notably increased emphasis upon improved worker safety and upon the elimination of air, water, and waste pollution stemming from industrial activities. While essentially desirable goals, such investments do not directly contribute to increased productivity and hence raise capital output requirements. The emergence of the energy problem also has added to the growing needs for business capital investment. New, less readily accessible and therefore more expensive, sources of energy must be found, developed, and made available for consumption. Storage facilities must be greatly expanded. Thus energy industries will be heavy demanders of investment capital. Moreover, higher energy prices and lessened availability of fuel supplies should encourage capital investment in new more efficient equipment for space heating and industrial processes.

5. Despite present difficulties, there is a need for continued large outlays to increase the quantity and quality of housing and to meet the financing pressures of rising land and building costs. In fact, the low level of housing activity in 1974 and 1975 merely added to the backlog of housing needs and will compound the housing problems of later years.

6. There will be continued high levels of government spending and debt financing, reflecting among other thnigs massive outlays to stimulate the economy, as well as efforts to mitigate the whole complex of problems associated with urban communities such as transportation, police protection, water supply, sewerage, waste disposal, and health facilities.

While investment needs will be very large, the supply of funds over the next five years is expected to remain relatively tight. Some of the reasons for this expectation are:

1. An easing in the rate of personal saving can be expected as the period progresses, due to a population mix with high proportions among older and younger people who tend to spend rather than save. This situation is aggravated by the general workings of a progressive tax structure in a period of rapid inflation which siphons an increasing proportion of income and potential saving from the private to the public sector.

2. As mentioned earlier, there will be a continuation of large dollar gaps between needs to finance long-term fixed investment and internally generated cash flow from depreciation charges.

3. Lenders and equity suppliers will be reluctant to provide funds unless adequately compensated for inflationary trends and risk in the rate of return.

4. Occasional flare-ups of disintermediation pressures will occur, accompanied by the tendency to invest funds directly rather than the more efficient method of using financial intermediaries. These pressures will exist so long as market interest rates remain above portfolio rates of return. While the real rate of interest may have increased slightly over the postwar period to reflect supply-demand realtionships and changing risk factors associated with declining liquidity, the inflation factor in the rate structure is the main reason for the gap between market rates and averages portfolio yields.

Recommendations to improve growth of savings and capital formation

Given the validity of the need for high levels of capital formation in the years ahead, an increase in the rate of saving would clearly be desirable rather than lower levels of investment. However, in considering ways and means of improving capital formation, careful analyses should be made of all proposals in the context of the total economy and the effects upon the entire money and capital markets. Many recommendations that may increase capital formation and saving in one area of the economy do so at the expense of other sectors and do not really add to the total volume of gross saving and investment.

In addition to considering steps to raise the total amount of saving in the economy, it is important to view the mix in terms of the private and government sectors. The government sectors appear to be growing beyond their optimum share of total economic activity. Table 1 highlights these trends, including five-year averages to reduce cyclical influences. The extent of this phenomenon is masked in the figures for gross national product based upon purchases of goods and services. For example, using the five-year averages for 1956–60 and 1971–75, federal purchases of goods and services show a decline from 11.2 percent of gross national product to 8.3 percent while state and local governments show a rise from 8.8 percent to 13.2 percent. The total government sector during this time

span shows a rise in purchases of goods and services from 19.9 percent to 21.5 percent of gross national product. However, when total government outlays, rather than just purchases of goods and services are examined, the magnitude of change and share of economic activity are considerably larger. Total federal outlays rose from 18.4 percent of GNP in 1956–60 to 21.5 percent in 1971–75 and state and local outlays moved up from 9.4 percent to 14.2 percent. All government outlays combined, after elimination of grants-in-aid to avoid double counting, jumped from 26.7 percent of gross national product in 1956–60 to 32.6 percent in the five-year period ending in 1975. Moreover, the rising trend in government outlays is likely to continue in the current five-year period. The effect of these trends has been a substantial increase in demand for funds in the money and capital markets by the government sector and increased taxes on the private sectors. The net result is a drain on the private sector's ability to generate an adequate volume of saving. Thus, in addition to considering ways to stimulate total saving, some serious consideration should be given to shifting the mix of saving toward a higher proportion for the private sector.

Probably the most effective efforts toward achieving the joint goal of increasing total capital formation and saving would be those aimed at bringing inflation rates down to more tolerable levels. This is not so dramatic as some of the other suggestions to increase saving. Yet in terms of over-all efforts toward reaching the goal, it probably is the most potent of all. Success in reducing the rate of inflation would in turn reduce inventory profits and the gap between current and historic depreciation costs that has been particularly troublesome to business in recent years. Since corporations have had to resort increasingly to external funds because of rapid inflation, their balance sheet positions have become heavily weighted with short- and long-term debt. This tendency has been reflected in the deterioration in such financial standards as the current ratio, the quick ratio, debt-equity mix, income coverage of fixed charges, and the size of corporate debt relative to dollar volumes of business. In short, there is a strong need for additional funds in the financial structure of many corporations, particularly equity funds.

A reduction in the rate of inflation would also facilitate capital investment in residential structures. It would make it easier for individuals accumulating funds for the initial down payment on a home to reach their objective. A lower inflation factor in the interest rate structure also would result in market interest rates moving back down to levels closer to investment portfolio yields of financial institutions. The closing of this yield spread would reduce disintermediation pressures—a force that has had particularly adverse effects upon the housing industry in the past decade.

A slower rate of inflation would also reduce the bias that now exists in the growth pattern of the economy due to the progressive income tax structure and the lag with which standard deductions, exemptions, and rates are adjusted to reflect shifts in the purchasing power of incomes. Even in less inflationary periods, this results in a gradual transfer of funds from the private to the public sectors, but the problem has been compounded by the extremely rapid pace of inflation over the past several years.

In addition to reducing the rate of inflation in the economy, there are other specific actions that are recommended to improve the rate of capital formation. Perhaps the most obvious would be to make the investment tax credit a permanent non-varying incentive for capital spending at the 12 percent rather than 10 percent level. If the investment shortage is a long-term problem, it does not make sense to use a varying investment tax credit as an instrument of contracyclical policy. Moreover, the short-run stimulus of a temporary investment tax credit in the past probably has been offset by fluctuations in investment plans influenced by expectations regarding size and availability of the tax credit. Its merits seem to be more geared to providing additional corporate savings for investment in productive facilities.

Another means of encouraging capital formation would be to accelerate depreciation by further shortening the depreciable lives of assets. This would shorten the pay-back period of the investment time horizon, thereby reducing uncertainty in decision making. It would be administratively easier than shifting to a replacement cost concept, yet woud improve corporate cash flow. In view of the large volume of capital spending required for pollution control, worker

safety, and energy exploration, development and conservation—all areas of special national interest—emergency accelerated amortization schedules might be instituted for these types of outlays similar to those used during war periods. Some reduction in the corporate tax rate should also be considered as an effective way of providing corporations with additional equity funds, improving debt-equity ratios, and stimulating investment. In addition to raising retained earnings, higher after-tax returns would facilitate new corporate equity flotations.

While the raw profit data reported by the Department of Commerce show a decline in the corporate federal tax rate in recent years, these figures fail to reflect two important points. First, corporations pay state and local income taxes as well as federal income taxes. These tax rates more than doubled between 1965 and 1975. Second, the quality of corporate profits deteriorated badly over the 1965–1975 period of time. Inflation, as reflected by the 70 percent rise in the implicit price deflator between 1965 and 1975, is the prime cause of deterioration.

During 1973–75, inventory profits accounted for one-sixth of the corporate profit total. These inventory profits are not profits that accrue to the benefit of any shareholder, but merely represents amounts that must be reinvested in new inventories if a corporation is to remain viable. Yet such profits are subject to taxation. Similarly, depreciation charges during periods of rapid inflation fail to even come close to reflecting replacement costs to the corporation seeking to remain viable. No allowance for this fact is made in computing corporate profits subject to income tax.

The attached table 2 represents a simple approach to calculating what the true effective tax rate on corporate profits would be when these two distortions are corrected. Corporate inventory profits are eliminated and depreciation charges are increased to partially offset inflation. The adjustment for inadequate depreciation allowances is based upon the application of seven-year percent changes in the implicit price deflator for business fixed investment to capital consumption allowances as used for tax purposes. The average age of plant and equipment in the U.S. is about 10 years but only a seven year change in capital asset prices was used in table 2 to reflect the fact that some corporations were calculating depreciation charges on formulas providing for a faster write-off than under a straight line basis. When these adjusted profit figures are related to the corporate tax liability data, the effective federal tax rate shows an increase from 40 percent in 1965 to the 70–80 percent range in 1974 and 1975. The effective rate for combined federal, state, and local corporate income taxes moves up from 43 percent to the 80–90 percent range. Incidentally, the capital consumption adjustment for inflation used in table 2 is larger than the newly developed but as yet unpublished inflation adjustment in the national income accounts. The latter does not really reflect the impact of inflation on capital consumption allowances taken for tax purposes, but is rather based upon a capital stock concept using straight line depreciation. In any event, even if these numbers are used, the effective or adjusted tax rate still shows a substantial rise in recent years relative to the mid-sixties.

Alternative suggestions have been put forth to help corporations by either making dividends tax deductible to the corporation or by exempting dividends tax deductible to the corporations or by exempting dividend income from personal income taxes. Either approach would probably result in higher levels of corporate saving and in higher equity prices, but the results would probably have different impacts upon different companies, i.e., the tax effects would not be neutral. For example, growth companies and smaller companies that rely heavily upon retained earnings for expansion purposes would probably be penalized relative to more mature companies paying out a higher percentage of their earnings in the form of dividends ratios between the two groups.

If dividends were made tax deductible it would also discriminate between those companies with strong balance sheet positions and those with heavy debt positions. Again, it is likely to cause a shift in the relative price-earnings ratio of different companies. A cut in the corporate tax rate would be more neutral and provide companies with the option of either retaining or passing through the tax saving, depending upon their corporate needs.

In terms of increasing personal saving, a tax credit for net new saving would be ideal. However, from a practical point of view, this would be difficult to measure and administer. Therefore, some indirect methods of attack should be

considered that would at least reduce the depletion of existing pools of saving or not penalize savers from holding financial assets for extended periods of time. For example, the capital gains tax on investments, including homes and financial assets, might be graduated downward based upon the holding period to indirectly reflect price increments due to inflation. In addition to a graduation of the capital gains tax, the maximum allowable capital loss deduction on individual tax returns should be increased from its $1,000 limit and long-term losses should be allowed to fully offset long-term gains. These changes are needed to encourage greater participation in the equities markets generally and for smaller companies in particular.

Mobility of capital also would be enhanced. The $100 exemption for dividend income should be increased. Similarly, an exception for the first several hundred dollars of interest from all sources might be considered as a means of compensating savers for saving in fixed dollar commitments despite the inflationary climate that exists. These tax exemptions should be broad in scope and not apply to any specific financial asset. Otherwise, the primary effect is likely to be a transfer of saving from one source to another rather than a net increase in total saving. Since the 1975 tax cut made the income tax structure more progressive in nature, as have the effects of the rapid inflation experienced in recent years, the introduction of some benefits to savers seems equitable as well as justifiable in terms of need.

Another area of federal taxation that depletes existing pools of saving is that on estates. The $60,000 exemption is grossly outdated because of inflation and should be revised upward. Many relatively modest homes owned by families, for example, can now account for all, or a large portion of, the $60,000 exemption. Thus, federal estate taxes have a far more serious impact on wealth reedistribution than was originally intended and could discourage asset accumulation in some instances.

With regard to the mix between the public and private sectors of the economy, more frequent revision of the tax rate schedules to offset increases in incomes due to inflation is clearly desirable. It is recognized that, in some instances, this practice may impose restraints on government spending.

Another area where the mix between the government and private sectors has shifted significantly is in the area of retirement income. This trend is expected to intensify as the social security tax base and benefits are geared to reflect inflation in the economy and will probably also incorporate other periodic upgradings of payments. Funds accumulated under the social security retirement program are not invested in the private sectors of the economy. Yet, it is the capital formation processes in the private sectors of the economy that facilitate productivity growth. Productivity in the private sector, in turn, enables the working population to support the nonworking age groups while still generating sufficient income to permit improved living standards generally. One method of achieving better balance in this area of need would be to encourage individual initiative in saving for retirement. Serious consideration should be directed toward further liberalization of existing tax treatment concerning accumulation of retirement funds for workers not covered by pension funds, as well as some extension of these tax privileges to employees seeking to supplement their employer-sponsored retirement plans. This would provide a disciplined form of saving for many individuals. Moreover, funds for this purpose can be earmarked, with many financial institutions already offering services geared to this type of market. Since investor preference for various investments can still be expressed through the many outlets available to them, such a tax stimulus would not distort the flow of saving to different sectors of the economy.

Summary and conclusion

There are many indications that the supply of saving in the U.S. economy will fall short of the expected demand for investment funds. Thus, efforts should be concentrated on increasing personal and business saving flows, which in turn would have a favorable impact upon capital formation in the private sector.

One key policy step in reaching this goal is a reduction in the rate of inflation. Another step would be to make periodic changes in the tax laws to eliminate the diversion of income flows from the private to the public sector merely because of inflation. This involves possible changes in tax rates for different income brackets, a capital gains tax related to length of time an asset is held, and a

for net new saving would be ideal, from a practical point of view measurement for change in the exemption allowed for federal estate tax purposes. While a credit this purpose would be extremely difficult. Some alternatives to be considered include a general tax credit of some sort for investment income from interest and dividends, and a tax incentive for individual savings geared toward retirement income. All attempts to stimulate saving should be focused toward providing capital to the private sector and should avoid interfering with existing market mechanisms for channeling these funds into various investment outlets.

These recommendations would result in erosion of the tax base, at least temporarily. The amount, of course, would be dependent upon the number of changes finally adopted. In general, this reduced level of taxes should be made up via a combination of slower growth in government spending and faster growth of the private sector. The multiplier impact of investment upon the economy would result in a larger tax base and, by facilitating employment, reduce the need for government outlays in some areas of social concern. In addition, the productivity gains needed to continue those outlays will be forthcoming as a result of higher investment spending.

A RESTATEMENT OF SPECIFIC RECOMMENDATIONS FOR TAX CHANGE TO STIMULATE CAPITAL FORMATION

1. Make Investment tax credit a permanent non-varying incentive to capital investment and raise it to 12%.
2. Shorten depreciable lives of assets.
3. Accelerate depreciation schedules for capital spending required for pollution control, worker safety, and energy conservation.
4. Reduce the corporate tax rate *per se* rather than make dividend payments deductible to either corporations or recipients.
5. Graduate capital gains tax downward based upon length of holding period.
6. Raise the maximum allowable capital loss deduction and allow full offset of capital losses against capital gains.
7. Increase dividend income exemption from present $100 limit and add similar exemption for interest income.
8. Raise the $60,000 exemption for federal estate tax purposes.
9. Moke more frequent adjustments in the tax schedules.
10. Liberalize individual initiative in saving for retirement.
11. Loss of revenue because of recommended changes should be made up via a combination of slower growth in government spending and faster growth of the private sector tax base.

TABLE 1.—TRENDS OF GOVERNMENT PURCHASES AND EXPENDITURES RELATED TO GROSS NATIONAL PRODUC

[Dollar amounts in billions]

Calendar years	GNP	Purchases of goods and services						Total Government expenditures					
		Federal		State and local		All government		Federal		State and local		All government[1]	
		Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP
1956	$420.7	$45.9	10.9	$33.5	8.0	$79.4	18.9	$71.9	17.1	$35.9	8.5	$104.5	24.8
1957	442.8	50.0	11.3	37.1	8.4	87.1	19.7	79.6	18.0	39.8	9.0	115.2	26.0
1958	448.9	53.9	12.0	41.1	9.2	95.0	21.2	88.9	19.8	44.3	9.9	127.6	28.4
1959	486.5	53.9	11.1	43.7	9.0	97.6	20.1	91.0	18.7	46.9	9.6	131.1	26.9
1960	506.0	53.7	10.6	46.5	9.2	100.3	19.8	93.1	18.4	49.8	9.8	136.4	27.0
1961	523.3	57.4	11.0	50.8	9.7	108.2	20.7	101.9	19.5	54.4	10.4	149.1	28.5
1962	563.8	63.7	11.3	54.3	9.6	118.0	20.9	110.4	19.6	58.0	10.3	160.4	28.4
1963	594.7	64.6	10.9	59.0	9.9	123.7	20.8	114.2	19.2	62.8	10.6	167.9	28.2
1964	635.7	65.2	10.3	64.6	10.2	129.8	20.4	118.2	18.6	68.5	10.8	176.3	27.7
1965	688.1	67.3	9.8	71.1	10.3	138.4	20.1	123.8	18.0	75.1	10.9	187.8	27.3
1966	753.0	78.8	10.5	79.8	10.6	158.7	21.1	143.6	19.1	84.3	11.2	213.5	28.4
1967	796.3	90.9	11.4	89.3	11.2	180.2	22.6	163.7	20.6	94.7	11.9	242.5	30.5
1968	868.5	98.0	11.3	100.7	11.6	198.7	22.9	180.6	20.8	106.9	12.3	268.9	31.0
1969	935.5	97.5	10.4	110.4	11.8	207.9	22.2	188.4	20.1	117.6	12.6	285.7	30.5
1970	982.4	95.6	9.7	123.2	12.5	218.9	22.3	204.2	20.8	132.2	13.5	312.0	31.8
1971	1,063.4	96.2	9.0	137.5	12.9	233.7	22.0	220.6	20.7	148.9	14.0	340.5	32.0
1972	1,171.1	102.1	8.7	151.0	12.9	253.1	21.6	244.7	20.9	163.7	14.0	370.9	31.7
1973	1,306.3	102.0	7.8	168.0	12.9	269.9	20.7	264.8	20.3	180.9	13.8	405.1	31.0
1974	1,406.9	111.7	7.9	189.4	13.5	301.1	21.4	300.1	21.3	201.3	14.3	457.5	32.5
1975	1,498.9	123.2	8.2	208.0	13.9	331.2	22.1	356.9	23.8	222.6	14.9	525.2	35.0
Totals for:													
1956–60	2,304.9	257.4	11.2	201.9	8.8	459.4	19.9	424.5	18.4	216.7	9.4	614.8	26.7
1961–65	3,005.6	318.2	10.6	299.8	10.0	618.1	20.6	568.5	18.9	318.8	10.6	841.5	28.0
1966–70	4,335.7	460.8	10.6	503.4	11.6	964.4	22.2	880.5	20.3	535.7	12.4	1,322.6	30.5
1971–75	6,446.6	535.2	8.3	853.9	13.2	1,389.0	21.5	1,387.1	21.5	917.4	14.2	2,099.2	32.6

[1] Excludes Federal grants-in-aid to State and local governments.

TABLE 2.—ACTUAL AND ADJUSTED TAX RATE FOR CORPORATE PROFITS

[Dollar amounts and percent]

	Profits before tax	Tax liability			Tax rate (percent)			Deflator: Nonresidential investment (percent)		Capital consumption allowances		Inventory valuation adjustment	Adjusted profits before tax	Adjusted tax rate (percent)		
		Total	Federal	State and local	Total	Federal	State and local	1972-100	7-year charge	Actual	Adjustment			Total	Federal	State and local
1950	$42.6	$17.9	$17.2	$0.8	42.0	40.4	1.9	54.3	52.1	$8.8	−$4.6	−$5.0	$33.0	54.2	52.1	2.4
1951	43.9	22.6	21.7	.9	51.5	49.4	2.1	58.9	60.9	10.3	−6.3	−1.2	36.4	62.1	59.6	2.5
1952	38.9	19.4	18.6	.8	49.9	47.8	2.1	59.9	63.7	11.5	−7.3	1.0	32.6	59.5	57.1	2.5
1953	40.5	20.3	19.5	.8	50.1	48.1	2.0	61.0	52.9	13.2	−7.0	−1.0	32.5	62.5	60.0	2.5
1954	38.1	17.6	16.9	.8	46.2	44.4	2.1	61.4	31.2	15.0	−4.7	−.3	33.1	53.2	51.1	2.4
1955	48.4	22.0	21.1	1.0	45.5	43.6	2.1	62.6	22.0	17.4	−3.8	−1.7	42.9	51.3	49.2	2.3
1956	48.6	22.0	20.9	1.0	45.3	43.0	2.1	67.0	26.9	18.9	−5.1	−2.7	40.8	53.9	51.2	2.5
1957	46.9	21.4	20.4	1.0	45.6	43.5	2.1	70.7	30.2	20.9	−6.3	−1.5	39.1	54.7	52.2	2.6
1958	41.1	19.0	18.0	1.0	46.2	43.8	2.4	70.6	19.9	22.1	−4.4	−.3	36.4	52.2	49.5	2.7
1959	51.6	23.6	22.5	1.2	45.7	43.6	2.3	72.0	20.2	23.6	−4.8	−.5	46.3	51.0	48.6	2.6
1960	48.5	22.7	21.4	1.2	46.8	44.1	2.5	72.2	18.4	25.3	−4.7	.3	44.1	51.5	48.5	2.7
1961	48.6	22.8	21.5	1.3	46.9	44.2	2.7	71.8	16.9	26.6	−4.5	.1	44.2	51.6	48.6	2.9
1962	53.6	24.0	22.5	1.5	44.8	42.0	2.8	72.3	15.5	30.4	−4.7	.1	49.0	49.0	45.9	3.1
1963	57.7	26.2	24.6	1.7	45.4	42.6	2.9	72.9	8.8	32.4	−2.9	−.2	54.6	48.0	45.1	3.1
1964	64.7	28.0	26.1	1.8	43.3	40.3	2.8	73.6	4.1	34.6	−1.4	−.5	62.8	44.6	41.6	2.9
1965	75.2	30.9	28.9	2.0	41.1	38.4	2.7	74.5	5.5	37.4	−1.3	−1.9	72.0	42.9	40.1	2.8
1966	80.7	33.7	31.4	2.2	41.8	38.9	2.7	76.8	6.7	40.6	−2.7	−2.1	75.9	44.4	41.4	2.9
1967	77.3	32.5	30.0	2.5	42.0	38.8	3.2	79.3	9.8	44.1	−4.3	−1.7	71.3	45.6	42.1	3.5
1968	85.6	39.4	36.3	3.1	46.0	42.4	3.6	82.6	15.0	48 1.	−7.2	−3.4	75.0	52.5	48.4	4.1
1969	83.4	39.7	36.2	3.4	47.6	43.4	4.1	86.6	19.8	53.0	−10.5	−5.5	67.4	58.9	53.7	5.0
1970	71.5	34.5	30.8	3.7	48.3	43.1	5.2	91.3	25.2	56.6	−14.3	−5.1	52.1	66.2	59.1	7.1
1971	82.0	37.7	33.5	4.2	46.0	40.9	5.1	96.4	31.0	60.9	−18.9	−5.0	58.1	64.9	57.7	7.2
1972	96.2	41.5	36.3	5.0	43.1	38.0	5.2	100.0	34.2	67.9	−23.2	−6.6	66.4	62.5	55.1	7.5
1973	117.0	48.2	42.5	5.7	41.2	36.3	4.9	104.0	35.4	73.5	−26.0	−18.4	72.6	66.4	58.5	7.9
1974	132.1	52.6	45.9	6.7	39.8	34.7	5.1	116.0	46.3	79.7	−36.9	−38.5	56.7	92.8	81.0	11.8
1975	117.1	45.7	39.0	6.7	39.0	33.3	5.7	132.3	60.2	87.8	−52.9	−10.8	53.4	85.6	73.0	12.5

The CHAIRMAN. The committee is now adjourned until tomorrow morning at 10 o'clock.

[Whereupon, at 12:30 p.m., the committee was adjourned, to reconvene at 10 a.m. Friday, April 2, 1976.]

TAX REFORM ACT OF 1975

FRIDAY, APRIL 2, 1976

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

The committee met, pursuant to recess, at 10 a.m., in room 221, Dirksen Senate Office Building, Senator Russell B. Long, (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Byrd, Jr., of Virginia, Curtis, Fannin, Hansen, Dole, and Packwood.

Senator TALMADGE. The committee will be in order.

The first witness this morning is Dr. Norman B. Ture, president, Norman B. Ture, Inc.

You may insert your full statement in the record and summarize it. Because of the great number of witnesses, we have had to limit testimony in chief to 10 minutes.

STATEMENT OF NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC., WASHINGTON, D.C.

Mr. TURE. I am Norman Ture, president of Norman B. Ture, Inc., economic consultants in Washington, D.C.

My testimony today is presented as my own views on the proper directions of tax policy; while I hope that others will subscribe to these views, they are the product of my own analysis and conclusions and should not necessarily be ascribed to any of my past or present clients.

I much appreciate the opportunity to appear before the committee, and I hope that my testimony may be of some assistance to you. Your job is a difficult one and your responsibilities are heavy, indeed. In making decisions about the future course of tax policy, you confront a strongly improving economy, still plagued, regrettably, by a very high rate of unemployment and underutilization of physical production capacity and still threatened by inflationary resurgence. The Congress faces extremely strong pressures, accentuated by election-year political requirements, to focus on the short run—to find quick, sure-fire remedies for lingering unemployment. In this context, you are presented with a budgetary dilemma: the administration urges you to be highly restrictive on Federal expenditure expansion lest you unleash the dogs of inflation, and the Congressional Budget Office urges you to up the ante by close to $20 billion lest you unduly depress the pace of the recovery.

May I respectfully urge the committee to shift the focus of its deliberations from these short-run concerns to the longer run economic

prospects and tax policy requirements of the Nation. I offer no forecast about the strength, speed, or duration of the recovery, but I am convinced that an expansionary expenditure policy will, at the least, impede the private sector's growth and, over time, cast up increasingly formidable obstacles, real and financial, to the steady, strong expansion of private production, employment, productivity, and real wage rates. It is time to shift gears, to attempt to determine how tax policy can best contribute to the solution of the long-term problems the Nation faces.

The central economic problem facing the United States is whether the rate of capital formation will be adequate to meet the economy's capital requirements over the next decade and longer. Virtually all of the other major issues with which public policymakers are concerned turn on this central problem of capital adequacy. Whether the focus is on attaining energy self-sufficiency, protection of the environment, improving and expanding mass transit systems, raising the housing standards of low- and middle-income individuals, providing safer and healthier working conditions, and so on, a basic constraint on achieving these goals is how much real capital will be available to meet the growing and varied demands of the U.S. economy. The less rapidly we add to our production capability, the more severely will pursuit of any of these public policy objectives limit success in achieving other public and private goals.

Mr. Chairman, I have attempted to estimate in the next several pages of my testimony the Nation's capital requirements based on the fundamental relationship between capital and labor services and the contribution of increases in capital to real wage rates and productivity. When you add to the amount of capital that is needed to maintain at least the trend rate of increase in capital per worker over the next 10 years the amount of capital that public policy has mandated, not the kind of capital business would ordinarily invest in but capital required to meet capital mandates, you come up with an aggregate amount of capital outlays between now and the end of 1985 which would require an aggregate amount of saving of $3.82 trillion in constant 1975 dollars.

The aggregate saving requirements are substantially larger if, more realistically, we take account of some continuing inflation. If the price level rises on the average by 3 percent a year through 1985, the total requirements aggregate not less than $4.55 trillion. At a 5-percent inflation rate, this total increases to $5.13 trillion.

If gross private saving as a fraction of GNP continues over the next decade at the postwar average rate of 15.51 percent, the total of such saving through 1985 will fall $744 billion short of estimated requirements, measured in constant 1975 dollars. At a 3-percent inflation rate, conservatively estimated, the gap is $893 billion; with inflation at 5 percent, the gap increases to over $1 trillion.

The importance of this observation is that you cannot get one single dollar's worth of capital formation without having an equal dollar's worth of savings.

So, our problem as we look down to 1985 is not that we anticipate a lack of adequate incentives or a lack of adequate demand by business for capital, but the problem is we are not likely to come up with an adequate amount of saving unless something is done in the public

policy area to increase inclinations to save out of current income. There is no assurance that the total private saving will continue at the postwar average rate, let alone that it will increase by the indicated amount.

What will happen if actual saving falls short of these requirements?

The capital formation shortfall will be largely in the investment in machinery, equipment, plants, working capital—the kind of capital which increases the real output of marketable good and services. If the private saving rate were to continue only at the postwar average rate, the saving shortfall in 1985, assuming no increase in the price level, would be $100 billion. This would be almost 22 percent of the estimated amount of the capital formation needed to maintain the trend rate of increase in the capital-labor ratio. If we do not come up with that amount of saving, the adverse effect of that shortfall on labor's productivity and, therefore, on its real wage rates and employment opportunities would be enormously adverse.

To repeat, the problem we face is not one of providing incentives to business to add more rapidly to the stocks of their capital. The problem, rather, is one of reducing the existing bias against saving. The capital shortage facing the Nation is, in truth, a saving shortage.

The tax policy imperative, accordingly, is to reduce the bias against private saving which is a major feature of the present tax laws. That bias results from the fact that, with few exceptions, taxes are imposed both on the amount of current saving and on the future returns to such saving, whereas the tax falls only once on income used for consumption.

The foremost challenge facing the Congress is to deal realistically with the urgent requirement for a higher rate of private saving. If this challenge cannot be met, one or more of the high-priority objectives of economic policy will have to bear the brunt of the failure.

Mr. Chairman, it is highly encouraging that many Members of Congress have become aware of the prospective capital shortfall, have perceived the potential of changes in the tax structure to deal with the problem, and have attempted to develop programs for constructive tax revisions to this end. Particularly promising, in my judgment, are those tax programs which address the problem with a variety of proposals aimed at expanding saving by individuals and business alike.

This approach recognizes that no one form of saving is superior to others, that all additional saving will find its way into the capital market where it will be allocated to the myriad capital formation uses, by and large on the basis of which of the market participants can make the most productive use of additional capital. No one tax change of limited scope is the best revision for purposes of reducing the existing tax bias against saving and investment. A variety of such measures are called for if everyone is to be allowed to get in on the act of accelerating the expansion of the Nation's production capacity, its total output, employment, and income.

In this connection, Chairman Long's vigorous espousal of tax provisions to encourage employees to invest in the stock of their employers reflects a recognition of the aspirations of people in a wide range of economic circumstances to have a piece of the action. An appropriate

complement to favorable tax treatment of employee stock ownership plans would be a universally available tax credit for individual taxpayers based on the amount of the net increase in their savings during the taxable year. The credit might be allowed at a rate of, say, 10 percent, with an upper limit of, say, $1,000 per return, or $2,000 on a joint return.

Relief of some form from the present incremental tax on capital gains is also urgently needed. As this committee is well aware, the deduction for one half of realized capital gains is widely identified by tax reformers as one of the principal loopholes in the income tax. In fact, however, any tax on capital gains is an additional tax on the returns to saving; it is a negative loophole which should be eliminated by excluding capital gains and losses entirely from the calculation of taxable income. Short of this drastic step, some measure, perhaps fully excluding the first $1,000 of capital gains each year provided the proceeds from the disposition of capital assets are fully reinvested in others, is highly desirable.

A long overdue tax revision is to replace our archaic depreciation system with a capital recovery system, based on short, standard recovery periods for all machinery and equipment and business structures. Also highly desirable would be to make the investment tax credit permanent and uniformly applicable to all classes of property and taxpayers, preferably at a substantially higher rate than at present.

There is a growing consensus that the corporation income tax should be eliminated. This tax is a differential and very heavy excise on saving invested in corporate equity capital.

As such, it contributes significantly to distortion of corporate capitalization. Far more important, its adverse effects are diffused, through the operation of the capital market, to all capital, depressing the overall private saving and investment rate. Useful initial steps toward the elimination of this tax would be reduction in the normal and surtax rates and elimination of the present double tax on distributed corporate earnings.

Proposals of this sort are opposed by some on the basis that they would result in excessively large revenue losses for the Treasury and by others on the basis that they would not be effective. Neither view, in my judgment, is well taken.

The kind of tax revision I very briefly alluded to would reduce the cost of saving. For any of us, it would take less pretax current income than at present to acquire a given amount of after-tax future income. This reduction in the cost of acquiring future income would certainly result in an increase in the amount people would save out of their current disposable incomes. This increase in saving would be matched by an increase in capital formation. The expansion of capital formation above the levels that would otherwise occur would add immediately to total production activity, to the extent that existing production capability could be more intensively utilized or that more individuals would be induced to enter the labor force; over the longer term, the expanded stock of capital would increase aggregate production capability, total output, hence total income. The tax base, therefore, would expand more rapidly than otherwise.

The net effect on Federal tax revenues, accordingly, would be far different from the misleading initial impact revenue estimates

customarily provided—estimates which unrealistically assume that taxpayers are completely inert and unresponsive to changes in tax provisions.

In conclusion, this committee, I am sure, has noted the public policy tendency to treat each new problem presented to public policymakers as evidence of the failure of the private market system. I believe that an objective examination of the evidence, however, urges that our unhappy economic record of recent years is the outcome of excessive and inept governmental intrusion in the operation of the economy, accelerating over the years.

The decisions this Congress makes about the basic content of economic policy will have a major bearing on whether the economy thrives, whether individual freedom, responsibility, self-reliance, and initiative will be encouraged and enhanced, on the one hand, or whether the economy and all its participants will become increasingly wards of the Federal, State, and local governments. In the field of public finance, the first course of action calls for a tight rein on Government spending and tax revisions aimed at making the tax system less repressive of effort, of saving, and of investment.

Past Congresses have faced the same choice. In the past, on one or another occasion, they have made a highly constructive and affirmative decision to move toward encouraging private initiative. I fervently hope this Congress and its successors will do the same.

The CHAIRMAN. Thank you.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

The Chairman. Senator Talmadge?

Senator TALMADGE. What is your firm?

Mr. TURE. Norman B. Ture, Inc. We are economic consultants. Our clients are primarily in the business sector.

Seantor TALMADGE. Some Members of Congress think any capital formation proposal is a loophole. I take it you disagree with that philosophy.

Mr. TURE. I do, indeed.

Senator TALMADGE. I have no further questions.

The CHAIRMAN. I believe you have created more imaginative thinking and you have pointed out more oversights in the traditional thinking of the Treasury and even our own joint committee and Finance Committee staffs than any person who has come to discuss these problems with us while this tax bill has been pending.

We are having a careful study made of your estimates of the revenue losses that simply do not meet the eye in the real estate area. Your estimates indicate there are about $2.8 billion of revenue losses alone that simply do not meet the eye, not to mention the fact that there would be a loss to the economy, mainly in wages, I believe.

In other words, if you look at a house or shopping center someone builds, you might say the expense is 70 percent material. But then if you go back a step and look at who made those materials, the cost winds up being about 80 percent labor. In a shopping center, how much do you think is labor by the time it is all through?

Mr. TURE. I think you have just about put your finger on the proper proportion. I would have to check that out.

The CHAIRMAN. On the construction site, it might look like not more than 30 percent, but when you get through looking at who built the parts and who hauled them to the site and who dug the gravel out of the ground, it ends up being nearer 80 percent than the 30 you started out with.

If the housing provisions in this bill cost $11 billion to the gross national product as you have estimated, then that has to mean that they will cost the American workers about $8 billion doesn't it?

Mr. TURE. Somewhere in that order of magnitude.

The CHAIRMAN. If you proceed to lose about $2.8 billion, as you have estimated, or anything that approaches that, you wind up with something where the Government picks up over a period of years $500 or $600 million a year, and it is costing $10 to pick up $1 in taxes. That is a pretty inefficient use of resources, is it not?

Mr. TURE. It is in my judgment. Moreover, I don't think the Government will see the additional revenues. I think revenues will be less than they otherwise would have been.

The CHAIRMAN. If you do what I have been trying to suggest, simply follow the ripple effects for a couple of steps down the road, you find out something that starts down the road raising a ton of money winds up costing you a fortune.

I wish that you would give us your thoughts with regard to the repeal of the DISC which is being recommended by some. We are told that will pick up $1.5 billion. But then we won't be doing anything to help our manufacturers compete in the world market or even to help our producers of rice compete in the world market, while these other countries are giving a 15 percent subsidy by way of giving back value-added taxes. Just looking a few steps down the road, we will be in the position that these foreign nations will be subsidizing everything entering into our market while we deny ourselves the same right—which means that any job they want they can have, and they will have the privilege of permitting us to keep the jobs they don't want, such as picking up litter.

I would hope that you would consult with our joint committee staff and with Treasury to see what information you can contribute on this ripple effect. They do not agree with all your figures, and I am sure you do not agree with all theirs. But basically we are not quarreling about the figures.

The question is, when you take those figures, you look at so much being done in a certain way. Then you change the tax laws around so that something that was very profitable is no longer profitable—in fact, it is a marginal investment at best. Then you have to try to guess what is going to happen after that.

Mr. TURE. Precisely.

The CHAIRMAN. I compare it somewhat to what I am trying to get the International Trade Commission to do now. We are not arguing about how much is coming into the country or going out, or how much we are collecting in taxes. We had all that information to start with. But at least certain people in the administration have traditionally wanted to add up figures where they tell us we are making a profit in foreign trade by leaving out the freight on the imports, which very few nations on earth would be so foolish to do, and by including within

their exports all the things that we are giving away, when we are not going to be paid for any of that.

They should instead take the same figures and put them together in the only way they make any sense. The Secretary of the Treasury agreed with me about that. I think the members of the Trade Commission have agreed with me about that. I have had the former Secretary of Commerce and special trade representative agree with me on that, and I have even had presidents agree with that.

The way they put the figures together now, it winds up that the point they call the break-even point is the point where you are losing $10 billion a year.

On these tax figures, I wish that you would work with our joint committee staff and with the experts in Treasury who are going to be made available for this purpose. Give them your input as to what will happen if we do something that would, on the face of it, appear to pick upon some revenue, such as with regard to the real estate area. When you look at the third and fourth steps of the ripple effect, the Government winds up losing money instead of making it. I wish you would work with them on that. They find some points of difference. It is kind of hard to get somebody to think on a new basis, but my impression is that basically they agree, just as Secretary Simon agrees, that we don't have an accurate estimate if we are not looking at the ripple effect.

Mr. TURE. Mr. Chairman, we are delighted, of course, to cooperate with those groups, and that operation is now underway. We are helping as best we can.

The CHAIRMAN. I do not want to ask them if they agree with you, but I think we are entitled to know at what point they take issue.

Mr. TURE. It is our hope at any rate that in that kind of confrontation among us that we can redefine the estimating process and procedures and to the benefit of all of us. We have no side at issue here.

I would be delighted to have any deficiencies in our mode of analysis pointed out to us, and we will proceed as vigorously as we know how to correct them. Our interest is in doing better work, and I am sure that is true of the staff.

The CHAIRMAN. I think each of us should be willing to waive any pride in his own tradition or in his own ideas, and we should decide these things not on the basis of who is right but on the basis of what is right. Any time that something has been overlooked, we ought to take another look at it and take new facts into account.

I have overrun my time, but I think that this is something we should very definitely explore.

Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman.

Mr. Ture, I do not think I have any questions.

I am tremendously impressed with your presentation. I cannot help relating a story I heard a long time ago about a young recruit who was presumed not to be too intelligent. He had on a big hat. They thought maybe he wasn't even intelligent enough to make the Army. That is not intended as a reflection on that service. The recruiter said, "What would happen if I cut off your right ear?"

The recruit said, "I couldn't hear on that side."

Then the recruiter asked, "What would happen if I cut off your left ear?"

The recruit said, "I couldn't see—my hat would fall down over my eyes."

I would have to think that the trouble with some of the estimates we are getting and the basis upon which a lot of these presumptions are made are about that simplistic. All we do is look at the amount of tax that presumably both Senator Talmadge and the chairman have indicated may be lost through "loopholes." We do not stop to think about how people are going to react. We thought we could tighten up on some real loopholes in the energy business so we changed the depletion allowance. I am one who thinks there is still some merit in the oil industry. You know what happened? There soon got to be a lot of oil rigs stacked in Wyoming for one very simple reason: people who think the oil business is going to keep on working no matter what you do to the tax laws are going to have their hat fall down over their eyes because they don't see the whole picture.

The only reason people are in that business or any other business is the hope that they are going to make some money.

When you say how you are going to shut off all the loopholes, pretty quickly we will find the investor or would-be investor or the businessman is a lot more perceptive than some of the experts who say try to get a billion and a half here and seven-tenths over here by lopping off this one and this one. Soon we find a lot of people are out of work. Instead of the income that could otherwise be generated that would add to the Treasury receipts, we have the problem of the unemployed.

In the longrun, I think there is only one answer to the unemployment situation, and that is to bring objectivity, if we can, to the kind of business and economic environment that will encourage people to invest in the private sector. When we get jobs there, we have done something.

You have made an excellent presentation. I hope a lot of people will read it.

Mr. TURE. Thank you, Senator. I obviously associate with the sentiments you have just expressed.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. I arrived a bit late, but I have scanned your statement. I appreciate what you have said.

You made the point that for every dollar of capital that we would hope to make available, somebody has to save a dollar. That is true, varying perhaps in some degree, regardless of how that dollar is saved, is it not?

Mr. TURE. Precisely, Senator.

Senator CURTIS. Is it a contribution to capital if they put it in the bank?

Mr. TURE. Surely.

Senator CURTIS. Or in Government bonds?

Mr. TURE. Even Government bonds.

Senator CURTIS. And in stocks?

Mr. TURE. Yes.

Senator CURTIS. Savings and loans?

Mr. TURE. Yes.

Senator CURTIS. About the only time capital would not be formed is when you hide it. That is when it would not be a contribution to capital.

Mr. TURE. Senator, I hate to get into something——

Senator CURTIS. I don't want to be argumentative.

Mr. TURE. I don't want to get into something that is very esoteric, but the equality of saving and investment and capital formation is inherent in our national income accounting. It is a definitional equality that always must be true. If you define saving as nonconsumption uses of current income, the point is clearly made. It makes no difference what you do with the saving.

Senator CURTIS. When dollars are put into a bank or savings and loan or used to buy a bond they are in somebody's hands who can put them to work.

Mr. TURE. Precisely.

Senator CURTIS. And that capital formation results in more jobs.

My point in bringing this out is that sometimes the layman, in talking about capital and risk capital, finds there are people who, because of age or their particular circumstance, are not investors in risk matters and should not be.

Mr. TURE. That is right.

Senator CURTIS. Nevertheless, if they defer or decline to use all of their income to spend for consumptive items and save some, it is going to help the capital situation in the country.

Mr. TURE. That is precisely correct.

Senator CURTIS. That is where a tax incentive comes in as a benefit to encourage saving. Is that right?

Mr. TURE. I prefer not to use the word "incentive," Senator Curtis.

Senator CURTIS. We had a witness the other day who objected to "preferences." I thought he had a good idea.

Mr. TURE. I thing our current tax laws has an enormous bias against saving uses of income and favors consumption use of income.

The sort of proposal that has been very briefly described in my testimony I would treat as modest reductions in that antisaving bias. I think of incentive as something that goes beyond neutrality in taxation. It seems to me this program of tax revisions would somewhat redress the balance.

Senator CURTIS. About half of the working population are not covered by company pension plans.

Mr. TURE. Just about half.

Senator CURTIS. The Congress a little over a year ago enacted legislation to encourage individual retirement accounts. To the extent that such accounts are utilized, that will be a very definite contribution to the capital of the country, will it not?

Mr. TURE. It certainly will. My only objection to the IRA provisions is that they are too restrictive. I would like to see IRA's liberalized.

Senator CURTIS. I think there is a political reason for it. If the IRA is made very much more liberal, individuals who should use the Keough plan, which requires that employees also be covered, might use the IRA just to avoid that obligation which, after all, applies to

corporations. There has to be a just relation between employee pensions and executive pensions.

How about the recommendation of the Treasury in regard to stock purchases. It would cover a man with $20,000 of earned income and enable him to get a deduction for investments up to $1,500. It is restrictive. If individuals avail themselves of it——

Mr. TURE. I would be astonished if they did not take advantage of it. It is unduly restrictive but, nevertheless, it is a step in the right direction.

I have suggested a kind of very broadly based, though limited, credit for increases in net savings no matter what the form of the saving is. Personally, I have a good deal of concern about recent developments over the past several years in the stock market. It seems to me we have lost it in large part where the individual stockowners in the population are concerned, and I do hope they are coming back into the market. I think it would be highly constructive to move in a direction that would remove some of the impediments to their doing so.

Senator CURTIS. I notice the importance you attach to depreciation, and I wholeheartedly agree with you.

If there is a reason for enacting a provision for accelerated depreciation, should we then try to recapture it or part of it in a minimum tax?

Mr. TURE. Not in my judgment, sir. It seems to me that if we very carefully and objectively and analytically examine the nature of the income tax, particularly with respect to income generated by fixed assets, that the appropriate neutral tax treatment would be to allow taxpayers to expense fixed capital outlays in the year in which they were made.

We do not allow them to do that. We set up extensive sets of regulations pertaining to the period of time over which they may write off these assets for tax purposes and restrictions on the formula they may use for determining the annual write-off, and then we say any time you move in the direction of liberalizing that even by a small amount it is opening up a tax preference that should be treated as an item for minimum tax. It seems to me that is really upside-down reasoning.

Senator CURTIS. The movement to encourage the formation of capital, so you have more jobs in this country, has a great deal of support on this committee. However, the big battle is going to be on the Senate floor. Senator Kennedy of Massachusetts has recommended the repeal of ADR, the repeal of DISC, and the repeal of the definition foreign subsidiary income. There will be a drive on the Senate floor for these proposals.

My question is: What would happen to our economy if we did repeal ADR, DISC and deferral?

Mr. TURE. I think the combined effort in the shortrun would be enormously adverse. I do not have any precise estimates as to what the magnitude would be with respect to capital outlays or employment or GNP, but the direction of the effect seems to me to be perfectly clear. I think you would see it in the equity markets and in bond rates.

I have the most enormous faith in the capacity of the market system

in this economy to adjust to very severe shocks. It has done so in the past and it will do so in the future if given a chance. This would be an enormously severe shock. It would not collapse the economy, but it would necessarily set it back, and severely.

Senator CURTIS. Agriculture is using DISC. Not all are using DISC, but our agricultural exports amount to $23 billion. I think it is pretty well established that, for every billion dollars of foreign exports of agricultural products, we have to have 50,000 jobs in this country.

Mr. TURE. I am not quite sure of the ratio, but I think that is not too far wrong.

Senator CURTIS. I think that includes the farmer, because he is a heavy purchaser of rubber, steel products, fuel, et cetera.

I thank you very much.

Are there any other questions?

[The prepared statement of Dr. Ture follows:]

STATEMENT OF NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC., WASHINGTON, D.C.

I am Norman Ture, President of Norman B. Ture, Inc., Economic Consultants in Washington, D.C. My testimony today is presented as my own views on the proper directions of tax policy; while I hope that others will subscribe to these views, they are the product of my own analysis and conclusions and should not necessarily be ascribed to any of my past or present clients.

I very much appreciate the opportunity to appear before the Committee, and I hope that my testimony may be of some assistance to you. Your job is a difficult one and your responsibilities are heavy, indeed. In making decisions about the future course of tax policy, you confront a strongly improving economy, still plagued, regrettably, by a very high rate of unemployment and underutilization of physical production capacity and still threatened by inflationary resurgence. The Congress faces extremely strong pressures, accentuated by election year political requirements, to focus on the short run—to find quick, sure-fire remedies for lingering unemployment. In this context, you are presented with a budgetary dilemma: the Administration urges you to be highly restrictive on Federal expenditure expansion lest you unleash the dogs of inflation, and the Congressional Budget Office urges you to up the ante by close to $20 billion lest you unduly depress the pace of the recovery.

May I respectfully urge the Committee to shift the focus of its deliberations from these short-run concerns to the longer-run economic prospects and tax policy requirements of the Nation. I offer no forecast about the strength, speed, or duration of the recovery, but I am convinced that an expansionary expenditure policy will, at the least, impede the private sector's growth and, over time, cast up increasingly formidable obstacles, real and financial, to the steady, strong expansion of private production, employment, productivity, and real wage rates. It is time to shift gears, to attempt to determine how tax policy can best contribute to the solution of the long-run problems the Nation faces.

CAPITAL ADEQUACY: THE BASIC CHALLENGE FOR TAX POLICY

The central economic problem for the long run facing the United States is whether the rate of capital formation will be adequate to meet the economy's capital requirements over the next decade and longer. Virtually all of the other major issues with which public policy makers are concerned turn on this central problem of capital adequacy. Whether the focus is on attaining energy self-sufficiency, protection of the environment, improving and expanding mass transit systems, raising the housing standards of low and middle-income individuals, providing safer and healthier working conditions, and so on, a basic constraint on achieving these goals is how much real capital will be available to meet the growing and varied demands of the U.S. economy. The less rapidly we add to our production capability, the more severely will pursuit of any of these public policy objectives limit success in achieving other public and private goals.

The Committee has heard much on the subject of the capital shortage, and much of what the Committee has heard has illuminated the public policy issues. The most serious impediment to effective legislative action to deal with this problem is that promising proposals to this end appear to oppose the interests of the affluent against the poor, of business against labor, and of consumers against producers and sellers. Such appearances are grossly deceiving. They arise from a regrettable proclivity to look only at the initial impact of tax changes — at the estimated initial changes in tax liabilities, rather than carefully examining how taxpayers will respond to changes in taxes and determining what the ultimate effects will be. For example, the Committee has before it in H.R. 10612 a large number of proposed tax revisions which ostensibly would raise calendar year tax liabilities by about $2.5 billion in 1976, ranging upwards thereafter to about $4.25 billion in 1981. Yet common sense insists that, in the case of many of those provisions, there will be no revenue gains at all but revenue losses, possibly substantial, as taxpayers change their activities to avoid the additional tax liabilities, thereby reducing their investment or production and cutting back on employment in the affected activities. When the adjustments that will be made in the market place are taken into account, the effects of changes in the tax laws are often profound and far reaching and quite different in character from those one might expect from examining only the initial change in the distribution of tax liabilities.

Tax changes to reduce the existing tax bias against saving and capital formation offer important cases in point. When one objectively examines the ultimate effect of such tax changes, most if not all of the apparent opposition of interest disappears. Tax changes to mitigate the capital shortage are not exactions from the poor, from consumers, from labor. On the contrary, their prospects for a better tomorrow depend critically on such constructive tax measures.

NATURE OF THE CAPITAL SHORTAGE

We should be sure, to begin with, about the meaning of the terms capital "requirements" and capital "shortage."

The term capital "requirements" does not mean that there is some specific amount of capital that must be on hand at some future time. As individual or business decision-makers, we want additional capital in order to increase our incomes; the amount of additional capital we seek to acquire depends on how much additional income we can obtain from the capital and how much it costs us to get it. Since neither of these factors is fixed, neither is the amount of capital we want.

For the economy as a whole, capital "requirements" should be seen in a somewhat different light. As in the case of the individual or the business, there is no unique amount of capital that the economy must have at any given time. There should be no public policy concern with adding to the stock of capital for its own sake. It makes sense to talk about capital additions and requirements only in relation to other things, viz., the contribution of additional capital to greater output, employment, productivity, and real wage rates.

The contribution of additions to the Nation's stock of real capital derives from a law of economics, popularly known as the law of diminishing returns. According to this law, an increase in the quantity of one production input used in combination with an unchanging quantity of other production resources increases total output, although the rate of increase in output diminishes relative to the rate of increase in the production input; at the same time, the productivity of the other production inputs increases. Thus, an increase in the amount of capital used in production with a given amount of labor services total output and at the same time increases the productivity of labor.

In a free market economy, this increase in the productivity of labor resulting from an increase in the ratio of capital to labor in production has two major consequences: (1) it increases the demand for labor services and (2) it increases real wage rates. How much of the effect of an increase in the capital:labor ratio will be increases in jobs and how much will be increases in wage rates depends on the conditions of supply of labor services; in general, both employment and real wages increase.

It is instructive to examine the postwar record of the business sector of the U.S. economy in this light. Our preliminary estimates based on the recently revised National Income and Product Accounts data show that from 1947 through

1973, the number of full-time equivalent employees in the private business sector of the economy increased at an average annual rate of 1.5 percent a year. Adjusting for changes in average hours of work per week and certain other fatcors, the average annual rate of increase of labor services was 1.7 percent. Over the same period, the net stock of capital in the business sector increased at an average annual rate of 3.5 percent. The capital:labor ratio, hence, increased at a trend rate of 1.8 percent. This increase in the capital:labor ratio, in turn, contributed to an average annual rate of increase of 2.9 percent in labor's productivity and real wage rates.

Further analysis of the postwar record also reveals that real output originating in the business sector increased at an average annual rate of 3.6 percent from 1947 through 1973. Of this increase, 28 percent is accounted for by the increase in capital, 33 percent by the increase in labor services, and 39 percent by technical progress—advances in the state of the industrial arts and their implementation in production processes.

The major conclusion, for purposes of public policy, which emerges from this analysis is that retarding the rate of increase in the capital:labor ratio necessarily means retarding the growth in employment and in real wage rates; accelerating capital formation and the rate of increase in the capital:labor ratio is the only certain means for increasing the rate of expansion of jobs and real wage rates.

ESTIMATING CAPITAL REQUIREMENTS

With this in mind, we can begin to estimate the Nation's capital "requirements" in a meaningful way. First, we begin with a projection of the growth in the labor force. Given this projection, it is possible to estimate by how much the net stock of capital must grow if the capital:labor ratio is to increase at least as fast as the average rate of the post-war period. To repeat, if the rate of increase in this ratio slows, so too will the rate of increase in employment and real wage rates. Projecting the postwar trends in employment and in the capital:labor ratio through 1985, we shall have to add $443.2 billion to the net stock of business capital, measured in constant 1975 dollars. Assuming no change in the rate at which business replaces fixed capital, this will require capital outlays totaling $2.236 trillion dollars, again measured in constant 1975 dollars.

This does not exhaust required capital outlays, however. We must add the amount of additional capital—and the capital outlays to acquire it—at least to extend the postwar trend rate of increase in the Nation's stock of housing. We must also add the capital that business will have to acquire not merely or even principally to increase its capacity to produce goods and services people want to buy, but to meet public safety mandates with respect to the environment, occupational health and safety, a wide array of product quality standards, energy self-sufficiency, and so on.

Much of this government-mandated capital which a business must acquire generates no increase in its total income. As a consequence, the business making these investments can obtain no return on such capital, hence cannot provide rewards for the private saving which must be channeled into such capital formation. The household or business customer doesn't go into the market to buy cleaner air or water; it's not easy to persuade the customer that a given amount of groceries are worth more because food processors and distributors produced less air or water pollutants. In other words, much of this type of capital makes only a negligible contribution to the market value of the products customers buy. Aggregate sales proceeds for a given amount of output, are not likely to increase by an amount equal to the additional costs of the public-mandated capital. Such capital, therefore, cannot be financed by business out of the insignificant additional cash flow, if any, it generates. And since it reduces the rate of return on the business' total capital, the business faces increasing difficulty in external financing of its capital additions.

Unless the aggregate flow of saving, generated internally by business or available in the capital markets, increases substantially, we face a serious shortfall in the capacity of business to finance the increases in capital used to produce the goods and services people buy—the capital that does contribute directly to increases in output, employment and real wage rates. This drain must somehow be offset by additional saving. This is not to suggest that these government-mandated capital outlays are not warranted or that the goals they seek are inap-

propriate. But it must be recognized that such capital formation cannot be had for free and that it adds substantially to the total requirements for capital.

The amount of the capital outlays business will have to make over the next 10 years just to meet the environmental control and OSHA requirements, on the on the business' total capital, the business faces increasing difficulty in external 1975 dollars.

PRIVATE SAVING REQUIREMENTS

For every dollar of these capital outlays, there must be a dollar of saving; gross private investment must be matched by gross national saving. Gross national saving is the sum of gross private saving plus government surpluses or minus government deficits. In most of the postwar years, the government sector has been in deficit, hence has reduced rather than augmented gross national saving. The burden of financing the Nation's capital requirements, therefore, falls on gross private saving. If it assumed that government deficits average no more than $10 billion per year over the next decade—an extremely conservative assumption in view of recent experience and near-term prospects—the Nation's total private saving will have to aggregate $3.82 trillion in constant 1975 dollars, through 1985.

The aggregate saving requirements are substantially larger if, more realistically, we take account of some continuing inflation. If the price level rises on the average by 3 percent a year through 1985, total requirements aggregate not less than $4.55 trillion. At a 5 percent inflation rate, this total increase to $5.13 trillion.

If gross private saving as a fraction of GNP continues over the next decade at the postwar average rate of 15.51 percent, the total of such saving through 1985 will fall $744 billion short of estimated requirements, measured in constant 1975 dollars. At a 3 percent inflation rate, the gap, conservatively estimated, is $893 billion; with inflation at 5 percent, the gap increases to $1008 billion.

Closing this gap between capital requirements and private saving will require an increase in the total private sector saving rate from the 15.51 percent postwar average to 19.26 percent, if we assume a zero inflation rate through 1985. At a 3 percent inflation rate, total private sector saving would have to increase to 19.29 percent of GNP. And if inflation is at 5 percent, the private saving rate will have to increase to 19.30 percent.[1] These estimates are summarized in Tables 8a, b, and c.

ESTIMATED CAPITAL REQUIREMENTS AND PRIVATE SAVING, 1976–85—a. ZERO INFLATION

[Billions of 1975 dollars]

Year	Capital requirements			Gross private saving	Saving gap
	Nonresidential fixed investment plus inventory accumulation	Other capital outlays, including Government deficits	Total		
1976	205.7	110.6	316.3	261.3	55.0
1977	213.0	115.8	328.8	270.6	58.2
1978	220.5	121.4	341.9	280.3	61.6
1979	228.1	127.5	355.6	290.3	65.3
1980	236.3	134.2	370.5	300.7	69.8
1981	244.5	141.4	385.9	311.5	74.4
1982	253.0	149.5	402.5	322.7	79.8
1983	261.9	158.3	420.2	334.2	86.0
1984	271.1	168.0	439.1	346.2	92.9
1985	280.6	178.6	459.2	358.6	100.6
Total	2,414.7	1,405.3	3,820.0	3,076.4	743.6

[1] The estimated required saving rates in the inflation cases err significantly on the low side. The estimated amount of private saving does not include downward inventory valuation adjustments which would reduce business saving under the 3 percent and 5 percent inflation cases. Moreover, the estimated saving implicitly assumes that capital recovery allowances would increase above the annual zero inflation amounts in the same proportion as the inflation rate. Since capital recovery allowances are based on historical rather than replacement costs, this assumption overstates the amount of this component of private saving under the 3 percent and 5 percent inflation cases.

ESTIMATED CAPITAL REQUIREMENTS AND PRIVATE SAVING, 1976–85

[Billions of dollars]

Year	Capital requirements	Gross private saving	Saving gap
B. 3 PERCENT INFLATION			
1976	325.8	269.1	56.7
1977	348.8	287.1	61.7
1978	373.6	306.3	67.3
1979	400.2	326.8	73.4
1980	429.5	348.6	80.9
1981	460.8	371.9	88.9
1982	495.0	396.8	98.2
1983	532.3	423.3	109.0
1984	572.9	451.7	121.2
1985	617.1	481.9	135.2
Total	4,556.0	3,663.5	892.5
C. 5 PERCENT INFLATION			
1976	332.1	274.4	57.7
1977	362.5	298.4	64.1
1978	395.8	324.5	71.3
1979	432.2	353.0	79.2
1980	472.9	383.9	39.0
1981	517.1	417.5	99.6
1982	566.4	454.1	112.3
1983	620.8	493.8	127.0
1984	681.2	537.1	144.1
1985	748.0	584.1	163.9
Total	51,29.0	4,120.8	1,008.2

There is no assurance that total private saving will continue at the postwar average rate, let alone that it will increase by the indicated amount. Some economists dismiss this problem by asserting that if the private saving rate were inadequate, the market rate of interest rise and private saving would, therefore, increase. But this answer confuses cause and effect: the rise in interest rates would be the result of the shortfall as I've attempted to define it; in saving and in capital formation, it would reflect a greater relative scarcity of capital, hence the higher price the economy would have to pay for the services of capital in production. To be sure, the market would clear, but there is no reason to assume that the market-clearing amount of saving and capital formation would be adequate to maintain the trend rate of increase in the capital-labor ratio and to satisfy the government mandated demands for capital as well.

Another answer to the prospective shortfall in saving which some economists offer is for the Federal government to achieve budget surpluses instead of deficits. As noted, a government budget surplus is a plus in gross national saving while a deficit is a minus. Whether this prescription would solve the problem, however, depends on how the surplus is achieved. A slowdown in the growth of government spending, allowing revenues at present tax rates to catch up and overtake expenditures, would certainly contribute to expanding the Nation's total saving. Desirable as this sort of fiscal development would be, it does not appear to be a realistic prospect.

The alternative means for shifting from deficit to surplus is to increase tax revenues at a faster rate than provided by the growth of economic activity, that is, by increasing tax rates, by eliminating or reducing so-called "tax-expenditures", or by adding new taxes. None of these approaches is likely, however, to contribute much to closing the saving-capital formation gap. Each is likely to increase the cost of private saving, hence to reduce its amount. Raising taxes, therefore, would transfer saving from the private to the public sector; it would not necessarily or even likely increase total saving by any material amount.

Particular caution should be attached to the recommendations to raise additional tax revenues by reducing tax "expenditures". Apart from the fact that the estimates of the additional revenues to be obtained thereby are woefully unrealistic (because they are based on the assumption that the affected taxpayers would be completely unresponsive to the increases in their taxes), the principal flaw in this approach is that the increase in taxes would almost entirely

represent additional taxes on the return to private saving, thereby accentuating the existing anti-saving tax bias. At best, private saving might be expected to fall by no more than the estimated increase in revenues; more realistically, the decline in private saving would probably exceed any ultimately realized increase in Federal tax revenues.

Whatever one's view about the desirability of reducing tax "expenditures", it is mere wishful thinking to project any increase in the Nation's total saving from doing so. All things considered, achieving a higher total saving rate from government surpluses is not a realistic solution.

CONSEQUENCES OF A PRIVATE SAVING SHORTFALL

What will happen if actual saving falls short of these "requirements"? In all likelihood, the capital formation shortfall would be largely in the investment in the machinery, equipment, plants, working capital, etc., which increase the real output of marketable goods and services. If the private saving rate were to continue only at the postwar average rate, the saving shortfall, in 1985, assuming no increase in the price level, would be $100 billion. This would be almost 22 percent of the estimated amount of the capital formation needed to maintain the trend rate of increase in the capital-labor ratio. The adverse impact of a shortfall of this magnitude on labor's productivity and real wage rates clearly would be enormous.

It is clear, I hope, that the problem we face is not one of providing incentives to business to add more rapidly to the stocks of their capital. The problem, rather, is one of reducing the existing bias against saving. The capital shortage facing the Nation is, in truth, a saving shortage.

THE TAX BIAS AGAINST SAVING

The tax policy imperative, accordingly, is to reduce the bias against private saving which is a major feature of the present tax laws. That bias results from the fact that, with few exceptions, taxes are imposed both on the amount of current saving and on the future returns to such saving, whereas the tax falls only once on income used for consumption. Since the amount we save today is the capitalized value of income we will receive in the future, we currently tax the same future income stream at least twice. More realistically, we tax saving over and over again: the corporation income tax, State and local income taxes, property taxes, estate, gift and inheritance taxes—all substantially add to the aggregate tax burden on saving. Saving uses of income are taxed by far more heavily than anything else.[1]

The foremost challenge facing the Congress is to deal realistically with the urgent requirement for a higher rate of private saving. If this challenge cannot be met, one or more of the high priority objectives of economic policy will have to bear the brunt of the failure.

TAX CHANGES TO EASE THE CAPITAL SHORTAGE

It is highly encouraging that many members of the Congress have become aware of the prospective capital shortfall, have perceived the potential of changes in the tax structure to deal with the problem, and have attempted to develop programs for constructive tax revisions to this end. Particularly promising, in my judgement, are those tax programs which address the problem with a variety of proposals, aimed at expanding saving by individuals and business alike. This approach recognizes that no one form of saving is superior to others, that all additional saving will find its way into the capital market where it will be allocated to the myriad capital formation uses, by and large on the basis of which of the market participants can make the most productive use of additional capital. No one tax change of limited scope is the best revision for purposes of reducing the existing tax bias against saving and investment. A variety of

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[1] I've attempted to detail the elements of the tax system which contribute to this anti-saving bias and to illustrate their impact in testimony presented to the Committee on Ways and Means, Panel Discussions on General Tax Reforms, 93d Congress, First Session, February 5, 1973, pp. 153 ff. and in "Tax Treatment of Savings and Capital Recovery", The George Washington Law Review, Symposium on Tax Policy, March 1974, Volume 42, Number 3, pp. 501 ff.

such measures are called for if everyone is to be allowed to get in on the act of accelerating the expansion of the Nation's production capability, its total output, employment, and income.

I alluded early in my testimony to a serious impediment to legislation to deal effectively with the capital shortage—the apparent opposition of interests of various groups in the society. Decades of adversary positions are not going to be legislated away in a single revenue act, but a start toward broader and fuller understanding of the importance of and benefits from removing the tax barriers to a higher saving rate can be made by tax legislation which eases the excessive tax burden on all taxpayers' saving.

In this connection, Chairman Long's espousal of tax provisions to encourage employees to invest in the stock of their employers reflects a recognition of the aspirations of people in a wide range of economic circumstances to have a piece of the action. An appropriate complement to favorable tax treatment of employee stock ownership plans would be a universally available tax credit for individual taxpayers based on the amount of the net increase in their savings during the taxable year. The credit might be allowed at a rate of, say, 10 percent, with an upper limit of, say, $1,000 per return ($2,000 on a joint return).

Relief of some form from the present incremental tax on capital gains is also urgently needed. As this Committee is well aware, the deduction for one half of realized capital gains is widely identified by tax "reformers" as one of the principal "loopholes" in the income tax. In fact, however any tax on capital gains is an additional tax on the returns to saving; it is a negative "loophole" which should be eliminated by excluding capital gains and losses entirely from the calculation of taxable income. Short of this drastic step, some measure, perhaps fully excluding the first $1,000 of capital gains each year provided the proceeds from the disposition of capital assets are fully reinvested in others, is highly desirable.

A long overdue tax revision is to replace our archaic depreciation system with a capital recovery system, based on short, standard recovery periods for all machinery and equipment and business structures. Also highly desirable would be to make the investment tax credit permanent and uniformly applicable to all classes of property and taxpayers, preferably at a substantially higher rate than at present.

There is a growing consensus that the corporation income tax should be eliminated. This tax is a differential and very heavy excise on saving invested in corporate equity capital. As such, it contributes significantly to distortion of corporate capitalization. Far more important, its adverse effects are diffused, through the operation of the capital market, to all capital, depressing the overall private saving and investment rate. Useful initial steps toward the elimination of this tax would be reduction in the normal and surtax rates and elimination of the present double tax on distributed corporate earnings.

Proposals of this sort are opposed by some on the basis that they would result in excessively large revenue losses for the Treasury and by others on the basis that they would not be effective. Neither view, in my judgement, is well taken.

The kind of tax revision briefly described above would reduce the cost of saving, i.e., it would take less pretax current income than at present to acquire a given amount of after-tax future income. This reduction in the cost of acquiring future income would certainly result in an increase in the amount people would save out of their current disposable incomes. This increase in savings would be matched by an increase in capital formation. The expansion of capital formation above the levels that would otherwise occur would add immediately to total production activity, to the extent that existing production capability could be more intensively utilized or that more individuals would be induced to enter the labor force; over the longer term, the expanded stock of capital would increase aggregate production capability, total output, hence total income. The tax base, therefore, would expand more rapidly than otherwise. The net effect on Federal tax revenues, accordingly, would be far different from the misleading initial impact revenue estimates customarily provided—estimates which unrealistically assume that taxpayers are completely inert and unresponsive to changes in tax provisions. Indeed, many tax proposals which appear to be revenue losers when only the initial impact revenue effects are considered turn out to be revenue gainers when their effects on economic behavior are realistically analyzed. Unfortunately, the net revenue effects, which take account of adjustments to tax changes, are seldom presented to the tax-writing committees of the

Congress by Congressional staff or the Treasury experts. For example, a recent Committee Print of the Senate Committee on the Budget shows substantial revenue losses in fiscal years 1975–1977 from the Investment Tax Credit.[1] As the authors of the report acknowledge, these estimates ". . . do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity. . ."[2] What useful construction or interpretation can be placed on initial impact revenue estimates, I must confess, eludes me entirely. I respectfully urge this Committee to ignore such revenue estimates in assessing the desirability of proposals for tax revisions.

CONCLUSION

The U.S. economy faces serious challenges as far into the future as our data and analytical skills allow us to project. Successfully dealing with these challenges will provide enormous rewards for all Americans. Whether we deal successfully with them will depend in large part on the future thrust of public policy, which in turn will largely depend on decisions made now and in the near future.

This Committee, I am sure, has noted the public policy tendency to treat each new problem presented to public policy makers as evidence of the failure of the private market system. An objective examination of the evidence, however, urges that our unhappy economic record of recent years is the outcome of excessive and inept governmental intrusion in the operation of the economy, accelerating over the years.

The decisions this Congress makes about the basic content of economic policy will have a major bearing on whether the economy thrives, whether individual freedom, responsibility, self-reliance, and initiative will be encouraged and enhanced, on the one hand, or whether the economy and all its participants will become increasingly wards of the Federal, State, and local governments. In the field of public finance, the first course of action calls for a tight rein on government spending and tax revisions aimed at making the tax system less repressive of effort, of saving, and of investment. The latter course of action calls for an expansionary expenditure policy, larger deficits, hence greater displacement of private saving and capital formation, government planning of economic activity, and increasing government employment.

Past Congresses have faced similar challenges. In the early 1960's, confronting economic circumstances not too dissimilar from today's, the Congress was asked to make a similar choice. The options were elegantly expressed by the then Chairman of the Committee on Ways and Means on September 16, 1963. I can think of no way to improve on that statement. With your permission, I would like to quote briefly from it:

"The purpose of this tax reduction and revision bill (H.R. 8363) is to loosen the constraints which present Federal taxation imposes on the American economy. The results of these tax reductions and revisions will be a higher level of economic activity, fuller use of our manpower, more intensive and profitable use of our plant and equipment; and with the increases in wages, salaries, profits, consumption, and investment, there will be increases in Federal tax revenues . . . there are two roads the Government could follow toward a larger, more prosperous economy—the tax reduction road or the government expenditure increase road. There is a difference—a vitally important difference—between them. The increase in Government expenditure road gets us to a higher level of economic activity with larger and larger shares of that activity initiating in Government—with more labor and capital being used directly by the Government and with more labor and capital in the private sector of the economy being used to produce goods and services on Government orders. The tax reduction road, on the other hand, gets us to a higher level of economic activity—to a bigger, more prosperous, more efficient economy—with a larger and larger share of that enlarged activity initiating in the private sector of the economy—in the decision of individuals to increase and diversify their private consumption and in the decisions of business concerns to increase their productive capacity—

[1] Tax Expenditures. Compendium of Background Material on Individual Provisions, Mar. 17, 1976, pp. 57–59.
[2] Ibid., p. 3.

to acquire more plant and machines, to hire more labor, to expand their inventories—and to diversify and increase the efficiency of their production."

The thrust of public policy—particularly tax policy—urged in that statement is even more appropriate today than it was in 1963. The Congress responded affirmatively then; hopefully, it will do so again in the very near future.

Senator CURTIS. The next witness is Charls E. Walker, president, Charls E. Walker Associates, Inc., on behalf of The Business Roundtable.

Mr. Walker, you are not a newcomer to this room or to this committee by any means, and we are happy to have you back. Will you tell us for whom you are appearing and identify your associates who are accompanying you.

STATEMENT OF DR. CHARLS E. WALKER, PRESIDENT, CHARLS E. WALKER ASSOCIATES, ON BEHALF OF THE BUSINESS ROUNDTABLE, ACCOMPANIED BY DAVID O. WILLIAMS, JR., TAX COUNSEL, BETHLEHEM STEEL CORP., AND ALBERT E. GERMAIN, TAX COUNSEL, ALUMINUM CO. OF AMERICA

Mr. WALKER. Thank you, Mr. Chairman.

Mr. Chairman and members of this distinguished committee, my name is Charls E. Walker and I am a consultant to The Business Roundtable, for whom I am appearing.

Speaking on behalf of its 170 members, I want to express the gratitude of The Roundtable for the opportunity to testify before this committee on tax revision. My oral remarks will be limited to 10 minutes, but a longer statement and a supplement are submitted for the record.

On my right is tax specialist David O. Williams, Jr., tax counsel for the Bethlehem Steel Corp.

On my left is tax specialist Albert E. Germain, tax counsel for the Aluminum Company of America.

Senator CURTIS. Does your paper indicate what The Roundtable is?

Mr. WALKER. No, it does not. It is a group of 170 business corporations organized to work on public policy issues.

[The list referred to follows:]

MEMBERSHIP

Allis-Chalmers Corp.
Aluminum Co. of America
AMAX, Inc.
American Can Co.
American Home Products
American Telephone & Telegraph
The Anaconda Co.
Anheuser-Busch, Inc.
Arizona Public Service Co.
Armco Steel Corp.
Armstrong Cork Co.
ASARCO, Inc.
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Bank of America
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Borg-Warner Corp.
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Burlington Northern, Inc.
Carter Hawley Hale Stores
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Citibank
Ford Motor Co.
GAF Corp.
General Cable Corp.
General Dynamics Corp.
General Electric Co.
General Foods Corp.
General Mills, Inc.
General Motors Corp.
The General Tire & Rubber Co.
The B. F. Goodrich Co.
The Goodyear Tire & Rubber Co.
The Greyhound Corp.
Gulf Oil Corp.
Gulf States Utilities Co.
Halliburton Co.
The Hanna Mining Co.
H. J. Heinz Co.
Hercules Inc.
Hewlett-Packard Co.
Honeywell, Inc.
Hoover Worldwide Corp.
Ideal Basic Industries
Illinois Tool Works, Inc.
Ingersoll-Rand Co.
Inland Steel Co.
IBM Corporation
International Harvester Co.
International Nickel Co.
International Paper Co.
Iowa-Illinois Gas & Electric Co.
Irving Trust Co.
Johns-Manville Corp.
Kaiser Industries Corp.
Kennecott Copper Corp.
Koppers Co., Inc.
Kraftco Corp.
The LTV Corp.
Libbey-Owens-Ford Co.
Eli Lilly & Co.
R. H. Macy & Co.
Marcor, Inc.
Merck & Co., Inc.
Metropolitan Life Insurance Co.
Middle South Utilities Inc.
Minnesota Mining & Manufacturing Co.
Mobil Oil Corp.
Monsanto Co.
NL Industries, Inc.
Nabisco, Inc.
National Steel Corp.
Norton Co.
Olin Corp.
Owens-Corning Fiberglas Corp.
Owens-Illinois, Inc.
Pacific Gas & Electric Co.
J. C. Penney Co., Inc.
Pennzoil Co.
Phelps Dodge Corp.
Phillips Petroleum Co.
Potomac Electric Power Co., Inc.
PPG Industries
The Procter & Gamble Co.
The Prudential Insurance Co. of America
Public Service Co. of Colorado
Public Service Co. of Indiana, Inc.
Public Service Co. of Oklahoma
Public Service Electric & Gas Co.
RCA Corp.
Ralston Purina Co.
Republic Steel Corp.
Reynolds Metals Co.
Roadway Express, Inc.
Rockwell Industries, Inc.
Rohr Industries, Inc.
Scott Paper Co.
Sears, Roebuck & Co.
Shell Oil Co.
SIFCO Industries, Inc.
A. O. Smith Corp.
Southern California Edison Co.
The Southern Co.
Southern Pacific Co.
Standard Oil Co. (Indiana)
Stauffer Chemical Co.
Sun Oil Co.
Sundstrand Corp.
TRW Inc.
Tenneco, Inc.
Texaco, Inc.
Texas Gas Transmission Corp.
Texasgulf, Inc.
Texas Instruments Inc.
Texas Utilities Co.
Trans World Airlines, Inc.
UAL, Inc.
Union Camp Corp.
Union Electric Co.
The Union Pacific Railroad Corp.
Uniroyal, Inc.
United States Steel Corp.
United Technologies Corp.
Utah International, Inc.
Westinghouse Electric Corp.
Weyerhaeuser Co.
Wheeling-Pittsburgh Steel Corp.
Whirlpool Corp.
White Motor Corp.
Xerox Corp.

Senator CURTIS. You may proceed.

Mr. WALKER. Mr. Chairman, this summary is confined to three major areas of tax revision: (1) tax measures to promote capital formation; (2) tax treatment of domestic international sales corporations; and (3) taxation of income earned abroad by U.S. businesses and their affiliates.

Mr. Chairman, from the Secretary of the Treasury, Dr. Ture and others, you have or will have received a mountain of testimony to the effect that our Federal income tax system is seriously titled in favor of consumption and against the saving, investment, and capital formation that are so crucial to the wellbeing of American consumers, workers and producers. Time does not permit me to restate these persuasive arguments. Instead, let me summarize quickly tax actions that this committee might recommend to start redressing the imbalance in our tax system. This should not be done by increasing taxes on individuals. In fact, we favor permanent extension of the individual and small business tax reductions expiring at midyear.

First, Mr. Chairman, President Ford's proposal to reduce the corporate rate from 48 percent to 46 percent has much to commend it. Unfortunately, few Americans realize that, as you have noted, corporations do not pay taxes; people pay taxes. This misunderstanding is a formidable obstacle to cutting corporate rates. Nevertheless, we urge the committee to seriously consider the Ford proposal.

Second, the investment tax credit, widely hailed as a powerful means of promoting jobs and growth through capital formation, should be made permanent at the 12 percent level recommended unanimously last year by the President's Labor-Management Advisory Committee. At the least, a permanent ITC of 10 percent—the current temporary level—is justified.

Third, our depreciation laws should be modernized by replacing the woefully inadequate historical cost system with one that allows for inflation. ADR should be retained and liberalized. And immediate writeoff of expenditures for pollution control is justified.

Finally, with respect to capital formation, some start should be made toward reducing the double taxation of corporate dividends, perhaps by permitting corporations to deduct a portion, say, 25 percent, of dividends paid.

Turning now to DISC, largely as a result of the work of this committee, this tax incentive was adopted in 1971 to increase exports while maximizing employment at home. Exports have more than doubled, and we are convinced, as is the Commerce Department, that DISC must be given a significant share of the credit.

Not so, say the critics. Devaluation of the dollar has in their view been the major factor, assisted by poor crops abroad. They also argue that in the future a "floating dollar" will solve all our problems—if exports weaken, the dollar will simply fall in exchange markets and exports will bounce back.

This is a false argument. Even if we were willing to see our dollar float downward indefinitely, thereby raising the real cost of imports, our competitors abroad would doubtless view the situation with considerable alarm, and we could reexperience a series of competitive currency devaluations reminiscent of the "beggar-thy-neighbor" policies of the 1930's. Nobody wants that.

Critics also complain that DISC is "costing" much more than expected. If it costs more, it is because exports are up. If exports are up, export-related jobs are also up. In other words, the higher estimates of revenue impact could reasonably be interpreted as a sign of signal success. And, beyond this, industry has been provided with job-creating capital funds in the process.

The attitudes in GATT are also interesting to note. If DISC is indeed ineffective, why have our competitors abroad screamed so loudly that it is an unfair export incentive?

Finally, with respect to DISC, Mr. Chairman, it is very difficult for me to improve on the basic thrust of the testimony earlier this week by Representative Karth who has studied this issue impartially and in great depth.

DISC should not be eliminated; it should not be made incremental; it should be retained in its present form.

Turning now, Mr. Chairman to taxation of foreign source income, there is a disturbing tendency on the part of some observers to depict the foreign source income provisions of our tax laws as riddled with so-called "loopholes" that facilitate widescale tax avoidance.

This is incorrect. As is generally true throughout the industrial world, the U.S. system of taxation of foreign source income recognizes that the country in which business income is earned has primary tax jurisdiction over that income; that taxes should not be confiscatory; and that income should not be taxed until received. Current foreign source income provisions of the tax laws, although exceedingly complex, are based on these principles.

Furthermore, abrogation of the principles would reduce the competitiveness of U.S. industry in world markets—and in many cases drive Americans out of business abroad—all to the detriment of American workers and consumers.

As is frequently the case, attacks on the existing system, and proposals to change it radically, are based largely on misunderstanding of the way the system actually operates.

Take, for example, the foreign tax credit, which is effectively designed to avoid double taxation of income earned abroad. Under the U.S. foreign tax credit provisions, a U.S. taxpayer can reduce his Federal income taxes, otherwise payable on his foreign source income, by foreign income taxes paid on such income. However, the reduction, or credit, for foreign income taxes paid on the foreign source income, cannot exceed the U.S. income taxes that would have to be paid on the taxpayer's income from foreign sources. This avoids double taxation and assures that taxes are paid in an amount at least equal to the U.S. corporate rate. It also eliminates the possibility of confiscatory taxation.

The foreign tax credit is no "giveway." It does not reduce the foreign and domestic tax burden below the level that would be applicable if the income were entirely domestic income. Press reports that U.S. corporations with operations abroad pay only a relatively small part of their worldwide profits as Federal taxes are highly misleading, because they ignore foreign income taxes paid on the portion of worldwide income earned abroad.

The suggestion that so-called "deferral" be eliminated—that income earned abroad by subsidiaries be deemed taxable to U.S. shareholders

before being received, rather than, as is now the case, when remitted in the form of dividends—is also based upon misunderstanding.

The term "deferral" is a misnomer. Taxation of this foreign income by the United States before remittance—before receipt by the U.S. shareholder—would be "anticipatory taxation," which is clearly in conflict with our basic precept of taxing dividend income only when received by the shareholder.

The enormity of the misunderstanding becomes even clearer when it is recognized that other countries do not tax the unremitted operating earnings of foreign subsidiaries of their domestic corporations. And some countries, such as France and the Netherlands, do not tax foreign source income even when actually received by their nationals.

But even when these misconceptions are cleared away, there are still critics who argue that the overall effect of our approach is to "export jobs" and increase investment of U.S. firms abroad at the expense of investment in the United States.

The facts are otherwise. The record clearly depicts a very favorable U.S. impact from operations of U.S. companies with subsidiaries abroad. U.S. employment of these companies has increased over twice as fast as other U.S. companies; their domestic sales and investment have increased faster; and their exports of goods produced here have outstripped those of other firms.

That record speaks for itself.

A final point, Mr. Chairman, brings us full circle to the capital formation problem discussed at the outset. Proponents of increasing U.S. taxes on foreign source income argue erroneously that the automatic result would be higher investment in the United States.

Domestic business does not go abroad because of so-called deferral. It invests abroad to develop market opportunities in competition with foreign-owned, foreign-based producers, in markets which cannot be served from the United States for a variety of reasons.

Rather than penalize foreign income through higher taxes, is it not far better to enact legislation specifically designed to increase the after-tax return of investment in the United States? That would be the precise result of the productive tax reform which I discussed earlier—and capital formation here would surely benefit.

In conclusion, Mr. Chairman, on behalf of the Business Roundtable, I cannot stress too strongly the fact that failure to adopt measures promoting greater capital formation, or the enactment of legislation violating the fundamental objectives of the foreign source income provisions of the law, would only in the first instance affect the business community. The ultimate impact would be on the American citizen—as a worker and consumer—and that impact would be detrimental to his economic well-being. Nothing less than his future standard of living is at stake.

Thank you very much.

Senator CURTIS. Senator Packwood.

Senator PACKWOOD. Surely on the foreign deferral, I do not understand your theory that this would be like taxing money before it is distributed to the shareholder. Don't we do that now with corporations domestically?

Mr. WALKER. Not the shareholders.

Senator PACKWOOD. Take corporation A in America. It sets up a 100-percent subsidiary in Germany. There is not an affiliate or agreement with a foreign country to pay dividends or not does pay them to American shareholders or otherwise. Why is that not taxed just as if it were operated here?

Mr. WALKER. It is. Stockholders of domestic subsidiaries are not taxed until dividends are paid. Also, you are assuming 100-percent ownership. There might be a bunch of other individual shareholders in addition to the parent U.S. corporation. The parent corporation receives its income in the form of dividends that are remitted. It is even clearer if you or I own a share of that controlled foreign corporation and under Senator Kennedy's proposal, if you own more than 1 percent you would be taxed before the corporate income is personal income to you.

It is almost the same as if you owned a share of stock in a U.S. corporation, and it earns a dollar per share but pays no dividends, you still would have to pay the tax on the dollar earned. That is anticipatory taxation.

Senator PACKWOOD. In your statement where you quote Chairman Long, you say corporations really don't pay taxes anyway. You are just a conduit and pass them along. If that is true, what difference does it make what corporate tax rate is if it is 20 percent or 80 percent.

Mr. WALKER. First of all, we have to understand we don't know the incidence. In some industries a great portion may be passed on to the ultimate consumer. If that is true—since most of the goods in this country are bought by people of low- and middle-income, rich people spend a lot more money per person but low- and middle-income people buy much more in the aggregate—then it would be a regressive tax. If you triple the taxes on grocery stores, which earn about a penny per sales dollar, they will pass the tax on to consumers and it will be highly regressive.

Economists will say some of the taxes pass back to the stockholder. We don't know how much. This committee assumed about 50–50 back in 1969 or 1971. The part that is passed back to the stockholder hurts capital formation and jobs, because it reduces the incentive to invest.

Senator PACKWOOD. You are saying it is not all passed on.

Mr. WALKER. Yes. It's split. But we don't know how.

Senator PACKWOOD. The corporation is a collector and sooner or later, the taxes are borne by you and me.

Mr. WALKER. If I am a consumer, to the extent they are passed on in the form of higher prices, I'm hit. If I am a stockholder, I am hit because it reduces the return on my investment. It hits forward and backward, in some combination, and veers all over the lot.

The point is that a lot of people think you can tax a corporation without affecting people. The corporate tax always affects people, sooner or later, and we don't know in what way and how much. I would be in favor of getting completely rid of the corporate income tax, partly for that reason. But I am a realist.

Senator PACKWOOD. What about the value added tax?

Mr. WALKER. The roundtable has made no study of the value added tax. So I want to emphasize this is personal.

I studied the value added tax in depth when in the Treasury Department. Assistant Secretary Cohen went to Europe to find out about

it there. I was personally impressed with the fact that a consumption-based value added tax—not applying to investment goods—would certainly be a powerful factor in reducing the bias against saving and investment in our tax system.

However, it has the image over here of being simply a retail sales tax, and also being very regressive. Furthermore, the impact among industries and companies would vary greatly; it depends basically on how labor intensive a company is. A number of members of the roundtable would probably be against the value added tax. But we have to study it. It is the wave of the future in some important parts of the world. That is one reason the tax burden on capital formation is less in Western Europe.

Senator PACKWOOD. Secretary Simon, about a year ago, presented excellent testimony. As I recall, all the European countries presently tax the great national productions, except Great Britain, less but still above us.

Mr. WALKER. The United Kingdom has finally gotten religion, but 25 years too late.

Senator PACKWOOD. But isn't the tax regressive?

Mr. WALKER. We devised in the Treasury Department, through the ingenuity of Mr. Cohen and others, a technique which would make the value added tax completely proportional by giving a refundable income tax credit to families—I forget the amount, $30, $40, $50, whatever it was—to offset the purchase of necessities. It is like the refundable credits given on Nebraska sales tax. You pay a sales tax in Nebraska and you get a credit on your income tax. If you don't have enough income tax, it is made refundable and you get a check from the State.

Senator CURTIS. It still serves another purpose.

The question was whether you should charge a sales tax on food items. That raises all the problems of having various taxes and how you describe something. The refundable credit is supposed to amount to about what would be paid for the food.

Senator PACKWOOD. Mr. Chairman, let me ask you a question, because I am curious about something I read in the paper this morning about the Budget Committee. Are they ordering us in this tax reform to come up with $2 billion with loophole closures where we have to find that money to meet those totals?

The CHAIRMAN. They are not ordering us to, no, though that is what some of their members wanted to do. They are going to put in their committee report that they would like for us to raise $2 billion by doing something of that sort.

Senator PACKWOOD. Will their budget totals be premised upon our coming up with $2 billion in revenues?

The CHAIRMAN. They are going to give us one net revenue figure for new legislation. They will say in their report that this figure is the net of two things—one plus figure and one minus figure. I contend that the budget process means that the Congress tells us how much revenue it wants and it is our duty to recommend how we can raise that much.

Some of the members of that committee want to give us two figures—how much of a revenue loss we should provide for the tax cuts, and how much revenue gain for tax increases. They want to give you two

figures. In my judgment, that would represent the first step in an effort of the Budget Committee to be the tax writing committee and the Appropriations Committee. The way the budget process was set up, they are supposed to recommend to the Senate how much revenue this Government should take in. It is our job to recommend how the Government can take in that much. I can live with that process, and I think this committee ought to—that is what was intended when we voted to set up the budget process. But if they try to tell us to put a tax on this man and not put a tax on that man, or that we should raise funds by way of an excise tax rather than by way of an income tax, then in my judgment, they are stepping outside their bounds.

And if they want to try to mandate that, I think we ought to take them on on the floor. But that is not what the Budget Committee is proposing to do now.

Mr. WALKER. Mr. Chairman, on this. I don't want to stick my nose into a congressional procedure.

The CHAIRMAN. I welcome your suggestions. You have been around here a long time. We call you the old Charls Walker, since we now have a new one.

Mr. WALKER. He is a fine person, but he is a little older than I am. Downtown they call me Charls the first, who knows how to spell his name correctly.

Seeing this problem coming down the pike, I discussed it in my biweekly economic report. [A copy is submitted for the record.] I referred to the misuse of the term tax expenditures—which is a very slippery concept—and, second, the threat to the budget process that could result from what the Senator referred to. It seems to me, that for the Budget Committee to tell you how to raise revenue, is tantamount for that same committee telling the Armed Services Committee that there should be appropriations for so many MIRV's, B-1's, and so on. To report, telling the tax committee how to raise revenue is, to me, basically the same. And, in my judgment, it could kill the budget process.

The CHAIRMAN. I hope that the Budget Committee will not yield to the temptation of trying to be the tax writing committee. That is a constant temptation, it appears. They have a far bigger staff than we have, so I don't know what the purpose of having all those people there is for unless it is just a make-work project or unless they do plan to tell us how to write our tax laws.

It may only be a matter of time before we will have to confront this matter of the Budget Committee wanting to be the tax writing committee. As of now, in my judgment, they are going to find this Finance Committee is far better qualified to write those tax laws—and it is far better balanced, may I say. At one time the Finance Committee was accused of not having enough liberals, but I think we have overcome that. We have our proportionate share relative to the proportion in the Senate. I think the Budget Committee is over-balanced the other way. They are lacking their fair share of moderate and conservatives on the Democratic side. We will see as time goes by if I am right about that.

In any event, it is clearly this committee that will hold the hearings on tax matters and hear witnesses like these gentlemen here and the

other 300 people who are affected by the bill and who have asked to be heard. I believe that if the people of this country make themselves heard, we will manage to work this thing out so that those who have heard the witnesses will write the tax laws and not those who have not heard the witnesses.

I appreciate your statement, Mr. Walker. I have not been able to give it as much attention as it deserves up to now, but I want you to know I will give it all the attention I can.

I will put it in my pocket and I look forward to talking with your people in the future about this matter.

Senator Hansen.

Senator HANSEN. I don't think I have any questions, Mr. Chairman.

I think that the real dangers I see in trying to write some good tax law this year is highlighted by the fact that this is an election year. It is an awfully easy thing to appeal, if a person is inclined to demogoguery it is always great to come out for the little guy and to point your finger at somebody else and say he is better off than I am or he is better off than you are and let's put sting on him and we will treat you better. Of course, you know there isn't any quick, immediate understandable answer for all too many people. It is only the end result. For those who talk about all of the progressive laws other countries have had, how archaic and regressive the United States is, I note with some ironic satisfaction that lots of the countries that have exhibited these great progressive ideas are down the drain now beginning with England. There are more that I think will follow.

I am not persuaded at all that we are going to do the kind of job that will be helpful to this country in the longrun if we fall sway to that temptation to try to achieve an immediate political goal and that is really what worries me about betting into a tax bill this year. I think there are too many people out on the stump who are going to be trying—they are appealing for votes. It is awfully easy to say if I get in there, I will change things around and I am just fearful if we yield, I share your feelings completely about the balance and the wisdom and the maturity that I think we have in our staff here as contrasted with some other staffs that I hope will not go unnoticed. It may be that we will have to just conduct a holding operation, not to try to improve the tax laws but to see that they are not made a hell of a lot worse.

Thank you.

The CHAIRMAN. That is one thing people have to keep in mind: No matter how bad a law is, it is possible to make a still worse one.

Senator CURTIS. I appreciate your statement very much, Mr. Walker. I think you have been most helpful to the committee. It seems to me that, in a time of budget problems, and so on, we should turn to those tax proposals which will do the most to create jobs.

There are many well-meaning senators who do not have the opportunity to hear all the testimony that we do in the course of 3 or 4 weeks here, and it has a cumulative benefit over the years.

If you would care to submit for the record a hypothetical example of the working of DISC to show its benefit for jobs in this country and the same thing in reference to deferral, I would appreciate it. What I would like, and the reason I say make it hypothetical, is that

I don't want to flout anybody's business transactions around. If it could be a hypothetical case that very nearly paralleled some actual operations so that we would have for our explanation on the Senate floor and debate, it would be most helpful.

Mr. WALKER. I would be delighted to do so.

The CHAIRMAN. I would like to ask you for a few charts to put in the record to illustrate your thinking.

I think sometimes if you can look at something in terms of columns of numbers, where you put assumptions down and see how they work out, it is easier to see what things we are going to have to argue about.

[The following was subsequently received for the record:]

I. DISC

Although it is difficult to pinpoint specifically the effect of DISC on U.S. jobs, Secretary Simon has testified that the latest Treasury report on DISC estimates that in 1974 DISC stimulated exports by $4.6 billion resulting in an increase of 230,000 jobs. He further testified that the employment associated with additional exports attributable to DISC in 1976 could be as much as 300,000 jobs. You also have testimony from others that exports and U.S. employment of companies using DISC have increased faster than companies not using DISC.

DISC has contributed to this growth in a number of different ways: by influencing business decisions to expand U.S. manufacturing facilities rather than establishing a facility abroad, by increased profit margins on export sales, by providing funds for long range export market development programs or by providing the necessary capital to permit U.S. businesses to meet the extended credit provisions offered by foreign competitors often with the assistance of their own governments. For example, in the case of one company, domestic receivables are outstanding an average of 50 days—that is, domestic receivable balances represent in the aggregate 13.9 percent (50/360) of its annual domestic sales. In the case of export sales, however, receivable balances are outstanding 120 days on the average, representing in the aggregate an average of 33.3 percent (120/360) of its annual export sales. Export receivables in this case require excess financing of 19.4 percent of annual sales value over its capital financing requirements for domestic sales. Exhibit A shows how over a period of years the DISC tax deferment gradually builds up funds to finance these excess receivables.

If without these funds the export division of this company were required to meet the same budgetary restraints on receivable balances as applied to its domestic business, it estimates that its U.S. export related employment would have been reduced as much as one third because of loss of export sales to foreign competition due to inability to meet the credit terms offered by its foreign competition.

II. "DEFERRAL"

The effect on U.S. jobs of deferral relates to the ability of foreign subsidiaries of U.S. corporations to remain viable vis-a-vis their foreign-based foreign-controlled competitors. Based on a 1975 NAM export job survey, it has been estimated that approximately one third of U.S. exports are attributable directly or indirectly to U.S. direct foreign investments. If the viability of these direct foreign investments were damaged by imposition of an additional tax burden not borne by foreign competitors, this would threaten the continuation of exports to foreign subsidiaries of U.S. manufactured component parts and equipment used in their manufacturing processes—components and equipment which would not be purchased from U.S. sources if those foreign investments were not under U.S. control. In addition, exports resulting from pull through the U.S. presence abroad would be significantly reduced.

For example, assume that the effective income tax rate in Country X is 30 percent and that the U.S. eliminates the so-called deferral. The relative status of a U.S. controlled vs. foreign controlled corporation in that country can be illustrated as follows, assuming an investment of $500,000.

	Foreign controlled	U.S. controlled
Sales	$1,000,000	$1,000,000.0
Income before taxes	100,000	100,000.0
Taxes:		
Foreign	30,000	30,000.0
United States	0	18,000.0
Total	30,000	48,000.0
Net income	70,000	52,000.0
Ratio N/I to sales (percent)	7	5.2
Return on investment (percent)	14	10.4

Thus the capital formation of the foreign controlled corporation would be increased $18,000 or 34.6 percent over the capital formation of the U.S. controlled foreign corporation. This increase in capital formation will give the foreign controlled corporation a decided advantage in planning its strategy for growth and in capturing markets from its U.S. controlled competition. This would include utilization of these excess funds not available to its competitor for price reductions, market development purposes, development of new or improved products, establishment of more efficient production facilities and the like. Eventually the competitive position of the U.S. controlled foreign corporation would deteriorate with reduction or even elimination of related U.S. exports and commensurate loss of U.S. jobs.

EXHIBIT A

EFFECT OF DISC ON FINANCING OF EXCESS EXPORT RECEIVABLES

	1972	1973	1974	1975	1976	1977	1978	1979	1980
A. Current year export sales	$100.0	$115.0	$132.0	$152.0	$175.0	$201.0	$231.0	$266.0	$306.0
B. Current year DISC commission (6 percent×A)	6.0	6.9	7.9	9.1	10.5	12.1	13.9	16.0	18.4
C. Income retained by DISC (50 percent×B)	3.0	3.5	4.0	4.6	5.2	6.0	6.9	8.0	9.2
D. Current year tax deferment (retained in C; 48 percent×C)	1.5	1.7	1.9	2.2	2.5	2.9	3.3	3.8	4.4
E. Cumulative DISC funds (summaries of amounts in C)	3.0	6.5	10.5	15.1	20.3	26.3	33.2	41.2	50.4
F. Export receivables (120/360×A)	33.3	38.3	44.0	50.7	58.3	67.0	77.0	88.7	102.0
G. Excess receivables (70/360×A)	19.4	22.3	25.7	29.6	34.0	39.1	44.9	51.7	59.5
H. Cumulative DISC funds as percent of excess export receivables (E÷G)	15.5	29.1	40.9	51.0	59.7	67.3	73.9	79.7	84.7

Assumptions and comments: A. Exports grow 15 percent per year. B. Profit margin on exports is 12 percent, ½ of 12 percent or 6 percent is allowable DISC commission. C. DISC is deemed to distribute 50 percent of its income back to its parent. D. 48 percent of retained DISC funds is the amount of tax deferred. E. Compound interest effect ignored for simplicity. Interest would add $9.0 to cumulative total of $50.4 through 1980. F. Export receivables average 120 days. G. Domestic receivables average 50 days, a difference of 70 days.

The CHAIRMAN. There are some who feel we ought to try to see to it that capital gains and all investment income are taxed as heavily as earned income. If that result is achieved, Senator Kennedy has an amendment to move the tax on earned income up to a 70 percent rate. I wish you would analyze that proposal and see how your people think it would work out.

Here is one example with which I am familiar. There is a good welder in Louisiana. He is a single man. He finds after he has made $25,000 net to him after taxes, he is in a 50 percent tax bracket. That takes him eight months. At that point, he quits working. Actually, he does not exactly quit. He tells the union steward he wants to be laid off. He is

laid off from this job and draws his unemployment compensation. He proceeds to fix up his boat and spends his time fishing and hunting for the rest of the year. Up to Mardi Gras time when the weather gets nice, he goes out and does some more welding. When that man quits, other people are put out of work. When you are welding pipes together to drill out in the Gulf of Mexico, if you are not going to buy more pipe, that puts those people out of work, those hauling the pipe, and it puts the trucker out of work, it puts people at the steel plant out of work, it puts people at the mine out of work, and it puts people at the railroad out of work. That is upstream.

Then downstream, the limiting factor on how many people can be drilling out in the Gulf of Mexico is the number of personnel. When that welder arranges to have himself laid off, he gets five other people laid off with him because here is where you have a shortage.

You know as well as I do, Mr. Walker, down around Houston, Texas, those who need welders are bidding up the wages against one another to get welders. After a certain period of time, the people quit because the tax law has become a disincentive.

I would appreciate it if you and your people, and perhaps Dr. Ture, would undertake a study of what is likely to happen in peacetime when you put into effect a 70-percent tax on earned income, and let's assume our liberal friends do everything that falls into the same category and knock out accelerated depreciation. By the time they are done, they should knock out the investment tax credit, too, because all their logic would support knocking out accelerated depreciation and would support knocking out the DISC.

I wish your people would give us your best estimate of what will be done to the economy and what will be done to our revenue if these proposals are enacted. When we considered repeal of the investment tax credit, we were doing it on the assumption that the country would stay profitable. You were in the Treasury at the time, Mr. Walker, and you know the country did not stay profitable. We did not attribute the recession that occurred to the tax bill.

I guess that at that time we in Congress could not afford not to do it, so we insisted on passing the investment tax credit repeal. You in the executive department couldn't oppose that because, under pressure from up here, your people recommended it. By the time we go through with all that, what was President Nixon asking us to do? It was to reinstate the investment tax credit.

Mr. WALKER. We goofed, and when we found out we goofed, we quickly ungoofed and came back up here and got ITC and ADR.

The CHAIRMAN. And didn't the economy start moving up again?

Mr. WALKER. There is no doubt about it.

The CHAIRMAN. It is amusing to me that economists who went along with that "reform" all like to say that it did not have anything to do with the economic disaster that occurred thereafter.

Do you believe that that economic downturn happened without any relevance to that Tax Reform Act of 1969?

Mr. WALKER. The Tax Reform Act of 1969 is the saddest experience in my career, in the way it ended up being so heavily weighted against investment, saving, and capital formation. I wish I could relive that chapter over again. We were caught up in a tide of misunderstanding throughout the country. It started when the incumbent Sec-

retary of the Treasury, in January 1969, made a speech up here about a few rich people who paid no income taxes.

In February—we had just come into office—we got more mail in the Treasury Department in one month griping about taxes than we got in the entire preceding year. It might have died away later, but the Congress happened to go home in April. People had just made out their income tax returns, and they got to the bottom line, felt they were through, and the form said "add seven and a half percent for the surtax." Excuse the expression—all hell broke loose. When you people came back, I knew there would be a tax reform act of 1969 because the tide could not be turned back.

It hurt. There is no question about it.

The CHAIRMAN. You sent down a bill that was supposed to be a balanced bill. Business was supposed to lose their deductions, but the trade off was to be a reduction in the rates. What happened when the bill went through?

Mr. WALKER. We did not get the reduction in corporate rate.

The CHAIRMAN. So the rate reductions came out and, in addition to what you were going to do with business, some of our liberal friends thought of other things to do with business. When they go through, the bill clobbered business and gave tax cuts to the rank and file, mainly labor, of a great deal more than it was supposed to raise.

On balance, it was supposed to be a $2 billion revenue loser. It probably lost us $10 billion if you look at the part it played in getting us into the recession after the effective date.

If you then look at how we proceeded to repeal the principal "reform" in the bill and how the economy then turned around, I think it is clear on the face of it that bill under the guise of reform clobbered business, and the result was that it probably played more of a leading role than any single item in the recession that followed. When we repealed that mischief, business began to move forward.

Mr. WALKER. That, coupled with too restrictive a monetary policy augmented the situation.

The CHAIRMAN. Thank you very much.

Senator Dole.

Senator DOLE. I am sorry I missed your statement. I am on the Budget Committee and we had a hard night last night trying to figure out how the Finance Committee would operate.

The CHAIRMAN. I think the record should show Senator Dole was not here when we discussed the problem earlier.

Senator FANNIN. Would it be fair to say the Budget Committee has had a hard morning here this morning in absentia?

The CHAIRMAN. We will do the best we can. Thank you very much.

[The prepared statement of Dr. Walker and supplemental statement of the Business Roundtable follow. Oral testimony continues on p. 1717?]

TESTIMONY ON TAX REVISION BY DR. CHARLES E. WALKER, CONSULTANT, ON BEHALF OF THE BUSINESS ROUNDTABLE

SUMMARY

1. Testimony is limited to three major areas of tax revision: (1) tax measures to promote capital formation; (2) tax treatment of Domestic International Sales Corporations (DISC's); and (3) taxation of income earned abroad by U.S. businesses and their affiliates.

2. The capital formation that creates jobs and enhances economic growth and competitiveness in world markets is severely hampered by the bias in our Federal tax system which favors consumption over saving and investment. A partial list of actions to redress the imbalance would include: (1) reduction in the corporate tax rate; (2) enactment of a permanent 12 percent investment tax credit; (3) modernization and liberalization of other capital recovery allowances; and (4) initial steps to eliminate the double taxation of corporate dividends.

3. DISC's were authorized in 1971 as a tax incentive for stimulating exports and increasing U.S. employment. The program has been very successful. Exports have surged and export-related employment has increased. DISC should be retained in its present form.

4. The recommendations of those who see the foreign tax credit as riddled with loopholes, are based on a fundamental misunderstanding of the way the foreign tax credit provisions operate. The foreign tax credit is designed to avoid double taxation of income earned abroad and thus prevent confiscatory taxation. Proposals to limit or repeal the foreign tax credit would severely reduce, if not eliminate the competitiveness of U.S. firms in world markets. The foreign tax credit principles of present law should be retained.

5. "Deferral" is a misnomer. A fundamental precept of U.S. taxation is to tax income only when received; taxation of income earned abroad before it is received by U.S. shareholders would violate that principle. Furthermore, the revenue gain would be small, if not eliminated (as foreign governments raised taxes). Jobs and investment here would be impaired because foreign affiliates are major customers of their U.S. parents.

Investment abroad does not displace investment at home. Foreign affiliates are a necessity for doing business in most instances. Studies have shown that companies doing business abroad invest in the United States at a much faster rate than those operating solely in this country.

For these and other reasons, the foreign source income provisions of the tax laws should not be changed.

STATEMENT

Mr. Chairman and Members of this distinguished Committee: My name is Charls E. Walker and I am a consultant to The Business Roundtable. Speaking on behalf of its 170 members, I want to express the gratitude of The Roundtable for the opportunity to testify before this Committee on tax revision. My oral remarks will be limited to 10 minutes. But a longer statement and a supplement are submitted for the record.

This summary is confined to three major areas of tax revision: (1) tax measures to promote capital formation; (2) tax treatment of Domestic International Sales Corporations; and (3) taxation of income earned abroad by U.S. businesses and their affiliates.

Mr. Chairman, from the Secretary of the Treasury and others, you have or will have received a mountain of testimony to the effect that our Federal income tax system is seriously tilted in favor of consumption and against the saving, investment, and capital formation that are so crucial to the well-being of American consumers, workers and producers. Time does not permit to restate these persuasive arguments. Instead, let me summarize quickly tax actions that this Committee might recommend to start redressing the imbalance in our tax system. This should not be done by increasing taxes on individuals. In fact, we favor permanent extension of the individual and small business tax reductions expiring at mid year.

First, Mr. Chairman, President Ford's proposal to reduce the corp rate from 48 to 46 percent has much to commend it. Unfortunately, few Americans realize that, as you have noted, corporations do not pay taxes, people do. This misunderstanding is a formidable obstacle to cutting corporate rates. Nevertheless, we urge the committee to seriously consider the proposal 1.

Second, the Investment Tax Credit, widely hailed as a powerful means of promoting jobs and growth through capital formation, should be made permanent at the 12 percent level recommended unanimously last year by the President's Labor-Management Advisory Committee. At the least, a permanent ITC of 10 percent—the current temporary level—is justified.

Third, our depreciation laws should be modernized by replacing the woefully inadequate historical cost system with one that allows for inflation. ADR should be retained and liberalized. And immediate write-off of expenditures for pollution control is justified.

Finally, with respect to capital formation, some start should be made toward reducing the double taxation of corporate dividends, perhaps by permitting corporations to deduct a portion (say 25 percent) of dividends paid.

Turning now to DISC. Largely as a result of the work of this Committee, this tax incentive was adopted in 1971 to increase exports while maximizing employment at home. Exports have more than doubled, and we are convinced (as is the Commerce Department) that DISC must be given a significant share of the credit.

Not so, say the critics. Devaluation of the dollar has in their view been the major factor (assisted by poor crops abroad). They also argue that in the future a "floating dollar" will solve all our problems—if exports weaken, the dollar will simply fall in exchange markets and exports will bounce back.

This is a false argument. Even if we were willing to see our dollar float downward indefinitely, thereby raising the real cost of imports, our competitors abroad would doubtless view the situation with considerable alarm and we could re-experience a series of competitive currency devaluations reminiscent of the "beggar-thy-neighbor" policies of the 1930's. Nobody wants that.

Critics also complain that DISC is "costing" much more than expected. If it costs more, it's because exports are up. If exports are up, export job-related jobs are also up. In other words, the higher estimates of revenue impact could reasonably be interpreted as a sign of signal success.

And beyond this, industry has been provided with job-creating capital funds in the process.

The attitudes in GATT are also interesting to note. If DISC is indeed ineffective, why have our competitors abroad screamed so loudly that it is an unfair export incentive?

Finally with respect to DISC, Mr. Chairman, it is very difficult for me to improve on the basic thrust of the testimony earlier this week by Representative Karth, who has studied this issue impartially and at great depth.

DISC should not be eliminated; it should not be made incremental; it should be retained in its present form.

TURNING NOW TO TAXATION OF FOREIGN SOURCE INCOME

Mr. Chairman, there is a disturbing tendency on the part of some observers to depict the foreign source income provisions of our tax laws as riddled with so-called "loopholes" that facilitate wide-scale tax avoidance.

This is incorrect. As is generally true throughout the industrial world, the U.S. system of taxation of foreign source income recognizes that the country in which business income is earned has primary tax jurisdiction over that income; that taxes should not be confiscatory; and that income should not be taxed until received. Current foreign sources income provisions of the tax laws, although exceedingly complex, are based on these principles.

Furthermore, abrogation of the principles would reduce the competitiveness of U.S. industry in world markets—and in many cases drive Americans out of business abroad—all to the detriment of American workers and consumers.

As is frequently the case, attacks on the existing system, and proposals to change it radically, are based largely on misunderstanding of the way the system actually operates.

Take, for example, the foreign tax credit, which is effectively designed to avoid double taxation of income earned abroad. Under the U.S. foreign tax credit provisions, a U.S. taxpayer can reduce his Federal income taxes, otherwise payable on his foreign source income, by foreign income taxes paid on such income. However, the reduction, or credit, for foreign income taxes paid on the foreign source income, cannot exceed the U.S. income taxes that would have to be paid on the taxpayer's income from foreign sources. This avoids double taxation and assures that taxes are paid in an amount at least equal to the U.S. corporate rate. It also eliminates the possibility of confiscatory taxation.

The foreign tax credit is no "giveaway." It does not reduce the foreign and domestic tax burden below the level that would be applicable if the income were entirely domestic income. Press reports that U.S. corporations with operations abroad pay only a relatively small part of their world-wide profits as Federal taxes are highly misleading, because they ignore foreign income taxes paid on the portion of world-wide income earned abroad.

The suggestion that so-called "deferral" be eliminated—that income earned aboard by subsidiaries be deemed taxable to U.S. shareholders before being re-

ceived, rather than, as is now the case, when remitted in the form of dividends—is also based upon misunderstanding.

The term "deferral" is a misnomer. Taxation of this foreign income by the U.S. before remittance—before receipt by the U.S. shareholder—would be "anticipatory taxation," which is clearly in conflict with our basic precept of taxing dividend income only when received by the shareholder.

The enormity of the misunderstanding becomes even clearer when it is recognized that other countries do not tax the unremitted operating earnings of foreign subsidiaries of their domestic corporations. And some countries, such as France and the Netherlands, do not tax foreign source income even when actually received by their nationals.

But even when these misconceptions are cleared away there are still critics who argue that the overall effect of our approach is too "export jobs" and increase investment of U.S. firms abroad at the expense of investment in the United States.

The facts are otherwise. The record clearly depicts a very favorable U.S. impact from operations of U.S. companies with subsidiaries abroad. U.S. employment of these companies has increased over twice as fast as other U.S. companies; their domestic sales and investment have increased faster; and their exports of goods produced here have outstripped those of other firms.

That record speaks for itself.

A final point, Mr. Chairman, brings us full circle to the capital formation problem discussed at the outset. Proponents of increasing U.S. taxes on foreign source income argue erroneously that the automatic result would be higher investment in the United States.

Domestic business does not go abroad because of so-called "deferral." It invests abroad to develop market opportunities in competition with foreign-owned, foreign-based producers, in markets which cannot be served from the United States for a variety of reasons.

Rather than penalize foreign income through higher taxes, is it not far better to enact legislation specifically designed to increase the after-tax return of investment in the United States? That would be the precise result of the Productive Tax Reform which I discussed earlier—and capital formation here would surely benefit.

CONCLUSION

In conclusion, Mr. Chairman, on behalf of The Business Roundtable, I cannot stress too strongly the fact that failure to adopt measures promoting greater capital formation, or the enactment of legislation violating the fundamental objectives of the foreign source income provisions of the law, would only in the first instance affect the business community. The ultimate impact would be on the American citizen—as a worker and consumer—and that impact would be detrimental to his economic well-being. Nothing less than his future standard of living is at stake.

Thank you very much.

SUPPLEMENTAL STATEMENT ON CERTAIN ITEMS OF TAX REVISION BY THE BUSINESS ROUNDTABLE

In order to focus attention on issues critical to the business community, The Business Roundtable has confined its statement to three major areas of tax revision: (1) tax measures to promote capital formation; (2) tax treatment of Domestic International Sales Corporations (DISC's); and (3) taxation of income earned abroad by U.S. businesses and their affiliates.

TAX MEASURES FOR CAPITAL FORMATION

Mr. Chairman, our Federal income tax system is tilted in favor of consumption and against saving and investment that are essential to a high and sustained level of capital formation. That view is supported by data and analyses, whether we compare the relative impact of tax structures here and among our competitors abroad, trends over the past few decades, or widely accepted projections for the future. If we do not begin now to redress this imbalance, it is the typical working man or woman who will ultimately suffer most.

This is because capital formation—coupled with the skill, industriousness, and ingenuity of workers and managers—is the secret of our economic success.

Capital formation is a "must" to create jobs for a growing labor force and enhance the productivity which restrains inflation and increases our competitiveness abroad. And, needless to say, capital formation is essential for achieving greater energy independence and financing future social services. In short, in the battle to foster capital formation, nothing less than the U.S. standard of living is at stake.

Although broad-based recovery is under way, the U.S. economy has performed poorly over the past decade. While there are those who would blame our recent problems of recession, unemployment and inflation on inappropriate stabilization policies, and these have indeed been less than perfect, the fact is that the economy had drifted badly out of balance in a fundamental sense. And a big part of the reason is that business had been unable to attract adequate amounts of investment—especially equity funds—at reasonable prices.

We must have Productive Tax Reform to stimulate capital formation in the producer sector. This is our most powerful means to increase productivity, prevent chronic inflation, provide jobs for a growing labor force, achieve greater energy independence, finance future social services, and advance our standard of living.

We need Productive Tax Reform—not the kind that sees every incentive to invest as a "loophole," but the kind that will enable business to finance this country's future.

Since 1960 the United States has had the lowest level of capital investment and the lowest rate of productivity growth of any of its major competitor countries. Here are the annual averages for the years 1960–73:

Country	Total investment as percent of GDP [1]	Nonresidential investment as percent of GDP [1]	Annual productivity increase (percent)
United States	18	14	3.3
Japan	35	29	10.5
Germany	26	20	5.8
France	25	18	6.0
Canada	22	17	4.3
Italy	21	14	6.4
United Kingdom	19	15	4.0

[1] Gross domestic product.

Source: Apr. 1, 1975, study by the Office of Financial Analysis, U.S. Treasury Department.

Nearly all these nations give more favorable tax treatment to capital investment than does the United States. Unless this imbalance is altered, the United States will face the loss of markets and jobs to these competitor countries.

Moreover, the United States will have to provide jobs for 7 million more persons in its labor force by 1980, and upgrade the productivity and earning power of the present labor force. By 1980, it will take an investment of $34,600 to support the average worker with needed plant and equipment.

It is estimated that in the period 1977–80, non-financial corporations will have to raise and invest about $312 billion a year, compared with $210 billion in 1974. If this is not done, the nation will face problems of chronic inflation, unemployment, and stagnation. Unfortunately, business is in no condition to raise $312 billion a year under present tax policies.

Business has four basic sources of funds for investment, and below is a reasonable estimate of where business would get the funds it needs each year, 1977–80, under present tax policies:

	Billions
Needed per year	$312
Depreciation	120
Retained earnings	36
New debt	96
New equity shares (best year to date: $11.4 in 1971)	10
Total raised	$262
Leaving a gap per year	$ 50

Business will be forced to try to close the gap by reducing investment in plant and equipment; by cutting back inventory buying; and by cutting back financial asset holdings. The result in all cases is reduced business activity, contributing to unemployment, slower growth in productivity, and posing problems of chronic inflation and stagnation.

This Committee can help solve this problem by recommending legaslation which will shift the anti-investment bias of the tax system to a more balanced one. This does not require an increase in individual income taxes; in fact, the tax cuts benefiting individuals and small business which expire at mid-year should be extended permanently.

The Federal government has recognized for many years the important role of tax policy in helping industry to generate internal funds for capital investment. Such tax policy measures have included the enactment of accelerated depreciation methods in 1954 and the investment tax credit in 1962, the issuance of the liberalized depreciation guidelines in 1962, adoption of the Asset Depreciation Range (ADR) system of depreciation in 1971, and the temporary two year increase in the ITC to 10 percent in 1975.

President Ford's proposal to reduce the corporate tax rate from 48 to 46 percent would, of course, be very constructive. However, the practical outlook for such action is not encouraging. One reason is that few Americans realize that—as you yourself noted on the Senate floor last year, Mr. Chairman—corporations do not pay taxes, people do. Since the corporation is simply a "surrogate collector" for the Internal Revenue Service, sooner or later the taxes are borne by people like you and me. Nevertheless, we recommend that the Committee seriously consider President Ford's proposal.

NEED FOR PERMANENT INVESTMENT TAX CREDIT

While it would be preferable to move to the 12 percent level recommended unanimously by the President's Labor-Management Advisory Committee last year, assurance that the temporary 10 percent credit will be converted to a permanent part of our tax system—not subject to the on-again, off-again treatment of the past—would do much to foster the long-term planning so essential to capital formation.

The investment tax credit and the ADR system have been improperly attacked by some as "loopholes." The critics imply that national policy objectives behind enactment of those provisions were somehow unintended. This simply is not the case. Congress recognized these as necessary measures to encourage activity that it considered to be in the best interests of the country.

These provisions were needed to stimulate the economy, create additional jobs, combat inflation by increasing the flow of goods into the market, encourage expenditures for machinery and equipment, help our exporters compete in foreign markets, and improve our balance of payments. Certainly these continue to be necessary national objectives.

Current and long-range capital requirements in the United States argue strongly for permanent increase in the investment tax credit for all taxpayers. Such an increase would help offset some of the effects of inflation on capital formation, would contribute to improved corporate liquidity and would serve as a strong incentive to the modernization and replacement of existing facilities and investment in new facilities.

It would be highly desirable that the investment tax credit be increased to a permanent 12 percent rate for all taxpayers and without any corresponding reduction in the basis of the property. The credit should be made fully applicable to expenditures as incurred in the case of property being constructed by and for the taxpayers, and the increase in limitation for the years 1975 through 1980 on the amount of a public utility's tax liability that may be offset by the investment tax credit should be made applicable to all regulated industries and to industry generally.

NEED FOR IMPROVED CAPITAL SYSTEM

U.S. tax laws relating to depreciation are badly in need of modernization. Here again, study, discussion and debate are necessary, especially with respect to appropriate methods of replacing the woefully inadequate historical cost system with one that allows for inflation.

Although Congressional actions in 1971 significantly improved the rate of capital recovery in the United States, existing capital allowances, which are

based on the outmoded concept of depreciable life, still do not fully take into account the rapid pace of technological advances, obsolescence, liberal depreciation allowances enjoyed by foreign competitors and the ever-increasing cost of asset replacement in an inflationary economy.

Current and long-range capital requirements in the United States require an immediate, permanent and substantial improvement in the nation's capital recovery system.

As an immediate step, Congress should increase the present depreciation range permitted under the Class Life ADR system from 20 percent to 40 percent of the current class lives, and provide shorter recovery periods for industrial buildings. Also, the class lives should be made permanent and not subject to administrative change. In addition, capital recovery deductions should be permitted when expenditures are incurred rather than when assets are placed in service, and taxpayers should be allowed to fully recover their investments without regard to salvage value.

For the longer term, Congress should enact a true capital recovery system. Under such a system the investment in machinery and equipment would be recoverable for income tax purposes over a period of up to five years and the cost of industrial buildings would be recoverable over a period of up to ten years.

Any capital recovery system, if it is to increase investment in the job-creating tools of production, must provide for a permanent investment tax credit at full rate and use of accelerated methods of computing the annual capital recovery deduction.

Finally, a start should be made toward development of a capital recovery system which will allow taxpayers to adjust their capital recovery allowances to compensate for the erosion of inflation. The present historical cost system is woefully inadequate and any permanent solution to the problem of capital formation in an inflationary economy requires adoption of some appropriate procedure that recognizes and allows for inflation.

WRITE-OFF OF POLLUTION CONTROL FACILITIES

As a further recognition of the need for adequate and timely capital recovery, Congress should enact legislation to permit amortization of the costs of certified pollution control facilities over any period selected by the taxpayer, including the immediate write-off of such costs in the year of acquisition. Expenditures for facilities including land, buildings and equipment, whose principal purpose is for pollution control, should qualify for immediate deduction for Federal income tax purposes.

Immediate write-off of pollution control facilities is consistent with the concept that the costs of pollution control facilities should be shared equally with the general public through the participation of the Federal government. In addition, although the concept of tying tax depreciation deductions to the underlying asset's useful productive life is obsolete and should be discontinued, the immediate write-off of pollution control expenditures would be consistent with the concept because such assets seldom are of an income producing character. The immediate write-off of such expenditures would also minimize the diversion of funds from other capital programs involving projects which would provide a financial return and result in increased output of goods and services.

RETENTION OF PERCENTAGE DEPLETION

Congress has consistently over the years recognized the significance of natural resources to the security and the economy of the nation.

The percentage depletion provision in the Federal tax laws represents the judgment of Congress that money which could be obtained by the public sector through taxes can better serve the public interest by remaining in natural resources industries, where it can be put to use in helping to offset deterioration of America's vital raw materials and energy base. This tax incentive has been available to the extractive industries for nearly half a century and has served well the purpose for which it is intended. Percentage depletion is fully as important today to the natural resource industries as it has been in the past, perhaps even more so.

While Congress recently cut back significantly the percentage depletion write-off for oil and gas, it should take no further adverse action in the depletion area, since the discovery of minerals is becoming more and more costly. The minerals

industry must expend great sums of money on exploration and this requires sophisticated and expensive geological, geochemical and geophysical equipment. On top of these expenditures, the extractive industries are faced with large increases in costs as a result of environmental and health and safety legislation which has been enacted in recent years.

Historically, the extractive industries could and did meet their capital needs by means of internally generated cash flow. This, however, is no longer true. In recent years these industries have turned increasingly to debt financing, thereby significantly increasing both the debt burden and the debt/equity ratio. The ability to generate capital internally, and to attract outside capital, is dependent on profitability since that determines cash flow and return on investment. The lower the profits, the less funds are generated internally to meet capital needs. Decreased profitability in turn decreases the attractiveness for external financing. Finally, even when external financing is obtained, the ability to service new debt burdens is impaired whenever profits drop.

Percentage depletion is essential because it will help generate some of the capital needed to finance the required expansion of mineral output. Specifically, it can contribute up to one-third of the estimated capital required, depending on the particular mineral. In addition, the allowance for depletion helps generate earnings and to that extent helps attract investment funds.

INTEGRATION OF CORPORATE AND INDIVIDUAL INCOME TAXES

The double taxation of corporate dividends—once to the corporation and again to the shareholders when they receive their dividends—has had undesirable effects on the American economy.

It has reduced the effective return on equity securities, making them less attractive to investors and diverting savings into other kinds of investments, with a depressing effect on the rate of return on those investments. Elimination of the double tax would increase the rate of return on all savings and facilitate the capital formation which is needed to meet the economic challenges which face us.

The double tax has created a strong bias against new equity capital and in favor of debt financing. The fact that interest is tax deductible while dividends are not has resulted in a steady increasing use of debt financing to expand the capital base of American industry. This has weakened the financial structure of many businesses and has contributed significantly to the rise in long-term interest rates.

The double tax discourages investment in dividend paying stocks. This has contributed to the difficulties faced by utilities in raising the equity capital they need to meet the expanding energy and communication needs of our growing economy, because they have to rely on high dividend payments to attract investors.

From the standpoint of tax equity, dividend income should not be taxed more heavily than other forms of income. The mere fact of doing business in corporate form should not subject the owners to a double tax and place them at a disadvantage vis-a-vis other forms of business enterprise.

There are two basic ways of alleviating this double taxation burden and they have different impacts on the corporation and its shareholders.

The simplest and most straightforward method is to allow the corporation a tax deduction for dividends paid. This method has many advantages: First, the tax savings can be used to increase retained earnings of the corporation, where the need for capital lies. Second, equity financing is put more nearly on a par with debt financing, because both dividends and interest would be tax deductible. This encourages the maintenance of sounder debt to total capital ratios. Third, the corporation may be enabled to increase the dividend rate, thereby increasing the rate of return and encouraging equity investment. Fourth, the corporation's cash flow and earnings are favorably affected with a beneficial effect on the price of the stock and the corporation's ability to market its stock. Finally, integration can be phased in by annual increases in the percentage of dividends allowed as a deduction.

Allowing the corporation a deduction goes somewhat beyond the elimination of the double tax, of course, because many holders of corporate stocks pay no tax on their dividends. Many large shareholders are nontaxable entities such as pension funds and charitable foundations. Other holders are in low income brackets and have no tax liability. However, these nontaxable holders are never-

theless bearing some of the burden of the corporate tax, because it results in lower dividend payments, so some form of relief is in order.

The other basic method of achieving integration is to require shareholders to gross-up their dividends by the amount of the corporate tax and allow them a refundable credit equal to the gross-up. This method has the following attributes: First, the tax savings accrue to the shareholders. If the corporation wishes to recapture the savings for capital investment, it may issue new equity securities, reduce the dividend rate, or both. Second, a reduction of the dividend rate can cause adverse shareholder reaction and have a depressing effect on the price of the stock, even though the credit allowed the shareholders is in fact an additional dividend which can be realized through reduction of the shareholder's tax liability. Third, the credit can be denied to tax exempt organizations and foreign shareholders if relief for them is considered inappropriate. Finally, integration can be phased in by annual increases in the dividend gross-up percentage, using multiples of 10 percent to simplify matters for shareholders.

Our principal foreign competitors already have in place integration methods which partially eliminate the double taxation of distributed corporate earnings. Canada, France, and Great Britain use the shareholder credit method, while Germany uses a split-rate method which is essentially the equivalent of a corporate dividend deduction. Japan uses a combination of the split-rate and shareholder credit methods, but with no gross-up of dividends by the shareholder.

In view of the pressing need for American business to generate additional capital through equity financing and retained earnings, prompt enactment of appropriate legislation to deal with the inequity of double taxation of corporate dividends is essential. Whether it takes the form of a dividend deduction or shareholder credit, or a combination of both as recommended by the Administration, is of secondary importance. The important thing is to accept the idea that integration will benefit the economy and enact a program which will achieve elimination of the double tax within a reasonable period of time.

DOMESTIC INTERNATIONAL SALES CORPORATION

The DISC provisions, which permit a U.S. taxpayer to defer payment of his U.S. tax on a portion of his income derived from the export of U.S. manufactured products, with certain exceptions, were enacted into law in December 1971. The purpose of this legislation was to create more jobs for American workers, stimulate the U.S. economy, provide funds for increasing the efficiency of U.S. production for both domestic and world markets, and make U.S. products more competitive in worldwide markets by partially responding to the tax and other export incentives given by many foreign countries to their own exporters. These incentives include not only rebates of taxes on exports but also government financing and insurance on terms not available to U.S. businesses, reciprocity agreements with other nations and nontariff barriers to shield export industries from local price competition so that export prices can be lowered.

To obtain the benefit of the DISC tax deferment, the taxpayer must invest the income on which tax is deferred in the taxpayer's export business or certain other export related activities. As a measure of the amount of tax deferment as compared with the sales dollar giving rise to the export income, the tax deferment in the case of a taxpayer realizing a profit of 8 percent on export sales would be approximately 1 percent of his export sales qualifying for DISC treatment. This benefit offsets only in part the tax rebates and incentives granted by other countries.

Since 1971, U.S. exports have increased from $43 billion to $107 billion in 1975—a 150 percent increase in only five years. While there are a number of factors affecting international trade, there should be no doubt that the existence of the DISC incentives has contributed to this tremendous growth, although its specific contribution cannot be quantified. The Commerce Department, however, has estimated that $7 to $9 billion of increased export sales of $27 billion in 1974 were attributable to DISC, that these export sales created 280,000 to 360,000 U.S. export related jobs, that there was a resultant increase in the Gross National Product of $21 to $27 billion with an increase in Federal tax revenues of $5 to $6 billion compared with an estimated tax deferral for DISC of $1.05 billion. These are impressive facts illustrating the beneficial effects of DISC on the domestic economy.

DISC has had a favorable influence on business decisions to expand or modernize U.S. facilities. It has provided funds in a period of a severe cash liquidity problem facing U.S. business to expand U.S. facilities, to finance export related

receivables which, in many instances, involve long-term credits requiring more permanent financing arrangements by the exporter, and to provide risk funds for supporting long-term marketing projects to expand exports, which otherwise would not have been funded because of budgetary and other economic restraints. Thus, it has not only contributed to an increase in current exports of U.S. manufactured products but also to the development of a base for future export sales which are vital to our U.S. economy and necessary to offset the costs of imports of required raw and other materials.

As indicated by Commerce Department's estimates, DISC is more than paying its own way. The fact that members of GATT (General Agreement on Tariffs and Trade) have registered strong protests that DISC is in violation of the terms of that agreement should be indicative the DISC does in fact offset, at least in part, export incentives of other members of that agreement and help in making U.S. products more competitive in worldwide markets. The considerations which gave rise to enactment of the DISC legislation in 1971 are even more valid today as the United States faces the task of revitalizing its economy in the face of a severe domestic capital shortage, increased costs of energy related imports and increased competition in world markets by foreign products supported by governmental export related programs of other nations.

It would be highly imprudent and adverse to the economic interests of the United States to repeal or water down any export related program under existing tax law which has been and is achieving its purpose of providing U.S. jobs and permitting U.S. business to be competitive in world markets.

FOREIGN TAX CREDIT

Not so. The U.S. system of taxation of foreign source income recognizes the foreign source income provisions of our tax laws as riddled with so-called "loopholes" that facilitate wide-scale tax avoidance.

Not so. The U.S. system of taxation of foreign source income recognizes the universally accepted premises that the country in which income is earned has primary tax jurisdiction over that income; that taxes should not be confiscatory; and that income should not be taxed until received. Current foreign source income provisions of the tax laws, although exceedingly complex, are based on these principles. Any changes made should continue to honor these principles. Abrogation of the principles would reduce the competitiveness of U.S. industry in world markets and drive Americans out of business abroad—all to the detriment of American workers, consumers, and the U.S. economy.

The foreign tax credit has been an established feature of the United States tax law since 1918. It permits an American taxpayer who has earnings derived from foreign countries to reduce his Federal income taxes otherwise payable on his foreign source income by foreign income taxes paid on such income. However, the reduction, or credit, for foreign income taxes paid on the foreign source income cannot exceed the U.S. income taxes that would have to be paid on the taxpayer's income from foreign sources. Its purpose and its effect is the prevention of double taxation of the foreign source income of U.S. investors and companies—once by the source country and again by the United States. In the absence of the foreign tax credit, the foreign source income of U.S. companies could be subject to tax at combined rates approximating 75 percent or more.

If the foreign tax credit should be eliminated, and as a result American business is taxed at what would be confiscatory rates competitively, American business could not operate in world markets. Among the results that could be expected from this situation would be (1) the United States could no longer remain involved in the development of the natural resources of the world, (2) exports from the United States would be significantly reduced, and unemployment in export industries would rise, (3) the United States balance of payments would suffer, and (4) tax treaties with the other major industrial countries would be jeopardized.

Host countries exercise their primary rights to tax income earned by American corporations within their borders. Moreover, the United States imposes income taxes on world-wide income including that earned abroad. Therefore, some form of accommodation is required to prevent double taxation. That accommodation is achieved, through the foreign tax credit or other equivalent means, by every major industrial country. Under the United States foreign tax credit provisions a U.S. taxpayer can reduce his Federal income taxes otherwise payable on his

foreign source income by the amount of foreign income taxes paid on such income.

Absent the present foreign tax credit mechanism, the result would be confiscatory taxation of income earned abroad, as is illustrated by the following example:

	Foreign income taxes allowed as a—	
	Deduction	Credit
Foreign subsidiary:		
Income before foreign income taxes	$1,000.0	$1,000
Foreign income taxes	400.0	400
Net income	600.0	600
Foreign withholding tax on distribution of net income	90.0	90
U.S. parent corporation:		
Dividend received	510.0	510
Creditable foreign income taxes		490
Taxable dividend income	510.0	1,000
Federal income tax—gross at 48 percent	244.8	480
Foreign tax credit		490
Net Federal income tax	244.8	
Net income	265.2	510
Effective tax rate (percent)	73.48	49

Certainly, an increase in total taxes from an effective rate of 49 percent to over 73 percent would be confiscatory, rendering U.S. interests operating abroad non-competitive with foreign-owned companies.

It should be noted that the foreign tax credit can be used only as a credit against taxes payable on foreign source income and cannot be used as a credit against Federal income taxes on U.S. source income. It should also be noted that the minimum tax payable on foreign source income is the U.S. corporate rate, and that in any case in which the foreign tax is below 48 percent at the present time, the taxpayer must pay U.S. taxes to the extent of the difference between the foreign tax and the U.S. tax at the 48 percent rate. Thus the effect of the foreign tax credit is not to reduce the overall tax burden borne by U.S. businesses operating abroad, but rather to accommodate to the situation where more than one nation has tax jurisdiction.

U.S. business must continue to be competitive in world markets. The benefits of such foreign investment are self-evident. These benefits (including the level of U.S. exports and repatriated foreign earnings) would be forfeited if U.S. business were subject to more burdensome taxation than its foreign competitors, as would be the result if the foreign tax credit provisions were repealed or subject to further non-competitive limitations. If situations exist where the present foreign tax credit provisions produce unintended results, then such situations should be dealt with specifically and not in a manner which would destroy the competitive position of all U.S. businesses engaged in international trade.

Therefore The Business Roundtable urges that the foreign tax credit principles under present law not be eliminated or changed.

ANTICIPATORY TAXATION OF U.S. SHAREHOLDERS OF CONTROLLED FOREIGN CORPORATIONS

Under present law, a U.S. shareholder of a controlled foreign corporation is not subject to tax on its proportionate share of the earnings of the foreign corporation until those earnings are received by it.

Notwithstanding, it is proposed by some that present law be changed so as to tax to a U.S. shareholder invested earnings of a foreign subsidiary even though such shareholder has not or may never receive such earnings. While this proposal is commonly referred to as the "elimination of deferral," this is a misnomer. Quite to the contrary, it represents anticipatory taxation of income which might never be realized by the U.S. shareholder. This is because of the probable existence in the foreign country of exchange or other restrictions on profit distributions.

reinvestment requirements of the business, devaluations of foreign currencies, subsequent operating losses, expropriation and the like.

Assumptions made by those suggesting the radical change to anticipatory taxation are unsound. They are that:

a. U.S. businesses have a completely free choice as to where they manufacture or produce their products for world-wide distribution.

b. Products manufactured by U.S. subsidiaries abroad primarily are for imports into the United States.

c. Such products would otherwise be manufactured in the United States.

These assumptions are not supported by the facts.

DEFERRAL NOT A PRINCIPAL FACTOR IN FOREIGN INVESTMENTS

The reason why U.S. firms establish operations abroad relates to market opportunities or marketing requirements. All too frequently obstacles are placed in the way of serving the foreign market by exports from the U.S., such as restrictive import duties, requirements that a percentage of the product be manufactured locally, on-site inspection requirements, governmental procurement practices, and other regulatory provisions. To overcome such obstacles and to retain a place in that market it becomes necessary for the U.S. producer to start to manufacture in that market area. Since he cannot serve that market by exports from the United States, his only alternative would be to leave the market to others.

The principle that is overlooked by the anticipatory taxation proponents is that foreign subsidiaries of U.S. firms are not in competition with U.S. manufacturing operations but with foreign-owned and foreign-based manufacturers. 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.

SUGGESTED CHANGE WOULD HAVE AN ADVERSE IMPACT ON U.S. ECONOMY

U.S. anticipatory taxation of income of foreign subsidiaries of U.S. businesses would place upon such subsidiaries a tax burden which would not be borne by foreign-owned competitors. No business can withstand this kind of competitive disadvantage without serious consequences.

Markets would be lost to foreign competitors, thus eliminating a source of earnings flowing back to the United States.

U.S. balance of payments and funds available for investment in production facilities and research and development in the United States would be reduced.

More important, it would adversely impact U.S. employment by the elimination of exports from the United States, which would otherwise be generated from sales of equipment, the exporting of high technology components and parts for further manufacture and assembly abroad, and the cessation of "draw through" sales which are made possible only by presence of the U.S. subsidiaries abroad.

A recent study by the National Association of Manufacturers estimates that, if foreign subsidiary earnings reinvested abroad were immediately subjected to U.S. taxation, employment in the United States over a 5-year period would decrease by 680,000 jobs. ("Tax Impact Project Report," National Association of Manufacturers, Washington, D.C., June, 1975.)

FOREIGN INVESTMENT BENEFITS THE U.S. ECONOMY

The great mass of information gathered from numerous surveys and analyses made in 1972, both governmental (Department of Commerce) and private (NAM, NFTC, ECAT and the like), provides persuasive evidence that foreign investment brings significant positive benefits to both the U.S. balance of payments and the domestic economy. The studies demonstrate that:

There is positive relationship between investment abroad and domestic expansion. Leading U.S. corporations operating both in the United States and abroad have expanded their U.S. employment, their domestic sales, their investments in the United States, and their exports from the United States at substantially faster rates than industry generally.

Very small percentages (from 3 percent to 9 percent, depending on the measurement) of the total sales of American-owned manufacturing subsidiaries abroad are made to the United States. Most imports come from sources other than foreign affiliates of U.S. firms.

Over half of the after-tax earnings of foreign affiliates are typically remitted back to the U.S. parent and nearly half of this amount is retained for investment in domestic plant and equipment. The net remitted earnings (total remitted earnings minus total foreign direct investment) of the key American firms with foreign direct investments have, for a recent 5-year period (1967–71) provided the capital to create or maintain more than 200,000 U.S. jobs.

Earnings remitted to the United States from foreign direct investments have exceeded those investments and have been the most important single positive contribution to the U.S. balance of payments.

The average payback period for U.S. investment abroad is six to ten years. On the basis of income generated, direct investment abroad is beneficial in the longer term to the U.S. balance of payments position.

29 percent of all U.S. manufactured exports are directed to foreign affiliates of U.S. companies.

SUGGESTED CHANGE WOULD NOT SIGNIFICANTLY INCREASE U.S. TAX REVENUES

We can be confident that the proposal would not result in any meaningful increase in Federal tax revenues. Any additional revenue would go to the foreign country rather than to the United States. Professor Dan Throop Smith put it very well when he said:

"The attempt to tax on the basis of presumptive distributions from foreign subsidiaries would in fact produce little revenue. The countries in which foreign subsidiaries are located quite understandably would tax the subsidiaries on presumptive dividend distributions, thereby providing a basis for foreign tax credits which would offset the U.S. tax.

"It is a strange state of affairs when enthusiasts for more taxes seem to be unconcerned as to whether the revenue goes to the U.S. Treasury or a foreign government. An additional tax burden on U.S. business abroad, induced by U.S. tax legislation, when the revenue goes not to the United States but to foreign governments would seem to represent the ultimate excess of a love of taxation for the sake of taxation." [1]

Finally, as most tax experts agree, including those in the Treasury, the elimination of deferral in whole or in part would be a further complication in the Internal Revenue Code. It would increase the administrative burdens on both Treasury and U.S. taxpayers. It would make more difficult tax treaty negotiations.

It would be strange indeed if the United States imposed such a punitive tax burden on international operations of U.S. businesses, so vital to the overall U.S. economy, one which would impact adversely on their competitive position abroad. No other country similarly penalizes the active conduct of the trade or business of its foreign affiliates abroad. In fact, some countries, such as France and the Netherlands, do not tax such earnings even when distributed.

The Business Roundtable urges that the existing U.S. tax treatment of foreign income should be continued in order to maintain the competitiveness of U.S. business in, and allow its entry into, these foreign markets.

The CHAIRMAN. Our next witness is Paul L. Dillingham, director and chairman of the Tax Policy Committee of the Tax Council.

STATEMENT OF PAUL L. DILLINGHAM, VICE PRESIDENT AND DIRECTOR OF TAXES, THE COCA-COLA CO. OF ATLANTA, GA., AND DIRECTOR AND CHAIRMAN OF THE TAX POLICY COMMITTEE OF THE TAX COUNSEL

Mr. DILLINGHAM. Mr. Chairman, I thank you for that introduction. I appear here today as a representative of the Tax Council of which I am director and also chairman of its Tax Policy Committee.

The council is a nonprofit, business-supported organization solely concerned with Federal tax policy. From its inception nearly a decade

[1] Statement before House Ways and Means Committee on Panel Discussion of Tax Reform, February 1973.

ago, it has stressed the benefits to the public which would flow from taking the bias against capital out of the Federal tax structure.

I am privileged to be here today, Mr. Chairman, and wish to express our compliments and appreciation for the inclusion of capital formation as a separate subject in these hearings. In the hope this opportunity would be provided, last fall our tax policy committee took an especially deep look at the council's program for a capital conscious Federal tax policy. We made some very material additions and revisions, and our appearance today enables us to present the new program to you. It is attached to this statement, and I ask that it be included in the record.

The CHAIRMAN. It will be included.

Mr. DILLINGHAM. Here, I will simply summarize and stress some major considerations.

SUMMARY

One: Forward legislating. Now is the time not only to plan but to enact the capital-releasing tax reforms needed to help avoid a new capital crunch in the late 1970's and early 1980's.

Two: Goal for capital-releasing reforms. The council proposes a national policy goal for capital-releasing reforms which would raise the level of gross investment spending from the range of 15½ percent to 17 percent of gross national product. This would add some $30 billion to investment spending in a $2 trillion economy.

Three: A spaced out program. The agreed upon reforms which cannot be fitted into the budget for the next fiscal year should be included in a legislative program with spaced-out effectuations. The council proposes that these reforms be financed by allocating for the purpose one-half of the projected revenue gain from economic growth, excluding social security levies.

Four: Avoiding new tax burdens. In pursuing the goal of letting more capital remain in the private economy, changes in the tax law which would increase the burden on actual or potential capital should be avoided. Specifically, with respect to the tax reform legislation pending before you, H.R. 10612, the council urges that—

A. Foreign business operations. There be no increases in tax on business and earnings from foreign investment and export, and

B. Capital gains. There be no increase in the tax on capital gains directly or through the minimum income or other tax forms.

Five: Capital-releasing tax reform. Briefly, the Council's proposals for capital-releasing tax reforms are:

A. Capital recovery allowances. Capital recovery allowances should permit the deduction of the cost of a tangible asset over a period of time considerably shorter than the present system permits.

B. Investment credit. The investment credit should be liberalized, made permanent and fully applicable to all assets subject to the capital recovery allowances with appropriate recapture rules.

C. Pollution control facilities. Taxpayers should be permitted to write off the cost of pollution control facilities—whether in connection with existing or new plants or properties—over such time as they deem appropriate and with reasonable rules for separating such facilities from productive facilities. These facilities should be eligible for the full investment credit.

D. Depletion. Percentage depletion serves the public interest by maximizing the search for and development of mineral deposits and minimizing prices paid by consumers. Hence, the provisions deleted in 1975 should be restored.

E. Corporate tax rates. The top rate of corporate tax should be reduced two or more percentage points a year in a legislative program designed to achieve a top rate below 40 percent over a period of years.

F. Double taxation. The double taxation of corporate income paid out in dividends should be ended through steps legislated to take effect over a period of years, preferably through a grossed-up stockholder credit.

G. Domestic intercorporate dividends. The tax on domestic intercorporate dividends should be eliminated.

H. Minimum income tax on corporate income. Corporate income should be removed from coverage under the minimum income tax because the tax form is not appropriate to the tax object.

I. Minimum income tax on long-term capital gains. Because long-term capital gains are capital and not income, they should be deleted from the list of so-called income tax preferences subject to the minimum income tax.

J. Personal income tax rates. The same scale of rates should be applied to the incomes of married taxpayers filing separate returns and to each half of the taxable incomes of married couples as is applied to the taxable incomes of single taxpayers; the 70 percent top rate on investment income should be reduced to the 50 percent top rate on earned income; and there should be begun a program of annual steps in reducing rates which would flatten the curve of graduation through the middle brackets to the top rates of 50 percent, while cutting all lower rates an average of about one-third.

K. A capital transfer tax system. Regular long-term gains of individuals should be taken out of the income tax system and taxed as the transfers of capital which they are under a new system aligned with the estate and gift taxes, with the new rates ranging from 4 to 22 percent.

L. Other gains and losses. With respect to sales of assets remaining taxable under the income tax system, both individual and corporate, (1) short-term losses should be fully deductible against income; (2) long-term losses should be deductible against income in the full value equivalents of the long-term rates; and (3) the accepted principle of averaging income should be recognized by both the carryforward and carryback of losses.

M. Estate and gift taxes. Rates should be reduced through an orderly plan extending over a period of years, and a practical means should be provided for paying taxes due in income-producing property out of income and not by liquidating the property.

N. Credit for capital gain taxes. In contrast to the proposal to exact a double tax at death on unrealized gains, the council proposes a credit of capital gains taxes paid during life against estate taxes due at death.

I hope I don't read it in the papers tomorrow that the Tax Council favors tax breaks for big business and the rich because that is not what our program is all about. The elimination of bias does not

add up to tax breaks for anybody. What the Tax Council seeks, and in fact what businessmen individually and collectively seek, is a system which puts less actual and potential capital through the tax grinder. The ultimate, economic question, and the one tax policymakers must face, is how to get more consumption. There is the message of the pied pipers of tax reform that the way to more consumption is heavier taxation of business and the rich. It may be fun for a day or a month to kill the goose that lays the golden eggs and eat the seed corn, but that's the end. Tax policy designed to favor consumption over capital will be adverse to both. Investment precedes consumption, and over any economic cycle increased investment is the only means to increased consumption. The business community, which carries the responsibility of being the primary user of the Nation's stock of capital, also must function as the claimant in the public interest for a tax policy which is not unduly restrictive of capital formation. There always will be those who suspect our motives. But, if the business community did not perform the function, who would?

Ever since the gloom-and-doom days of the Great Depression, the role of claimant for a lesser tax impact on capital has been complicated by the myth of idle capital. A pervasive thought among some political leaders and other opinion molders has been that there always is plenty of capital around—the only problem is to decide what to do with it. In the 1972 Presidential campaign, for example, candidate McGovern talked of employing idle capital for specific purposes.

The problem, of course, is just the opposite. It always is where to find the capital, not what to do with it. The myths of idle capital may rest in part on misunderstanding as regards capital movements or the mobility of capital. Capital is moving around all the time, but from one use to another. In the economic sense, existing capital always is employed. When capital moves from one investment to another, other capital moves in where the disinvestment occurred. Thus, while old capital may be used for new ventures, and new capital may replace capital in old ventures, net increase in the total of investment in any period is dependent on the net generation of capital in that period.

It is an economic fact that yesterday's capital will not be available to meet tomorrow's needs.

Nor will tomorrow's capital ever be enough to meet all the needs which would serve the public interests.

Now is the time to get ready if there is to be more capital as we turn the corner from the 1970's into the 1980's.

Over the past 25 years, the ratio of investment or capital spending to gross national product in the United States has ranged around 15½ percent. There is a consensus that this ratio must increase if the Nation is to realize what's needed in relation to progress and jobs over the years ahead. For the purpose of suggesting a national policy goal, we have assumed that a 10-percent increase to a range of 17 percent of GNP would reasonably meet the need. Such an increase would add $30 billion to investment spending in a $2 trillion economy. In such an economy, consumption expenditures would be rising at a rate of over $100 billion a year without taking into account the increased production which would result from the capital-releasing tax reforms.

There seems to be a belief around that conventional tax reform, and what might be called capital formation reform, are compatible movements. The objective of the conventional movement is to increase the tax burden on business, high incomes and the rich—which translates into increasing the taxes on existing capital and on income which, if not taxed, would become new capital. The only way we can get to a higher ratio of investment to GNP is by lessening the impact of taxes on capital. The movements are incompatible in the sense that their overall objectives are poles apart. A dollar of capital is part of the aggregate capital supply no matter where it is located in the economy. Capital converted to Government spending by taxes must be replaced by new savings out of current income before there is net addition to the aggregate supply—or there is any prospect of increasing the investment ratio.

The success of the conventional reform movement has come from implanting in the public mind a single thought—that the average and lower incomes would not be taxed so heavily if the rich paid their fair share of taxes. Even if the tax system did spare the rich, it would be misleading to tell the public that their taxes would be less if the rich were taxed more. After the brief feast, there would be less capital formation and economic growth, and fewer jobs, and there soon would be less tax revenue leading to higher tax rates on the general public.

But the present tax system spares neither capital nor the rich. In our new program we estimate that, at current tax levels, the tax drain on actual and potential capital supply totals some $70 billion annually: $12 billion of this total represents the conversion of capital to Government spending via the taxes on estates, gifts, and capital gains.

As regards the rich, the conventional reformists make the points: More rich people than others pay no income tax; a higher percentage of the higher incomes than of the lower incomes is carried forward to the tax base; high-income people don't pay the statutory rates; and adjusted gross income is a meaningless figure for higher incomes because of exclusions. As shown in the four tables in exhibit A, each of these assertions is refuted by official data.

You may have noted as I have presented this statement, and with respect to other Tax Council writings, that we do not describe any of our tax proposals as incentives or stimulants. The reason is that we do not think of them in this frame of reference and, in fact, do not believe that either description would be accurate with respect to any of them. Some of the anticapital bias of the tax law have a disincentive effect and, to the extent that it does, the correcting proposal(s) would serve to moderate or eliminate disincentive. But the problem of the tax law with which we are concerned is that it destroys too much existing capital and does not permit the building of enough new capital out of income. All economic experience testifies to the fact that more capital means a better life for everybody.

American businesses and businessmen, managers and shareholders, all want to retain more of their existing capital and to be able to build more capital out of current income. But their desire for more capital is for constructive purposes, to put it to work to increase production, the number of good jobs and the level of consumption. It may be rough going politically to get the antitax bias out of the tax law, but the public interest would be well served if it could be done.

The CHAIRMAN. Thank you very much, sir. I would like to invite your group, Mr. Dillingham, to have whoever you think is best qualified to understand the economics of this problem consult with Dr. Ture who testified here today, and those with whom he will be consulting in Treasury and on the joint committee staff, and add your input on what the final impact of these proposed tax changes would be. I just don't want us to be thinking that we can raise $1 billion in revenue by putting additional taxes on business which might not raise us anything. We should see 1, 2, 5, 6, 7 years of impact so that if we are voting on something that is going to do more harm than good. we should know about it. We would not overlook the ripple effect, for better or for worse, of these various suggestions that you are making and those that have been made in exactly the opposite direction. As you have indicated, some of these proposed tax increases would be counterproductive. I think they probably would be. I would like to hear both points of view.

We enacted the DISC to help encourage sales abroad. We have a lot of evidence presented to us to support two different arguments, one that the repeal of DISC would greatly help tax revenues, and the other that the estimates are altogether too optimistic and the repeal would not achieve anything like that.

We still don't know for sure which side is right about that, but we ought to hear the best argument that can be presented for both sides. We would welcome you and your economists making an input in this matter.

Mr. DILLINGHAM. We would be delighted to participate in this.

The CHAIRMAN. Senator Byrd.

Senator BYRD. No questions.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. I have 2 questions I would like to read and hand them to Mr. Dillingham so he can respond to them or respond in writing so they may be included in the record. Whatever would serve your purpose best.

I note you recommend elimination of double taxation of dividends income over a period of years preferably through a stockholder credit. Why do you prefer a stockholder credit over a deduction of dividend payments by the corporation?

The second question is: Would you elaborate with respect to your proposals on capital recovery and the investment credit. How would you balance the proposed liberalization in the two areas.

Mr. DILLINGHAM. I will try to briefly answer that Senator Hansen.

First of all with respect to double taxation of dividend income, we have noted in our formal paper that we would prefer the stockholder credit. However, we expressed willingness to go along with the corporate discussions. I think individual corporations may prefer a deduction because of the immediate effect on cash flow of internal funds. I would feel the broad economic view is there seems to be little difference between the two as regards increase in the amount of capital.

It seems to me that stockholder credit would have better effect, in that it would perhaps reduce the cost of equity capital which has been a problem in the last several years and would take companies in a better position to attract new capital through equity issues. This would

tend to spread stock ownership among a greater number of people, perhaps at the lower income levels. In the full program that the Tax Council prepared last December we have a chart which shows an interesting effect that if you look at an individual stockholder who is in the 48-percent tax level, then by a stockholder credit on dividends, he would still pay the same amount of tax. If he is in the 70-percent level, he would still pay a fairly significant amount of tax, as I remember, about 42 percent, whereas an individual in the lowest income level, 14 percent, would end up with a tax credit for some 65 percent of the dividend he would receive which he could offset against other tax liability. This would encourage the low-income individual to invest in stock. We prefer the credit but certainly either a credit or deduction would accomplish the same goal.

Your second question was how we would balance the liberalization of the capital recovery allowance and investment credit, We believe the economy would benefit if the regular investment credit were raised up to say 12 percent and made permanent which I think is the most important part of it, and if the depreciable lives were reduced to something around one-half of their present range or down to at least no more than 10 years on longer term assets. Certainly a permanent investment credit of at least 10 percent would be very helpful.

Senator HANSEN. Thank you very much.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. You are an able tax lawyer and you have made a positive contribution here. We appreciate it. I am looking at your cover summary. You have one point here, "long-term capital gains as transfers of capital under a new system."

That is no doubt covered in your paper but just briefly what are you alluding to there as a "new system."

Mr. DILLINGHAM. With the thought that this is a transfer of capital, as opposed to an income, on the sale or gain of assets that have been held for some length of time we feel they should not be subjected to the tax rates they are now, even at the capital gains rates. The proposed system would lump long-term gains under a structure separate from the income taxes, and credit the taxes paid under the system against estate taxes due at death.

Senator CURTIS. I do not think it is an uncommon experience among older people. The last survivors may find, for good reason, that he or she wants to sell the home which they have owned many, many years. Yet in an inflationary period, even the capital gains tax is quite an unjust tax on that person.

Mr. DILLINGHAM. Precisely.

Senator CURTIS. In reference to estate and gift taxes, particularly the estate tax, you have reduced the rates. Would you also raise the $60,000 exemption?

Mr. DILLINGHAM. Yes, there have been several proposals to reduce the impact on estate, certainly the exemption level must have been set 30 years ago or so at $60,000. It is outmoded in today's economy, I would think. That certainly would be a helpful proposal.

Senator CURTIS. I think we should go back to basics. The estate tax was not a tax intended to reach all of our people, but it was a tax applied to the transfer of rather large estates. About the only way

that you could relieve not only the burden of taxation but all of the problems of payment and so on for people of very modest means is to raise the exemption.

Mr. DILLINGHAM. Certainly that is desirable. We would like to see a reduction in rates, also.

Senator CURTIS. You could, of course, include that in your recommendation as to the overall approach?

Mr. DILLINGHAM. Yes. In fact, part of our proposal also would be to provide some way to avoid the necessity of liquidating farms or small businesses in order to pay estate taxes.

Senator CURTIS. In reference to the depletion provisions that were repealed last year, that has had a bad effect in two ways, has it not? First, it has lessened jobs and, second, it has lessened a very critical material that our economy needs.

Mr. DILLINGHAM. Yes, in our opinion that is true.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Dole.

Senator DOLE. No questions.

The CHAIRMAN. Thank you very much, sir.

I notice that you don't recommend anything with regard to employees. All these tax suggestions you mention would be to the benefit of the investor. I don't see anything in here that would cause the employee to feel he is better off, or that it might give him a better chance to have a job. Are your people opposed to employee stock ownership?

Mr. DILLINGHAM. No, sir, not at all. I was attempting to emphasize releasing capital for formation, use of new capital, and this is what we want to do. Actually we are so interested in this tax employee ownership plan, the Tax Council is planning a meeting next week where that is the topic for discussion and a lot of our companies have already adopted ESOP plans. Certainly if you want to look further at it, the proposal to reduce the double taxation on corporate dividends, as discussed a moment ago, I think would be helpful as regards investment at low-income levels.

The CHAIRMAN. I wish you would let us know what the result of your deliberations are after you have met, because it would be helpful to us.

It seems to me that as long as investment means "the other guy" to labor, you are going to have these irreconcilable conflicts. I was interested by the testimony that was brought here by Mr. Kelso. He pointed out that oddly enough, when employees own stock in the company. the employees tend to vote their stock even more consistently in support of present management than do the other shareholders. That just showed how when employees feel they are part of the action, when they have stock in it, when they feel they are part of the team and they are in on the decisionmaking, they tend to back the people who are trying to make the corporation succeed and seem to understand their problems even better than the ordinary shareholder. That type of understanding between management and its labor, that sense of comradeship and teamwork, is one of the things that I think we are going to need to hold prices down and to control inflation.

Mr. DILLINGHAM. As I mentioned, we have this meeting next week. Obviously, a lot of companies are taking a serious look at it. I think there will be some movement in that direction.

The CHAIRMAN. Thank you very much.

[The exhibit, tables, and additions and revisions referred to by Mr. Dillingham follow. Oral testimony continues on p. 1739]

EXHIBIT A

As would be reasonable to expect, Table I shows a heavy concentration of nontaxable returns in the lower adjusted gross income groups, 58 percent in the 0–5,000 group and 4 percent in the 5–10,000 group, but no more than one-half of one percent in all higher groups.

Table II shows that some three-quarters of adjusted gross income in the higher income group becomes subject to tax, but only a little more than a third in the lowest group, with the percentage moving up abruptly thereafter.

Table III shows tax burdens as percentages of adjusted gross incomes in smaller income intervals than the other tables. These percentages are known as effective tax rates. With these rates rising steadily from two percent in the $1,000,000 and over group, as compared with statutory rates ranging from 14 percent to 50 percent (earned income) and 70 percent (investment income), the claim that the higher incomes get a special break in this area is shown as false.

Table IV shows that exclusions are not substantial as a percentage of adjusted gross income at any income levels although the lowest income group has the highest percentage, 5.5. The 4.0 percent in the highest income group largely results from the exclusion of interest on state and local debt. This exclusion has its source in strictly political considerations. Hence, it would be unfair to use its existence to enhance public resentment of the tax status of the rich even if it did result in substantial tax relief for them as a class—which it does not.

TABLE I.—NONTAXABLE RETURNS, 1972, BY ADJUSTED GROSS INCOME GROUPS

[Dollar amounts in thousands]

Adjusted gross income groups	All returns (1)	Taxable returns (2)	Nontaxable returns (3)	Percent (3) of (1)
0 to $5	$26,963,312	$11,224,360	$15,738,952	58.0
$5 to $10	21,175,854	20,325,602	850,252	4.0
$10 to $15	15,364,155	15,284,303	79,852	.5
$15 to $20	7,773,413	7,755,147	18,266	.2
$20 to $50	5,697,683	5,683,307	14,376	.3
$50 to $100	483,677	482,087	1,590	.3
$100 and over	114,636	114,211	425	.4

Source: Table 1.1, "Statistics of Income, 1972, Individual Income Tax Returns."

TABLE II.—INCOME SUBJECT TO TAX BY ADJUSTED GROSS INCOME GROUPS, TAXABLE RETURNS 1972

[Dollar amounts in thousands]

Adjusted gross income groups	Adjusted gross income	Income subject to tax	Percent
0 to $5	$40,203,955	$13,894,889	34.6
$5 to $10	151,215,307	80,017,295	52.9
$10 to $15	187,712,717	112,854,989	60.1
$15 to $20	132,944,126	87,911,733	66.1
$20 to $50	152,048,854	109,370,412	71.9
$50 to $100	31,877,108	24,450,533	76.7
$100 and over	21,413,807	16,113,098	75.2

Source: Table 1.1, "Statistics of Income, 1972, Individual Income Tax Returns."

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TABLE III.—INCOME TAX BY SIZE OF ADJUSTED GROSS INCOME

[Dollar amounts in thousands]

Size of adjusted gross income	Adjusted gross income	Total income tax	Percent tax of adjusted gross income
No adjusted gross income	$2,950,226	$12,158	0.05
$1 under $1,000	3,093,756	387	1.8
$1,000 under $2,000	8,765,931	9,186	3.5
$2,000 under $3,000	12,397,055	202,893	2.6
$3,000 under $4,000	17,343,979	639,829	4.9
$4,000 under $5,000	22,685,715	1,252,894	6.4
$5,000 under $6,000	25,988,241	1,787,531	7.5
$6,000 under $7,000	27,643,361	2,175,030	8.3
$7,000 under $8,000	32,012,938	2,741,335	8.9
$8,000 under $9,000	34,142,692	3,139,234	9.4
$9,000 under $10,000	36,997,378	3,508,101	9.6
$10,000 under $11,000	38,220,835	3,834,497	10.1
$11,000 under $12,000	39,773,069	4,061,413	10.3
$12,000 under $13,000	38,827,863	4,087,184	10.6
$13,000 under $14,000	37,483,389	4,099,611	11.0
$14,000 under $15,000	34,357,664	3,903,170	11.4
$15,000 under $20,000	133,253,331	16,681,550	12.5
$20,000 under $25,000	68,449,109	9,816,508	14.4
$25,000 under $30,000	34,416,463	5,477,599	16.0
$30,000 under $50,000	49,578,235	9,427,594	19.1
$50,000 under $100,000	31,983,024	8,528,394	26.8
$100,000 under $200,000	11,993,092	4,136,163	34.6
$200,000 under $500,000	5,415,003	2,198,397	40.8
$500,000 under $1,000,000	1,791,260	809,142	45.4
$1,000,000 or more	2,301,383	1,046,273	45.7

Source: Table 1.1, "Statistics of Income, 1972, Individual Income Tax Returns."

TABLE IV.—EXCLUSIONS[1] BY ADJUSTED GROSS INCOME GROUPS

[Dollar amounts in thousands]

Adjusted gross income groups	Total adjusted gross income (1)	Exclusions except interest on State/local debt (2)	Percent (2) of (1) (3)	Exclusions including interest on State/local debt (4)	Percent (4) of (1) (5)
0 to $5	$40,203,955	$2,218,000	5.5	$2,218,000	5.5
$5 to $10	151,215,307	2,949,000	2.0	2,950,000	2.0
$10 to $15	187,712,717	2,219,000	1.2	2,223,000	1.2
$15 to $20	132,944,126	1,668,000	1.3	1,690,000	1.3
$20 to $50	152,048,854	2,328,000	1.5	2,426,000	1.6
$50 to $100	31,877,108	597,000	1.9	986,000	3.1
$100 and over	21,413,807	320,000	1.5	866,000	4.0

[1] Source: Table released by Senator Walter F. Mondale (Democrat of Minnesota), May 26, 1975.

A Program for a Stable Capital Conscious Federal Tax Policy

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INTRODUCTION

From its organization nine years ago, the Council's policies have rested on the inherent need for and natural scarcity of capital and the public interest in its formation and conservation. Because growth in the future is dependent on generation of new capital, over and above that destroyed by taxation or other means, it could be argued that tax policy should be weighted in favor of capital. The Council, however, has not gone this far, but has stressed the importance to the nation of revising the present tax system at all points which are biased against capital.

The opposite of bias would be a capital conscious approach to tax policy, and five years ago the Council released its first composite program detailing steps toward such a policy in the 1970s[1]. Two years later the first edition of the program[2], herein revised for the second time, was released. The first revision appeared last year.[3]

While not repeated in this revision, the background material as revised in the first revision is as timely now as when written.[4] In its place, we have some new material further demonstrating the extent of the tax bias against capital and how the public interest will be served by turning policy towards the capital conscious approach.

The major point of the material is that more capital spending as a percentage of Gross National Product would soon mean more not less spending for consumption. Conversely, a smaller percentage of Gross National Product devoted to capital formation would soon mean less not more spending for consumption.

In the summer of 1975, the Ways and Means Committee took the constructive step of scheduling capital formation as a separate subject in its tax reform hearings. Responding to the request of the Committee to be specific about reforms which would serve capital formation, Treasury Secretary William E. Simon presented the Administration's plan for ending the double taxation of dividend income. Witnesses from the business community, including The Tax Council, presented a wide range of proposals, including ending double taxation, with great emphasis on reforms to hasten tax free capital recovery. As was to be expected, when the Committee in executive sessions reached the capital formation area, time was running out if reform legislation containing an extension of tax cuts

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[1] "Towards a Capital Conscious Federal Tax Policy in the 1970s—The Composite Tax Program of The Tax Council", November 1970.

[2] [3] "A Program for a Stable, Capital Conscious Federal Tax Policy", The Tax Council, November 1972; Revised edition, November 1974. Copies of the latter are still available on request.

[4] The titles include: "Shift in the nature of government"; "Tax principles and tax economics"; Capital and the Public Interest"; "The myth of idle capital"; "The bogey of tax reform"; "The Corporate tax target"; and "The tax bias against capital".

voted in the Spring was to have any chance of enactment this year. On October 20th, the Committee decided to give added life to the 10 percent investment credit and $50,000 corporate exemption provided by the spring legislation, while delaying for six months consideration of other capital subjects pending study by a task force.

The key to achieving a stable, capital conscious tax policy is allocation of revenue gain for the purpose over a period of years as long recommended by the Council and presented again herein. The Administration embraced this approach in proposing an end to double taxation of dividends, and we may hope the tax-writing committees and Congress as a whole will come to recognize that here is the key to a tax policy which would mean stronger economic growth, more new and better jobs, increased consumption and less inflation over the years ahead.

The new text, including all of Section I and revisions in Section II, was approved by the Tax Policy Committee of The Tax Council on December 9, 1975.

PAUL L. DILLINGHAM,
Chairman, Tax Policy Committee, The Tax Council.

I. GOAL, ECONOMICS AND PROCEDURES OF CAPITAL-RELEASING TAX REFORMS

Policy summary.—Capital formation, because it enlarges the base for economic growth, provides more new and better jobs, increases productivity and lessens inflationary pressures, is the means to more not less consumption. The public interest thus would be served by capital-releasing tax reforms directed to increasing the level of capital formation (gross investment spending) as a percentage of gross national product. Accordingly—

1. A national policy goal should be established to raise the level of gross investment spending from the range of 15½ of gross national product to a range of 17 percent, which would add some $30 billion to investment spending in a two trillion dollar economy (the level expected at the end of this decade).

2. The increase in investment spending should be totally achieved by reducing federal taxes (and limiting growth in federal spending) thus avoiding even a temporary slowdown in consumption spending generated in the private sector of the economy.

3. The federal tax reductions should be achieved by a program of immediate and spaced out reforms financed by allocating for the purpose one-half of the revenue gain from economic growth (excluding the gain from social insurance levies).

4. Major steps in the program should be subject to a postponement procedure to provide the government with flexibility for meeting emergencies.

Discussion

A. *The relation of consumption and investment spending.*—This relationship often is discussed as though investment spending is at the expense of consumption spending, and as though the former benefits only large corporations and rich people while the latter matters only to low income people. Yet, refutation of the proposition will bring forth no defenders, as least among sophisticated people, because it is indefensible.

Investment preceeds consumption, and over any economic cycle increased investment is the only means to increased consumption. In periods when utilization of resources is well below the optimum, however, and monetary policy is accommodative of rapid progress toward the optimum, expansion of investment spending will add to instead of supplanting consumption spending. There will be more jobs and more rapid increase in income in the economy as a whole.

As utilization of resources approaches the optimum, the consumption benefits from continued expansion in investment spending will be deferred until the facilities involved are in production. A conservative estimate of the annual economic yield from marginal capital investment is 25 percent. That is, for every additional dollar of capital investment, there is an annual addition to national product of 25 cents. On this basis, marginal capital investment will yield, compounded, its value in current consumption in less than four years, with the annual yield thereafter being all bonus for having saved and invested the original income instead of using it for immediate consumption.[1]

[1] See Table I, "The benefits of capital formation are no trickle", Tax Legislative Bulletin No. 17, October 14, 1971.

In recent years, the relation of investment or capital spending to gross national product has ranged around 15½ percent. There is a consensus that there should be a moderate increase in this percentage if the capital formation is to take place which the nation needs for economic balance over the years ahead. For policy purposes, it is assumed that a ten percent increase to the range of 17.0 percent of GNP would reasonably meet the need.

Or, in money terms, an increase of one and one half percentage points in investment spending would add $30 billion to such spending in a two trillion dollar economy (the level expected at the end of this decade). In such an economy, consumption expenditures would be rising at a rate of over $100 billion a year without taking into account the increase production which would result from this program.

With the increase in investment spending coming entirely from capital-releasing tax reforms, moreover, there would be at no time even a temporary slowdown in the rate of increase of consumer expenditures generated in the private sector of the economy. The only slowdown would have come in the rate of increase which otherwise would have taken place in spending by the government and its beneficiaries.

B. *Economic impact of taxing and spending.*—Taxing and spending often are discussed, especially in the context of what groups should pay more or less tax, as though the economic impact is the same regardless of the function of the funds involved. Actually, the impact is quite different dependent upon whether the funds taxed and spent are income which otherwise would have been used for a) consumption spending or b) investment spending, or were c) established capital.

In the case of a), the total of consumption spending in the economy is not affected currently or prospectively. Private taxpayers spend less and government (and its employees and beneficiaries who also may be taxpayers) spend more. It is a transfer process which may hurt the private taxpayers but does not of itself hurt the entire economy or change the total numbers in the GNP.

In the case of b), there is an immediate and then a quite divergent long term result. The immediate effect, a shift from private investment to public consumption, again does not change the total numbers in GNP. The aggregate of consumption expenditures is greater than it otherwise would have been, but the aggregate of investment spending is less. However, the loss of the investment spending lowers the trend line of support for future consumption spending, and (using the preceding model) four years later aggregate consumption spending is no greater than it would have been if the shift from private investment spending to government spending had never taken place. Total GNP would have declined from its potential in the second year, and after the fourth year the decline would extend to total consumption spending.

In the case of c), the economic impact is even more drastic. While the taxing of income which would have become new investment capital reduces the potential for growth in production and consumption, the taxing of established capital reduces current capacity to produce and consume. If there were no new saving in the economy, the use of the taxing power to convert capital to government spending might provide an instant feast, as with killing and eating the goose which lays the golden eggs or eating the seed corn, but at the price of economic disaster.

Of course, the fact that there always is new saving in the economy[6] serves to mitigate the destruction of capital by taxation. However, it is self-evident that capital so destroyed must be replaced by new savings out of current income before there is net addition to the nation's stock of capital. The excessive taxation of income which otherwise would be saved compounds the economic setback resulting from the taxation of established capital.

With its anti-capital bias, the federal tax system has a heavy impact on capital supply. At current tax levels, it is estimated that the drain on capital supply totals some $70 billion annually. $12 billion of this total represents the conversion of capital to current government spending via the taxes on estates, gifts and capital gains. $34 billion represents corporate income which absent the profits tax would have been saved (as retained earnings) by the corporation or

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[6] But not necessarily *net* new saving. In 1933, the nation dissaved to the tune of $2.6 billion which would be the rough equivalent of $75 billion in the current economy. These figures do not take into account capital consumption allowances, $3.8 billion in 1933, which are included in gross savings which in turn equate with total investment spending.

saved by stockholders from the part distributed to them as dividends. $19 billion represents the part of income (excluding capital gains) which would have been saved in the absence of the income tax. The remaining $5 billion relates to the excises, customs and miscellaneous revenue sources.[7]

The total impact on capital would be much greater if the current recession had not occurred. Based on official revenue projections through 1980, the total would be substantially in excess of $100 billion by then if the tax system retains its present bias.

$70 billion is approximately one-third of the level of gross investment spending in 1975.

C. *Federal surpluses and capital supply.*—Among scholars there is some complacency about releasing capital for private use through tax reduction in the belief that the problem can be solved by running federal budget surpluses.

It is true that a surplus resulting in the reduction of publicly held debt releases the funds involved for other investment purposes. The question is whether this would be a viable solution to the problem of a capital shortage.

Because budget surpluses do not have a constituency, the discipline required to achieve them would be a lot to ask of the political process.

However, even if it were feasible to anticipate the necessary discipline, the concept is not a viable one. It has to be faulted in two major respects.

First, whatever the political rhetoric, both major parties are committed to use of fiscal policy to counteract swings in the economy. At best, this means alternating deficits and surpluses, although the experience so far is heavily on the side of deficits. To the extent business capital spending had become dependent on surpluses, this source of capital would disappear when the economy turned downward. Moreover, as the federal government turned from a supplier to a borrower of funds from the capital markets, less credit would be available for non-governmental use. The contraction in capital spending inevitably would be greater than would have taken place if the surpluses had not been available as a source of funds in the first instance. The whole process would add a new instability to capital spending and the entire economy, instead of contributing to stronger and better balanced growth.

Second, the additional tax burden necessary to release any net amount of capital from federal use would be substantially greater than that amount. Specifically, using the $70 billion estimate of tax impact on capital as a guide, a $30 billion surplus would release to the market only about $20 billion in capital. Or, to provide $30 billion in capital would require a surplus of $45 billion.

There simply is no escape from the conclusion that federal surpluses are not a viable alternative to reducing the tax impact on capital to increase the proportion of investment spending in GNP.

D. *Financing capital-releasing tax reforms.*—Deserving respect is the considered view that large capital-releasing tax reforms are desirable even though financed through enlarged deficits. Insofar as the initial impact is concerned, this would be a take-and-put process, with the government serving as the intermediary for taking capital from investors and releasing it to taxpayers. As long as the government obtained the funds by crowding other borrowers out of the market, there would be no inflationary impact but neither would there be any immediate expansion in investment spending. If the funds were obtained by expanding the money supply beyond that which otherwise would take place, increased inflation would be the price of the expansion in investment spending. Either way, it's a tough case to get over when inflation and deficits already are out of control. If it could be realized, however, the results would be to crowd out federal spending which otherwise would take place over succeeding years while generating a replacing flow of economic benefits for the nation.

The Council has not espoused this approach although it does not oppose any achievable means of reducing the tax bias against capital. From its inception, the Council has sought to achieve recognition in the continuing tax policy dialogue that the bias is a disservice to the public interest. It has consistently linked capital-releasing tax reforms with the public interest in stronger and sustained economic growth, more new and better jobs, steady advance in productivity and hence living standards, a broader tax base and less inflation. But always it has tried to look at the possible within the framework of how top policy-makers in

[7] These estimates do not cover the levies to support specific social insurance programs (which total some $90 billion) because they do not go into the general revenue.

the Executive Branch and in Congress view their overall responsibilities in the fiscal area.

In the absence of absolute reduction in the level of government spending, the only source of tax reduction is the revenue gain from economic growth. From its first policy/program released in 1967[8], the the Council's consistent position has been that part of the gain should be used over a period of years to reduce taxes which prevent greater growth (and hence revenue over the long term). The level of current spending is so distorted by the combination of inflation and temporary tax cuts,[9] it is impossible at this time to identify a base in simple terms from which to project the fiscal results of a program of scheduled tax reductions over several years.[10]

If recovery is sustained, however, there will be large increases in revenue over the next few years. Budget projections indicate that, by 1978, a surplus would be in sight in the absence of new spending commitments and with strict control of spending under present programs. If a new recession is avoided, there should develop substantial margins for tax reduction and orderly growth in spending. However, the propensity for public spending is nourished by groups and people who not only would commit to spending all of the revenue gain long before realized but, given the opportunity, would continuously influence a spending level which could only be validated by repetitive increases in taxes.[11]

The Congress has made a start under the Budget Control Act towards a more responsible attitude on spending, but it is too much to expect that control will be exercised so as to provide margin for tax reduction unless the Congress is committed in advance to this course. It seemingly would not be enough to visualize tax reduction as a benefit of future spending control. Just as spending commitments for the future are embedded in legislation, so must be competing claims to use part of the revenue gain to reduce the tax impact on capital, economic growth and job creation.

The Council's proposal is that one half of the anticipated annual revenue gain from economic growth, excluding that coming from social insurance levies, be allocated for tax reform and reduction with the goal of releasing $30 billion in actual and potential capital from taxation in a two trillion dollar economy. Even with inflation under control, the gain should run from $15–$20 billion upward through the years permitting prescheduled allocations for tax reduction of from $7½ to $10 billion upwards. Because dollarwise the largest tax reductions would come in the personal income tax area with a large part of the tax savings being spent for consumption instead of saved and invested, a total tax reduction substantially larger than $30 billion would be necessary to increase available capital supply by that amount. Even if the total reduction went to $50 billion or more, there would be no losers in the private sector nor over time in the public sector.

In considering this proposal, attention should be given to the major difference between forward commitments for spending and for tax reduction. Once committed to spending for any domestic purpose, the government always finds difficulty in turning off the spigot or even slowing down the flow of taxpayer dollars.

By contrast, it is feasible and desirable for the government to forward schedule tax reductions while providing an easy to use procedure for postponing any of the reductions, as next discussed.

E. *Postponement procedures.*—No matter how expertly and faithfully done, longterm budget projections could not be infallable. Thus, any program of substantial annual tax cuts spaced out over the years would be subject to budgetary hazards making desirable some flexibility in effectuation. This flexibility could

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[8] "Needed: A Long-Range Approach to Federal Tax Policy", The Tax Council, February 1967.

[9] Which budget projections do not take into account beyond the applicable year or years even though failure of extension (or replacement with alternatives) would be the same as a tax increase.

[10] For example, take the President's current program. The budget ceiling of $395 billion which he proposes for the next fiscal year is $2 billion more than the projection for that year included in last January's budget. It is referred to as a cut because that projection had been increased to $423 billion in the mid-session budget review, but the figure nevertheless represents an increase of $25 billion over the total now estimated for the current fiscal year. As regards the $28 billion of tax cuts, some $17 billion represents substitutes and extensions of cuts now in effect, leaving only $11 billion of new cuts.

[11] From the mid-1960s, the freely-stated goal of the ideological spenders was to increase the government share of GNP from the range of 30+ to the 40 percent range of major European countries. While the public's disenchantment with public spending has forced this goal underground for the time being, it inevitably would resurface in a receptive political climate.

and should be provided by postponement procedures in the legislation which could be used to defer specific cuts without cancelling them or changing the substance of the legislation. The procedures also could provide for accelerating cuts if conditions warranted.

A program of scheduled tax cuts to be financed from revenue gain combined with postponement procedures would provide a sharp contrast with past experience in copying with fiscal emergencies. With all revenue gain typically committed or overcommitted in advance to support spending programs, fiscal emergencies have been characterized by much talk of budget cuts or tax increases or a combination of the two—but mostly resolved by ever more red ink.

By contrast, the program proposed here would be one of stock-piled flexibility. While the existence of enabling legislation would be a force for imposing the discipline necessary to its fulfillment, it also would provide the means for financing higher than anticipated levels of spending without increasing taxes.

Some might say they see a hazard in the postponement procedure, claiming its existence would invite its abuse and thus defeat the public interest in achieving a higher level of capital formation as related to GNP. That there would be some hazard can not be denied. Without the procedure, however, it would seem too much to ask the government to enact a single piece of legislation to achieve $30 billion of capital release. It should be kept in mind that a bite at the time tax legislation does not offer much promise of getting the capital release job done.

It is worth noting that, even if there was not a problem of excessive taxation of capital, with the postponement procedure the allocation of part of the revenue gain for tax reduction would provide a safety valve for government financial operations which has not existed heretofore and otherwise could not be expected to exist hereafter.

F. *Extent of tax bias against capital.*—The tax law is seriously biased against capital. The monologue of the conventional tax reformers is totally directed to increasing the weight of that bias.

Underlying the weight of taxes on capital, the bias in the law is reflected in (1) the mix of tax methods used, (2) excessive rates of tax on income, capital gains, and estates and gifts, (3) excessive progression of the personal tax, (4) the inadequacy of provisions for capital cost recovery, (5) the double taxing of dividends and capital gains, and (6) putting an additional tax on capital gains through the minimum income tax.

In the monologue, the objective of increasing the bias is reflected in (1) the underlying assumption that any tax on low incomes or consumption is bad, and that any tax on high incomes, big corporations and capital is good, (2) the consistent unrelenting search for the top tax dollar from such incomes and capital without regard to economic consequences,[12] (3) the description of any tax-saving provision or proposal affecting these sources as a tax loophole, break, expenditure, preference or subsidy, and (4) the monstrous allegation (based on a handful of cases) that the rich do not pay their fair share of taxes compared with other income levels.[13]

Because of its bias against capital, the Council describes conventional tax reform as the anti-capital tax reform movement.[14]

II. CAPITAL-RELEASING TAX REFORMS

Summary of proposals

A. *Capital recovery allowances.*—Capital recovery allowances should permit the deduction of the cost of a tangible asset over a period of time considerably shorter that the present system permits.

B. *Investment credit.*—The investment credit should be liberalized, made permanent and fully applicable to all assets subject to the capital recovery allowances with appropriate recapture rules.

C. *Pollution control facilities.*—Taxpayers should be permitted to write off the cost of pollution control facilities—whether in connection with existing or new plants or properties—over such time as they deem appropriate and with

[12] For example, in the recent tax reform hearing a leader of the anti-capital tax reform forces, Dr. Joseph A. Pechman, Director of Economic Studies of the Brookings Institution, expressed the view that "tax equity", obviously meaning his concept of equity, should have priority over increased economic growth.

[13] See section "Smoke in your eyes", in testimony entitled "The Last Pound of Capital", including four supporting tables, Tax Legislative Bulletin No. 49, The Tax Council, July 9, 1975.

[14] See "Countering the Anti-Capital Tax (Reform) Movement", Tax Legislative Bulletin No. 14, July 23, 1971, where the term was first used.

reasonable rules for separating such facilities from productive facilities. These facilities should be eligible for the full investment credit.

D. *Depletion.*—Percentage depletion serves the public interest by maximizing the search for and development of mineral deposits and minimizing prices paid by consumers. Hence, the provisions deleted in 1975 should be restored.

E. *Corporate tax rates.*—The top rate of corporate tax should be reduced two or more percentage points a year in a legislative program designed to achieve a top rate below 40 percent over a period of years.

F. *Double taxation.*—The double taxation of corporate income paid out in dividends should be ended through steps legislated to take effect over a period of years.

G. *Domestic intercorporate dividends.*—The tax on domestic intercorporate dividends should be eliminated.

H. *Minimum income tax on corporate income.*—Corporate income should be removed from coverage under the minimum income tax because the tax form is not appropriate to the tax object.

I. *Minimum income tax on longterm capital gains.*—Because longterm gains are capital and not income, they should be deleted from the list of so-called income tax preferences subject to the minimum income tax.

J. *Personal income tax rates:*

1. *Equal treatment for married and single taxpayers.* The same scale of rates should be applied to the incomes of married taxpayers filing separate returns and to each half of the taxable incomes of married couples as is applied to the taxable incomes of single taxpayers.

2. *Investment income.* The 70 percent top rate on investment income should be reduced to the 50 percent top rate on earned income.

3. *Rate graduation.* There should be begun a program of annual steps in reducing rates which would flatten the curve of graduation through the middle brackets to the top rates of 50 percent, while cutting all lower rates an average of about one-third.

K. *A capital transfer tax system.*—Regular longterm gains of individuals should be taken out of the income tax system and taxed as the transfers of capital which they are under a new system aligned with the estate and gift taxes, with the new rates ranging from 4–22 percent.

L. *Other gains and losses.*—With respect to sales of assets remaining taxable under the income tax system, both individual and corporate, (1) short term losses should be fully deductible against income, (2) longterm losses should be deductible against income in the full value equivalents of the longterm rates and (3) the accepted principle of averaging income should be recognized by both the carryforward and carryback of losses.

M. *Estate and gift taxes.*—Rates should be reduced through an orderly plan extending over a period of years, and a practical means should be provided for paying taxes due on income-producing property out of income and not by liquidating the property.

Discussion of Proposals

A. *Capital recovery allowances.*—While a dollar of saving anywhere in the economy will go to meet aggregate caiptal needs, federal tax policy should give full recognition to the fact that optimum growth and productivity of the economy depend in major part on the funds currently generated through capital recovery allowances and the investment credit. Since growth and productivity are the keys to the creation of new and better jobs and increased standards of living, and are a counterinflationary force, the public at large is the major beneficiary of whatever improves the cash flow of business. It is an evident economic fact that the shorter the period of time over which capital recovery allowances are deducted, the greater the benefit to the public.

B. *Investment credit.*—One views of the investment credit, which has surrounded it with an atmosphere of impermanence, is that it is largely intended and primarily serves as an aid, prop, subsidy, incentive, stimulant or encouragement to induce business to do what it would not otherwise undertake.

The alternative view is that both the major purpose and major economic effect of the credit are to diminish the tax restraints on planning and financing capital spending for growth and increased productivity. In supporting the credit and in advocating its reenactment in 1971,[15] the Council always has placed complete emphasis on the capital which it would release from taxation.

[15] "Investment Credit Needed Now", The Tax Council's Tax Legislative Bulletin No. 6, March 25 ,1971.

The Council urges that it be recognized by policymakers in the Executive Branch and the Congress that now is the time to liberalize, make permanent and apply to all assets this major instrument for lightening the immediate tax impact on capital. Regardless of the indecisiveness of present economic signposts, the nation can not safely postpone action on capital formation tax changes until a resurgence of capital spending and job creation has created the prospects of a new capital crunch.

C. *Pollution control facilities.*—The temporary provision for five-year amortization of pollution control facilities only nibbles at the problem, and has proved of extremely limited benefit to taxpayers.

Pollution control facilities generally do not produce income and earnings, but capital used to produce and install the facilities reduces the supply of capital available for expenditure on productive facilities contributing to economic growth. This seems reason enough to permit writeoff in the pollution area as the taxpayer's judgment dictates, for new or old plants, under reasonable rules for separating pollution from productive facilities. The new provision should not be considered a tax preference under the minimum income tax.

The proposal for complete writeoff has been opposed on the ground that, since the pollution control facilities are necessary to the operation of the productive facilities, consumers of the products of the facilities should foot the bill for both. In rebuttal the narrow point could be argued that the pollution facilities are dictated by the public interest and not with an eye to consumer preferences and needs. But the stronger, and seemingly incontrovertible point, is that the public as a whole is deprived of the benefits which would flow from immediate use of the capital involved to create productive facilities and therefore it is the public which will benefit from the proposal.

D. *Depletion.*—Percentage depletion is a reasonable solution to the problem of taxing resources which are not renewable as they are brought into consumption. A mineral deposit clearly is a capital asset. As parts of a deposit are withdrawn from the ground, they enter the stream of production and income. The total transaction is similar to those involving characteristics of both capital and income which are taxed at special rates under the income tax law. Percentage depletion thus is a reasonable and rational tax adjustment to take account of a tax problem peculiar to the minerals industries.

With the economy threatened with shortages of both energy and hard minerals, tremendous amounts of new capital must be drawn into discovering, developing, transporting and marketing new supplies over the years ahead. With the nonproductive expenditures for pollution control which must be made at the same time, and with keen competition for available capital and high capital costs expected for the indefinite future, there would seem no way to equate the public interest with dismantling the system of depletion which dates back 50 years. To the contrary, the Council urges recognition that the public interest would be best served by retaining in the law the depletion provisions affecting hard minerals, and restoring to the law the provisions affecting oil and gas which existed prior to enactment of the Tax Reduction Act of 1975.

E. *Corporate tax rates.*—Because taxing corporations is taxing people, with the direct and indirect burdens inevitably spread among workers and consumers as well as owners, there is a prima facie case against above average taxation in this area. With after tax earnings of corporations the major source of capital spending to expand production and markets, creating new jobs in the process, it is evident that substantial reduction in the top rate of corporate tax would be very much in the public interest.

The Council's first policy-program proposed use of revenue gain to reduce corporate as well as personal tax rates over a five year period, subject to postponent. With the top corporate rate still at the 48 percent level legislated in 1964, five steps of two-percentage point reductions would bring the top rate down to 38 percent. This is suggested as a minimum goal for long term tax policy.

F. *Double taxation.*—After the dividend credit[16] enacted in 1954 was repealed in 1964, there was no sustained effort to make a new start on ending double

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[16] The 4 percent credit deducted from tax bills without grossing up was controversial from the beginning because of the criticism that it provided greater relief value for high bracket than for low bracket stockholders.

taxation until the Council so recommended in the first issue of this program. In the belief the time was propitious for generating a national dialogue on the subject, in early fall a year ago the Council released a pickup bulletin relating its proposal to the contemporary economic scene.[17] As stated in the bulletin, a quick start towards this end "would be a timely and effective means for redressing some of the inflationary and related ills of our capital markets and the economy as a whole."

The administration deserves great credit for facing up to the task of complete elimination of double taxation of dividend income, as presented to the Ways and Means Committee by Treasury Secretary William E. Simon on July 31, 1975.

There are two methods for eliminating double taxation which would distribute the relief value equitably between stockholders in all tax brackets.

The first method would be to permit corporations to deduct dividend payment just as they have always been permitted to deduct interest payments.

The second method would be a stockholder's credit for corporate taxes using a procedure known as "grossing-up" to produce an equitable sharing of the relief. The procedure would require legislative rules to protect all parties involved when a corporation is obliged to report to stockholders in advance of final determination of its tax bill, but would not be complicated insofar as the stockholder is concerned. He would simply add to his taxable income the pro-rata share of his corporate taxes as reported to him by the corporation, and then deduct the same amount of taxes from his personal tax bill as otherwise computed. In effect, the result would be that stockholders in each bracket would pay the same rates of tax on their dividend income as they do on other types of income.

The Council's policy has expressed preference for a gross-up dividend credit while indicating willingness to go along with a deduction at the corporate level if a consensus should develop for that approach.

The Administration's program contemplates six annual steps in eliminating double taxation beginning January 1, 1977, split equally between a grossed-up stockholder credit and a deduction by the corporation. Without taking feedback into account, Secretary Simon estimated a revenue loss of $15 billion from the entire program computed at 1977 revenue levels.

One criticism of a stockholder credit is the amount of tax relief which would go directly to rich people. Over time, of course, just as much tax relief would go to them from a corporate deduction. Despite the divisive, class conscience rhetoric of the anti-capital group, a tax inequity is no less equitable because it affects high income people. Nor for communities, states or people who need new and better jobs, nor for the nation which needs stronger and more sustained economic growth, is the adverse economic impact of double taxation less because it affects high income people.

Of course, a true believer in anti-capital tax reform is hooked on the fact that any kind of uniform resolution of a tax problem obviously means more tax dollars of relief for a taxpayer in the 70 percent bracket than for one in the 14 percent bracket. However, it is interesting to note that, with a gross-up credit, stockholders whose marginal rates of tax are considerably higher than the corporate rate will still pay substantial tax on the dividends they receive, while those whose rates are lower will receive credits ranging up to 65 percent of their dividends, as set forth in the following table:

Marginal tax rate	Tax rate on dividends under present law	Tax rate on dividends with grossed-up credit
70	70	42
60	60	23
50	50	4
48	48	0
40	40	[1] 15
30	30	[1] 34
20	20	[1] 54
14	14	[1] 65

[1] Becomes a credit against other tax liability.

[17] "Needed: A Quick Start on Ending the Double Taxation of Dividend Income", Tax Legislative Bulletin No. 48, October 1, 1974.

G. *Domestic intercorporate dividends.*—Corporate income should be taxed only once. When dividends are received by one corporation from another, the 85 percent dividends received credit leaves 15 percent which is double taxed. When the after-tax part of this 15 percent is distributed to individual shareholders, there is triple taxation. Increase of the 85 percent credit to 100 percent would equalize the tax treatment as regards all dividend income going to individual shareholders. It is a long overdue reform.

H. *Minimum income tax on corporate income.*—The concept of a minimum tax is in conflict with the concepts involved in the taxing of business income. Corporate income was brought under the minimum tax in 1969 on the floor of the Senate as a superficial reaction to statements with respect to some corporations paying little or no income tax in some years. To this day, there is no objective writing which makes any kind of a case that this is reasonable and appropriate tax policy, and it should be abandoned.

I. *Minimum income tax on longterm capital gains.*—Because the tax treatment of longterm capital gains reflects legislative recognition that such gains are in fact capital and not income, the treatment can not accurately or fairly be described as an income tax preference. Such description and listing under the minimum income tax is seriously counter educational in this era in which the public interest in conserving and expanding the nation's stock of capital can not be rationally denied. The listing should be deleted.

J. *Personal income tax rates.*—Reform and reduction of personal tax rates involve three moves: applying the same scale to the incomes of married taxpayers filing separate returns and to each half of the taxable incomes of married taxpayers filing separate returns as is now applied to the taxable incomes of single taxpayers;[18] reducing the 70 percent top rate on investment income to the 50 percent top rate now applying to earned income; and beginning a program of annual steps in tax cutting which would smooth out the curve of graduation through the middle brackets to the top rate of 50 percent while reducing all lower rates an average of about one-third.

In its first policy-program,[19] the Council suggested that the smoothing out of graduation and reduction of rates be achieved over a five-year period subject to the postponement procedures discussed under E. of section I. Adjusted to the base of rate changes enacted in 1969, the chart shows the ultimate rate scale which would result from the plan and be applicable to all taxable incomes including the split income of married taxpayers.

The discussion of the Council plan on pages 33–35 of the November 1974 revision of this program is as timely as when written, so is not repeated here.

K. *A capital transfer tax system.*—In taking the regular longterm gains of individuals out of the income tax system, the program[19] developed by the Council in 1968 would:

(*a*) Establish a new system, associated with the federal estate and gift tax system, for taxing these long-term gains as the transfers of capital which they are.

(*b*) Provide for seven brackets of taxable transfers of capital with rates ranging from four to 22 percent. The taxable brackets for married taxpayers filing joint returns would be double the brackets for single taxpayers.

(*c*) Provide for an exemption from the capital transfer tax of $500 for single taxpayers and $1,000 for married taxpayers filing joint returns.

(*d*) Limit loss deductions on the sale of assets taxable under the system to gains realized under the system with unlimited carryover, carryback and use of excess losses.

(*e*) Allow a credit for capital transfer taxes paid during life under the new system against estate taxes due at death.

(*f*) Bring to an end Federal taxation on the sale of homes, repealing the existing special legislation in the area.

The discussion of the transfer system on pages 36–38 of the November 1974 revision of this program also is as timely as when written, so is not repeated here.

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[18] See "Fair Tax Treatment of Partners in Marriage", statement of John C. Davidson before the House Committee on Ways and Means, May 1, 1972, Tax Legislative Bulletin No. 23.

[19] "A Program for Reform of Capital Gains Taxation", The Tax Council, July 1968. (out-of-print)

L. *Other gains and losses.*—Two of the important byproducts of placing regular longterm gains of individuals under a capital transfer tax system would be: first, in removing the cloud of controversy and uncertainty over the taxation of these gains, the need and justification for special treatment of the "mixed" transactions under the income tax system would become more apparent and, second, the way would be cleared for the equitable treatment of losses on the sale of all assets remaining taxable under the income tax system.

The mixed transactions include such matters as the cutting or other disposition of timber which in effect begins with a capital asset and ends with an income situation; and the sale of patents by the inventor which in effect begins with an income situation and ends with a capital asset.

The contemporary inhibition against permitting capital loss offsets against income under the income tax system stems from experience in an earlier era when such losses were fully deductible. The case examples which brought a change in the law involved persons with high incomes going income tax free because of losses incurred on the sale of assets held a long time. With the regular, longterm transactions of individuals taken out of the income tax system and taxed as transfers of capital under a separate system with loss offsets not going beyond the system, without risk of a repetition of the earlier experience the way would be cleared for the equitable offset of losses against income of transactions remaining under the income tax system.

M. *Estate and gift taxes.*—Estate and gift taxes are designed to liquidate property, that is, to convert accumulated capital into current government spending. Violating the economic rule that taxes should be derived from the stream of production, and not by diminishing the capacity to produce, the high rates of these taxes were enacted in the doom-and-gloom of the great depression of the 1930s. At the time, the dominant economic thought was that the depression had been caused by oversaving and underspending, long since discredited. The continuation of such high rates of tax is totally incompatible with the economic sophistication of our times; a sophisticated, however, which seems to have passed by the economists in the anti-capital tax reform movement.

The Council program [20] would:

Allocate to rate reduction and other tax saving revisions of the estate and gift taxes the revenue gain which otherwise would be expected from these taxes for a decade ahead—estimated at $600 million in fiscal 1975 and to grow at 10 percent a year thereafter consistent with past experience.

Authorize "tax payment trusts" in which testators of donors could place income-producing property, the income from which would be used to pay the taxes attributable thereto thus preserving the property intact.

Make other improvements in the structure of estate and gift taxation while avoiding revisions which would subject affected property to greater taxation.

III. TAX TREATMENT OF FOREIGN SOURCE INCOME

Summary

The U.S. tax treatment of business income earned abroad serves the national interest and such income should not be subject to further tax penalty.

Discussion

The United States taxes business income earned abroad so that U.S. companies can compete on relatively equal tax terms with foreign based companies. For many years after World War II, this policy reflected the national policy objective of aiding in rebuilding war torn economies and in economic development throughout the free world. When the balance of payments deficits became a worrisome problem some 15 years ago, however, the campaign began and continues to this day to rewrite the tax laws to inhibit the outflow of capital.

The substance of the business counterattack at that time—that capital sent abroad soon developed a greater return flow of income—has been amply proved by subsequent experience. Four years ago, however, the Burke-Hartke bill was launched under AFL–CIO auspices to remedy what was asserted to be tax induced export of U.S. jobs. In a timely and illuminating talk before a Tax Council conference, Dr. Norman B. Ture pointed out why the tax changes which would be wrought by the bill "would retard the advance of productivity, reduce em-

[20] "A Program to Reform Estate and Gift Taxes", The Tax Council, November 1970.

ployment and results in a less efficient economy in the U.S." [21] a conclusion corroborated by many business studies and the record in the 1973 and 1975 tax reform panels and hearings conducted by the Ways and Means Committee. Nevertheless, in what seems a strange obeisance to ideas because of their source and not their validity, efforts persist to move in some part towards the Burke-Hartke goal. Yet, if ever there was a time when the national interest in maximizing the return flow of income from investments for the long pull was evident, it is now.

In short, any increase in tax on foreign business earnings would—

Adversely affect the balance of payment over the years ahead by diminishing the return flow of income from direct foreign business investment.

In the short and long term, diminish the amount of capital available for domestic purposes.

Reduce job opportunities in the United States a) by reduced demand for exports of goods and services to back up U.S. foreign investment and operations, b) for personnel in support of foreign investments and operations, and c) by the reduction in available capital.

There simply is no measure by which the conversion to government spending of more business earnings from investment and exports could serve the public interest in this era.

CONCLUSION

This program rests on the simple economic fact that over any period of time taxes which shortchange the capital formation process also shortchange the public as regards economic growth, jobs, real earnings and living standards.

There is abundant evidence to support the logic of a pressing national need for a stable, capital conscious federal tax policy. The Ways and Means Committee in placing capital formation on its tax reform agenda, and the Administration in advocating complete elimination of the double taxation of dividend income, have taken significant steps in the direction of such a policy. Whether at this stage of history the federal government (the Executive Branch and the Congress together) has the capability for facing up to the full task of meeting the need remains to be seen.

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The Tax Council, Suite 431, 1120 Connecticut Ave., NW., Washington, D.C. 20036.

[21] "Economics and International Taxation—Consequences of the Hartke-Burke Bill", a talk by Dr. Norman B. Ture at the annual Tax Legislative Conference of The Tax Council, February 22, 1972, Tax Legislative Bulletin No. 21.

[22] A non-profit business membership policy organization, incorporated in the District of Columbia on August 4, 1966, and formally organized on Jan. 5, 1967.

The CHAIRMAN. Next we call Mr. George A. Strichman, chairman, Ad Hoc Committee for an Effective Investment Tax Credit.

Mr. Strichman, it is a pleasure to have you. I had a chance to discuss some of your views before, and I will take your statement and the other four statements with me when I get on the airplane this afternoon and do justice to them. We would be pleased to hear your presentation in chief.

STATEMENT OF GEORGE A. STRICHMAN, CHAIRMAN, AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT, ACCOMPANIED BY WILLIAM K. CONDRELL, GENERAL COUNSEL

Mr. STRICHMAN. I thank you for the opportunity to be here today, Mr. Chairman.

I have with me Mr. William K. Condrell, partner in the firm of Steptoe & Johnson.

To refresh your memory, the committee consists of some 275 American companies and also represents the views of about 50 or 55 associations.

The CHAIRMAN. You have this group listed and I think it might be well to have it listed in small print as you have them listed in small print on the back of your stationery so that everybody who reads your testimony, as I will, will know for whom you speak. It is a very impressive list.

[The list referred to follows:]

AMP Incorporated
A-T-O, Inc.
Acme-Cleveland Corporation
Air Products and Chemicals Inc.
Airco, Inc.
Akzona, Inc
Albany International Corp.
Alberto-Culver Company
Allegheny Ludlum Industries, Inc.
Allis-Chalmers Corporation
AMAX, Inc.
American Corporation
American Brands, Inc.
American Financial Corporation
American Greetings Corporation
American International Group, Inc.
American Telephone and Telegraph Company
Ampex Corporation
Amtel, Inc.
Anchor Hocking Corporation
Arcata National Corporation
Arvin Industries, Inc.
Ashland Oil, Inc.
Atlantic Richfield Company
Avnet, Inc.
Baltimore Gas and Electric Co.
Beatrice Foods Company
Belden Corp.
Bemis Company, Incorporated
Boeing Company
Booth Newspapers, Inc.
Brown Group, Inc.
Brunswick Corporation
The Budd Company
Bunker Ramo Corporation
Burlington Industries, Inc.
Burroughs Corporation
Butler Manufacturing Company
CBS Inc.
CCI Corporation
CF Industries, Inc.
CPC International, Inc.
The Carborundum Company
Carlisle Corporation
Carpenter Technology Corporation
Carrier Corporation
Castle & Cooke, Inc.
Ceco Corporation
Cessna Aircraft Company
Champion International Corp
Chemetron Corporation
The Chesapeake Corporation of Virginia
The Chesapeake and Ohio Railway Company
Chicago Bridge & Iron Company
Chromalloy American Corporation
The Citizens and Southern National Bank
Clow Corporation
Coastal States Gas Corp.
Collins & Aikman Corporation
Colt Industries Inc.
Columbia Gas System, Inc.
Columbus McKinnon Corporation

Commercial Shearing, Inc.
Consolidated Foods Corporation
Consumers Power Company
Container Corporation of America
Continental Can Company, Inc.
Continental Machines, Inc.
Continental Telephone Corp.
Cooper Tire & Rubber Company
Cooper Range Company
Crouse-Hinds Company
Cyclops Corporation
Cyprus Mines Corporation
Dana Corporation
Dean Foods Company
Deere & Company
De Laval Turbine Inc.
Dennison Mfg. Co.
The Detroit Bank & Trust Company
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
DoAll Company
R. R. Donnelley & Sons Company
Dresser Industries, Inc.
ESB Incorporated
E-Systems, Inc.
Eagle-Picher Industries, Inc.
Earth Resources Company
Eaton Corporation
Echlin Mfg. Co.
Economics Laboratory, Inc.
Electronics Memories & Magnetics Corp.
Elgin National Industries, Inc.
Emerson Electric Company
Emery Industries, Inc.
Esmark, Inc.
Evans Products Company
Ex-Cell-O Corporation
FMC Corporation
Federal-Mogul
Federal Paper Board Company, Inc.
Federal Department Stores, Inc.
First National Bank of Chicago
The Fying Tiger Corporation
Franklin Electric Co., Inc.
Freuhauf Corp.
Fulton Industries, Inc.
Fuqua Industries, Inc.
Gannett Co., Inc.
Gardner-Denver Company
Garlock, Inc.
General Cinema Corporation
General Dynamics Corporation
General Telephone & Electronics Corp.
The General Tire & Rubber Company
Getty Oil Company
Giddings & Lewis, Inc.
Globe-Union, Inc.
Gould, Inc.
Great Northern Nekoosa Corporation
Greyhound Leasing and Financial Corporation
Grow Chemical Corp.
Gulf Oil Corporation
H & H Industries, Incorporated
Hamischfeger Corp.
Harris Corp.
Harsco Corporation
Hart Schaffner & Marx
Hesston Corporation
Hewlett-Packard Company
Houdaille Industries, Inc.
Household Finance Corporation
Howmet Corporation
Ideal Basic Industries, Inc.
Illinois Central Industries, Inc.
Ingersoll-Rand Company
Inland Steel Company
International Business Machines Corporation
International Minerals & Chemical Corporation
International Multifoods Corporation
International Paper Company
International Telephone & Telegraph Corporation
Jewel Companies, Inc.
Josten's, Inc.
Joy Manufacturing Company
Kansas Beef Industries, Inc.
Katy Industries, Inc.
Kennecott Copper Corporation
Kerr-McGee Corporation
Kraftco Corporation
The LTV Corporation
Lance, Inc.
Land O'Lakes, Inc.
Lear Siegler, Inc.
Leaseway Transportation Corp.
Longview Fibre Company
Louisiana-Pacific Corporation
Lucky Stores, Inc.
Macmillan, Inc.
Marquette Cement Manufacturing Co.
Maryland Cup Corporation
Masonite Corporation
Michigan General Corporation
Michigan National Corp.
Midland-Ross Corporation
Milton Bradley Company
Modine Manufacturing Company
Mohasco Corporation
Monsanto Company
Moore McCormack Resources, Inc.
Morton-Norwich Products
NL Industries
NVF Company
Nalco Chemical Company
National Distillers & Chemical Corporation
National Gypsum Company
National Presto Industries, Inc.
National Starch and Chemical Corporation
Newmont Mining Corporation
Norris Industries, Inc.
Olin Corporation
Otis Elevator Company

Owens-Illinois, Inc.
Oxford Industries, Inc.
Pantasote Company
Parker Hannifin Corporation
Perkin-Elmer Corporation
Peter Paul, Inc.
Phelps Dodge Corporation
Philip Morris Incorporated
Phillips Petroleum Company
Pittsburgh-Des Moines Steel Company
Portec, Inc.
Potlatch Corp.
Public Service Electric and Gas Company
Raytheon Company
Reed Tool Company
Reeves Brothers, Inc.
Reliance Electric Company
Rockwell International Corp.
Rohm and Haas Company
Rohr Industries, Inc.
Roper Corporation
Rubbermaid, Inc.
The Rucker Company
Safeway Stores, Inc.
St. Joe Minerals Corporation
St. Regis Paper Company
Sangamo Electric Company
Scott, Foresman & Company
Scott Paper Company
G. D. Searle & Co.
Sears Roebuck and Co.
The Signal Companies, Inc.
Southwest Forest Industries, Inc.
Square D Company
Stanadyne, Inc.
Standard International Corporation
Standard Oil Company (Indiana)
Standard Oil Company (Ohio)
The Stanley Works
Stauffer Chemical Company
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Sundstrand Corporation
SWECO, Inc.
TRW, Inc.
Tecumseh Products Company
Texas Eastern Transmission Corporation
Texas Industries, Inc.
Texas Instruments, Inc.
Texasgulf, Inc.
Thiokol Corporation
Time Incorporated
The Timken Company
Todd Shipyards Corporation
Tropicana Products, Inc.
UV Industries, Inc.
Uarco, Incorporated
Unarco Industries, Inc.
Union Carbide Corporation
Union Trust Company of the District of Columbia
U.S. National Bank of Oregon
Universal Leaf Tobacco Co.
Universal Oil Products Company
V.F. Corporation
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Valley National Bank of Arizona
Van Dorn Company
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The Warner & Swasey Company
Wean United, Inc.
Weil-McLain Company, Inc.
Western Electric Company, Inc.
Western Publishing Company
Wheelebrator-Frye Inc.
Whirlpool Corporation
The Williams Companies
Winn-Dixie Stores, Inc.
Zayre Corp.

Mr. STRICHMAN. At this particular time, there is urgent need for a change in legislation affecting capital formation. The country needs it now in order not to lose the benefits we have already achieved. We have seen stop and go policies since 1960. Let's not repeat them now.

Legislation is needed to keep us in the state of recovery that is going on, but is far from being complete. The December 31 termination date of the present investment tax credit is already too close to permit businessmen the necessary continuity of policy for their business planning.

Since I last spoke to this committee, there has been public debate about capital formation. It is so important, and I would like to focus on it in the brief time allotted for my oral statement.

The longer statement which has already been submitted by the ad hoc committee for your committee provides detailed reasoning and data in support of our recommended program.

One fundamental is that stimulation of capital formation through tax law is essential to the well-being of all of us in the United States. It is good for American consumers and American labor as well as

industry. Industry investment in capital improves American productivity which, in turn, helps hold down prices for the consumer. It stimulates competition to the consumer's benefit. Capital investment increases jobs. It adds to the size of the plant in which labor is employed. In fact, in this highly mechanized age, investment in new plant and replacement of depreciated machinery is almost the only means for increasing the number of jobs and safeguarding existing jobs.

There is a long overdue adjustment for the effect of inflation on depreciation allowances. In inflation's ravages, the value of our existing depreciation allowances now fall short of replacement value of physical assets by as much as $23 billion and this has nowhere been recognized in the tax code. So, we are all in this together.

There is no realism to the contention that what is good for one part of society is not good for another.

In my experience, improved tax law regarding capital formation is elevated and can lift us all together with faster recovery. At present we are still moving too slowly toward recovery.

Another fundamental concern is the way we use our savings, the amount of savings we can generate. The capital shortage we face today is in the private sector. Unless appropriate tax changes to increase the rate of private saving, the result will be a continuation of a short fall of capital even if the country only stands still—status quo.

The chart on page 6 in the full statement depicts the real GNP per employed civilian, 1950–72. We are near the United Kingdom in performance which is pretty bad. The United States is about one-third of Japan, about one-half of Germany, and ranks at the bottom next to Canada and the United Kingdom, and that is pretty bad ranking.

The chart on page 8 shows one of the causes for decline in productivity. It can be seen that we are behind all of our trading partners. Again, the United Kingdom and the United States are at the bottom of the scale.

Germany and Japan beat us at our own game for the last 25 years and are at 35 percent.

The chart on page 9 deals with capital intensity and worker earnings. Here we find a striking correlation. It is that the highest wage earners are those where industry has invested the highest amount of capital per worker. For example, the petroleum and coal industry has $87,190 per employee and their average earnings—and this was as of 1972 from the Department of Labor—were $4.47 an hour. And then go to the other extreme, and they go right down in order, with $2,000 invested per employee getting $2.57 per hour.

Thus it would seem that the way to get peoples' wages and earnings up is to put a lot of money or investment in the plants in which they are working.

Another fundamental I would like to refer to is that we are falling down in capital investment per worker. And that one, for example, is stated on page 10 in 1958 dollars, and it is gross nonresidential fixed investment per employee. It is very striking as to what is really happening. Between 1956 and 1960, it was almost $50,000 per person; in 1961 to 1965, $55,000, and in 1960–70 starting down, $46,000, and

right now it is $41,000—another measure of how badly we are falling back.

Although investment is so important to jobs, productivity, and wage rates, we are nonetheless behind our trading partners in rate capital recovery allowances.

On chart 20, we have a chart showing what is happening. The United States is equated in its recovery only by Japan which has a very special set of circumstances.

Canada, Sweden, Australia, France—go through them all and they are materially faster than we are.

The final fundamental I would like to refer to is that the investment tax credit is perhaps the leading example of how wise incentives can create tax revenue and not reduce it. The increase in credit we propose will lead to greater, not less, Federal tax revenues. Quite apart from the economic forecasts of exports to confirm this, look at the historical record.

On page 28, we have a chart showing what has happened, not what is predicted. From the time it was first put on by President Kennedy, there was a spurt in real corporation income taxes collected by the U.S. Government until it was suspended when it dropped precipitously. It was then reinstated for 1 year and bounced up amazingly and taken off and down again for the next 2.

So, while you talk about revenue lost because of these "loopholes," some people can't tell an incentive from a loophole.

The CHAIRMAN. If I might interrupt you for a moment, I was reading ahead and looking at the same chart. I cannot help but be amused.

In 1969 when we repealed the investment tax credit, we thought we were going to make about $3 billion. Instead of making $3 billion, by the end of the year, we had lost about $5 billion, and by the following year, we had lost $10.

So, I am not saying that that was the sole effect. The monetary policy played its part, but repealing that tax credit played its part. So, between those two, when we took this investment tax credit off, we slowed the economy down to a screeching halt both times.

Mr. STRICHMAN. If it were taken off again, it would happen again. I know you all know this better than I, but it has to be continually repeated for the record because there are so many individuals in Congress who do not understand properly and applied incentives do yield more revenue to this Government than the revenue that is considered lost by changing a number and applying it to the status quo. This has been shown so consistently and so dramatically in what has been done with the yo-yo effect of the tax credit, it is not hard to predict what will happen in the future.

Mr. CONDRELL. We have a color coding of the chart we will provide the committee. The conclusions are correct, but the specific lines are improperly shaded.

The CHAIRMAN. For what years?

Mr. CONDRELL. It was suspended in October of 1966 and not fully reinstated until June of 1967. Then in 1968, it was in effect, but the reduction in 1968, we believe, was due to the lag time.

Mr. STRICHMAN. That was the lag it takes for the investment tax credit to start operating in either direction, down or up.

The CHAIRMAN. I would like to see you prepare a chart big enough so that someone could see it from one end of this room to the other. Perhaps you might put some coloring on it so that people could help understand what they are looking at, because I would like to have our staff and the Treasury check it out to see if this is really what it appears to be. If it is, I think the Senate might profit by it.

Mr. STRICHMAN. We will be glad to do that.

In addition, we will add to it the predictions made by our economists as to what we had for recommendations as to what will happen. It won't be a loss of revenue but dramatic increase in revenue to the Government.

The CHAIRMAN. Your figures show that after enacting the investment tax credit that corporation tax revenue went up. The spurt ahead to the economy made it work out differently than some people expected.

One point that does concern me a little bit here is that while we are trying to get more efficient machinery, it seems to me we need to have more efficient workers. Thus far, the testimony indicates that when workers own stock in this company, they are more efficient. They work harder. They take the interest of the company more to heart and feel as though they are more part of the team.

What is the attitude of your group toward employee stock ownership?

Mr. STRICHMAN. We have had a chance to talk among ourselves and to our group. We heartily favor it providing some things are done. First of all, there would have to be several changes in it. The first change is it has to be permanent. Anything as short-lived as 2 years will never go over with anybody because you cannot practically put it into effect; so it has to be permanent.

Second, it must be bigger than it is. It is so small at the present time it is almost not worth administering.

We propose it would be considered part of the structure on a permanent basis and on an increased basis.

The CHAIRMAN. About what would you recommend if you were going to have an ESOP plan?

Mr. STRICHMAN. At least 2 or 3 percent.

In addition to that, there are some technical things in there which have to do with voting or nonvoting, with what happens if there are different changes made on audit or if equipment is sold and what happens after you have invested or contributed to your ESOP.

All of those are not problems. They are things that have to be addressed and properly solved, and I am sure they will be.

The CHAIRMAN. I wish your people would consult among themselves and give us a list of the various problems; for example, the fear of some that perhaps the workers are going to gain control and take it away from management, and how these various problems could be met.

From my point of view, I would favor letting management have a broad latitude to make decisions to where the vote of stock held by the employee can be voting stock or nonvoting stock, or it can be voting when the employee retires. There are just all kinds of ways. I would be willing to give management the latitude of decision as to how these things should be done. You could even require it be voted in a

neutral fashion, so 60 percent would be voted one way and 40 percent the other so the employee stock would have to be split 60/40 at a shareholders' meeting. That would be an option I would be happy to vote for. If you had someone voting employee stock of the board, he woud vote only in the case of a tie. There are all kinds of ways. Or, he would have to vote in a neutral fashion in the event of a tie. There are all kinds of ways you could accommodate yourself to these various problems.

I would like to have all the suggestions your people can generate. I do not want to see us straitjacket employee stock ownership so that management won't use it. We made that plain before with these pension plans.

Mr. STRICHMAN. That is a good approach and we will take it up promptly with our executive committee and get it to you in writing.

[The material referred to above was subsequently supplied for the record:]

AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT,

Washington, D.C., April 27, 1976.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: After my testimony on behalf of the Ad Hoc Committee for an Effective Investment Tax Credit on April 2, 1976, you asked a number of questions regarding Employee Stock Ownership Plans (ESOP). In particular, you asked whether the Ad Hoc Committee has any suggestions for improving the existing ESOP legislation in relation to the Investment Tax Credit.

In order to provide a complete response to your questions, I contacted each of the members of the Ad Hoc Committee. As a result of comments received from about 100 companies, we submit the following suggestions:

(1) The additional 1 percent investment tax credit terminates on January 1, 1977. The short period for which this provision will be in effect is not sufficient to justify the accounting, administrative and other expenses of forming an ESOP, nor is the amount great enough. In order for this provision to be effective, it should be made permanent and it should be increased in amount from the present 1 percent to 2 percent or 3 percent (together with a 12 percent investment tax credit).

(2) A great deal of concern was raised with respect to coordination of the ESOP legislation with the rules governing companies' existing qualified profit-sharing and pension plans. Every effort should be made to coordinate the rules in order that existing pension and profit-sharing plans can be used in connection with the investment credit ESOP. Liberalizing and extending the use of existing plans would greatly reduce administrative costs and the complexity of adopting an ESOP Plan. Further, there is no reason why the concept of the investment credit ESOP could not be integrated with existing plans in a manner consistent with its purposes.

(3) The investment credit ESOP provisions should be amended to prohibit the recapture of any portion of the investment tax credit actually contributed to the ESOP, unless bad faith on the part of the taxpayer can be demonstrated.

(4) The investment credit ESOP should be amended to allow subsequent adjustments to ESOP contributions to reflect subsequent audit redeterminations.

(5) The investment credit ESOP should be amended to allow a recovery by the employer from the ESOP trust of those expenses which are attributable to trust administration.

(6) In the case of a closely held company, the provisions of ERISA and section 301(d)(9)(B) of the Tax Reduction Act of 1975 require a determination of the fair market value of the employer's securities at the time of each transfer to the trust. In order to eliminate prohibitive administrative costs, a provision should be adopted allowing transfers based on a reasonable valuation formula established by the plan. In the case of publicly held companies, the valuation date

should be the date of transfer and not the date of claim. Otherwise, there could be a variance from the date of claim to the date of transfer which would have to be made up from general corporate funds.

(7) In the case of public utilities, it should be provided that the portion of the tax credit going to the ESOP is treated as equity capital for the employees, with regulatory flow-through prohibited.

(8) The requirement that employees have the right to vote shares in the ESOP should not apply to partial shares. Any other rule creates an administrative burden.

(9) Section 301(d)(9)(A) of the Tax Reduction Act of 1975 defines "employer securities" as common stock of the employer or of a corporation in control of the employer within the meaning of section 368(c) of the Internal Revenue Code (i.e., a corporation in 80 percent or more control of the employer). In order to eliminate any question as to whether this provision effectively excludes second and lower tier subsidiaries from participating in investment credit ESOPs, it was suggested that the consolidated return test which is used in section 407(d)(7) of ERISA should be substituted for the section 368(c) control test contained in section 301(d)(9)(A) of the Tax Reduction Act of 1975.

(10) Most employee benefit plans are based on the concept of "base" wages and salaries excluding variable items such as overtime and bonuses. However, the ESOP provisions require a broad definition of wages and salaries including variable items. Thus, for example, certain employees receiving relocation allowances and overseas allowances of various types receive an unfair advantage. For this reason, wages and salaries should be limited to the base figure and not include variable items.

(11) A number of legislative proposals have been introduced which would permit a deduction for dividends paid on common stock held in ESOPs. The enactment of these proposals would significantly enhance the adoption of an ESOP.

(12) There is uncertainty with respect to the tax effect on employees following the 84-month holding period in the ESOP provisions. If the employee has a right to withdraw the shares at that time, is he obligated to pay tax on them at that time even though he wishes to leave them in the ESOP until a future date? It should be fairer to make it clear that the employee is only taxed when he actually withdraws the shares.

(13) It should be made clear that any investment credit ESOP established under section 301(d) of the Tax Reduction Act of 1975 will qualify under section 401 of the Internal Revenue Code even though it will be continued only so long as funding through the investment tax credit is permitted.

(14) If any or all of the above suggestions are adopted, or other amendments are adopted making the ESOP more advantageous, the effective date for electing the investment credit ESOP in 1975 should be extended for a 6-month period after such amendments to allow companies who wish to elect the ESOP provisions the ability to make the election for 1975.

I hope that the above comments will be helpful to you and the members of the Finance Committee in formulating legislation in this area.

I enjoyed appearing before you and the Committee and appreciate your interest in this area and with regard to capital formation as a whole. If I or the Ad Hoc Committee can be of further assistance, please let me know.

Sincerely,

GEORGE A. STRICHMAN,
Chairman.

Mr. STRICHMAN. I have a little more I was going say, Senator, about a specific program if you will and that is with the foregoing behind us, our recommendations for the ad hoc committee are: (1) a 12 percent investment tax credit without a termination date and without basis for adjustment and, added to that, Senator Long, whatever two or three percent we think could be used for ESOP; (2) Permissible depreciation range under the ADR system should be increased 40 percent from the present 20 percent; (3) The cost of pollution controls should be allowed as expense first year of operation; and (4) certain technical changes should be enacted to make the investment credit

and ADR more effective in stimulating productivity improvements in all sectors, including small businesses and those with low profit margins.

Of crucial importance is immediate action raising the investment credit to 12 percent and extending it beyond December 31, 1976, by removal of the termination date. The long lead time for a large share of the facilities covered by the credit require early action. Plans of some businesses are already being prejudiced by the December 31, 1976, terminal date in the present legislation.

Mr. Chairman, I would like to adjust one more thing.

During this month, Sir Frederick Cappel, chairman of the British Overseas Trading Board, made this statement:

"I think the miserable level of investment, and that alone is to be blamed for the poor state of the British economy—neither strikes nor shop stewards explain the U.K.'s economic decline in recent years. Only the low level of investment—

Senator HARRY F. BYRD, Jr. I am sorry but your time has expired.

Mr. STRICHMAN. I would merely point out that our numbers are so similar to theirs these days, it is something to look at.

Senator HARRY BYRD, Jr. I think you make a very good point. I am afraid our country is going in the direction of England, or accelerating in that direction.

I was interested in your comments where you mention the need for these and other measures to stimulate savings and investment have never been more critical. Our economy has been subjected to a prolonged period of inflation which has seriously distorted the distribution of national income. Large Federal deficits have been regularly incurred, reducing total savings and creating enormous impact on the Nation's financial markets and, at the same time, accelerating the shift of national resources from the private economy into the public sector expenditures.

I take that to mean that you see a very definite relationship between the huge and accelerating Federal deficits and the lack of savings and investments for capital needs.

Mr. STRICHMAN. Absolutely. If we go back to Dr. Ture's presentation at the beginning of this morning, the savings that are available for investment come from total savings which are the private sector, the public sector plus or minus the governmental deficits. Those deficits have reached such huge proportions that the real total savings effect we have of the dollars available for investment are just going the wrong way.

Senator HARRY F. BYRD, Jr. Do you regard the huge deficits as being a highly dangerous trend for the Nation as a whole?

Mr. STRICHMAN. I certainly do, and if I may be a little flippant about it, the only difference between the Federal Government and New York City is the Federal Government can print money.

Senator HARRY F. BYRD, Jr. You are so right. As a matter of fact, if you really analyze it, I would say the Federal Government is in worse shape than New York City.

Mr. STRICHMAN. At least they can print the money to keep it going.

Senator HARRY F. BYRD, Jr. Except for the fact that it has some printing presses here, continued annual accelerated use of the printing press reduces the value of everyone else's dollar.

You mentioned the problem of inflation. How do you see inflation not for calendar 1976 but, say, 18 months from now or 2 years from now? Do you see inflation continuing or abating?

Mr. STRICHMAN. I am not much of a soothsayer, but if we look at what happened, we all know what happened in 1974, it was materially reduced in 1975 and highly reduced for the first couple of months this year. We run a close reporting system only on what is happening on our own costs, and it is again beginning to speed up.

Senator HARRY F. BYRD, Jr. It is now beginning to speed up?

Mr. STRICHMAN. It is now beginning to speed up. I believe that tendency will continue.

One of our problems will have to be trying to hold it down to keep it from getting back to the kind of numbers we had in 1974. At the time of large deficits going on now, we will be facing that problem again in the 18 months we are speaking of.

Senator HARRY F. BYRD, Jr. I certainly concur with that view. I do not see how we can avoid it. In this fiscal year, the Government's deficit will be $76 billion and then going into the next 15 months, which is a transition period for the new fiscal year plus the new fiscal year which ends September 30, 1977, in that 15-month period, the Federal funds deficit will be $68 billion. That is just in a 2-years, 3-months' period. To me it is a highly dangerous situation, and it is bound to lead to accelerated inflation.

Senator CURTIS. I want to say it is excellent testimony, and in view of the hour, I will forego the questions, but I do appreciate your recommendations.

Senator HARRY F. BYRD, Jr. Senator Dole.

Senator DOLE. I appreciate the statement which I intend to read. I think it is excellent, as were the others, but you did just say as an aside that many do not know the difference between a loophole and an incentive. We had a long discussion in the Budget Committee yesterday, and I did not hear the word incentive used in that committee. I will not name anyone, but I did hear the word loophole used repeatedly. That is the popular attack. I don't know how you focus in on what is in fact an incentive and what is in fact a loophole for either individuals or business. It is like water on a duck's back.

You seem to have an information program afoot generally to inform the American people. I think it would be helpful if you could inform some Members of Congress. Unfortunately, some of them won't listen.

Are there others with you whom you would like to identify for the record or are there just the two of you?

Mr. STRICHMAN. There are others here but they are not presenting anything today.

If I may say something in addition to what you are saying, it would be a plea for the fact that intelligent incentives in tax law are really one of the greatest ways to accomplish all the things this country should accomplish. One of the easy ways to demonstrate—and I think there are enough Members of the Congress who understand about it—that those incentives that by performance can show that they increase the amount of revenue, not decrease it, are in no way, nor should they be considered to be loopholes. It is a travesty to talk of them that way, because they are really building up the economic ability of the Nation. and that is where all our taxes come from.

Senator DOLE. I am not certain I share your view that there is a majority in Congress. I guess we will find out.

What is the impact of the December 31 expiration date on a current basis?

Mr. STRICHMAN. I think the termination date of the 10 percent is having an adverse effect already.

For example, if you are a farmer and you are buying some equipment and you get it off the shelf, obviously it has little effect, but for most of us you do find an adverse effect. For example, where one is trying to buy and receive equipment, installing it and getting it operational between now and the end of the year, which is necessary in order to achieve the 10 percent credit, it is difficult to do. There is no way of doing that. Those things which are being ordered by all the companies I know, by my own company, are being ordered with respect to what do we have to do and nothing more, not what is well worth doing, because we don't know the situation with respect to whether the credit is going to be there or not.

We have reached the point where we only consider hopefully that we will have a 7 percent tax credit next year, because that is all we could go back to, and maybe we won't have that.

It is a very bad situation. It may be felt in Congress that we have lots of time, but it is now for us.

Senator DOLE. The impact is adverse.

Mr. STRICHMAN. The adverse is here already.

Senator HARRY F. BYRD, Jr. You mentioned a moment ago there are already signs of inflation heating up, accelerating. Could you indicate in a little more detail what those signs are?

Mr. STRICHMAN. As a matter of company policy, we keep a continual listing of our changes in cost of the supplies which are maybe 50 percent of our total expenditures which are for things we buy, and we buy them from other people. We keep the record of how they are changing month by month.

During the year 1974, Senator Byrd, the increase was like 24 percent in one year. That was the increase in prices we had to pay for the things we brought into our shop and we did something to them and then sent them out again.

During 1975, it got down pretty low. During the first half of the year, it was almost nothing. During the second half of the year, it was running annualized about 4.5 percent a year. These are the actual figures, past tense not future tense. They have speeded up a little in the last 2 months, 9½ to 10 percent. As we asked our divisions to do, which is forecast to us what they hear from their suppliers for the next 3 or 4 months, it will go up 2 or 3 percent in the next 4 months on an annualized rate, so we are looking at a rate that will approach 10 to 12 percent very shortly.

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

[The prepared statement of Mr. Strichman follows. Oral testimony continues on p. 1773.]

STATEMENT OF AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT

SUMMARY

Objectives of the Ad Hoc Committee

The Committee's immediate objectives are a permanent 12 percent investment tax credit; an increase in the permissible range under the Asset Depreciation

Range (ADR) System from 20 to 40 percent; expensing of pollution control equipment in the year placed in service; and technical and substantive changes in the investment credit and ADR to reflect the critical need for more effective cost recovery provisions.

Need for business savings and investment

The United States has the lowest rate of private sector investment in the industrialized world. Today's principal economic concern should be the formation of sufficient capital to meet projected requirements for job producing investments in United States business and industry. Such requirements are estimated to be as high as $5 trillion between now and 1985. Based on present national trends in savings, there will be a shortage of investment capital by 1985 in the range of $575 billion—or over 10 percent of total requirements. It is significant that the United States has never achieved a rate of savings adequate to meet this deficiency. The need for public policy changes to emphasize savings and investment is apparent.

Role of business capital recovery in total national savings

Since World War II, the contribution of business savings to the nation's total savings has risen from 48.1 percent of the total in 1947 to 65.9 percent in 1974. Capital recovery provisions of the Internal Revenue Code accounted for 58 percent of total business savings. Therefore, such cost recovery factors are immensely important to the level of national savings and investment.

International comparison of capital recovery systems

Relative to other industrialized nations, the United States capital recovery system (even with a 10 percent investment tax credit) has consistently ranked at or near the bottom. Other nations have recently taken steps to stimulate savings, investment and national productivity by further liberalizing their capital recovery systems.

Historic effects of the investment credit and depreciation provisions on investment, employment, productivity and tax revenues

The correlation between the applicability of effective cost recovery provisions and such leading economic indicators as savings, investment, employment, productivity and Federal tax revenues is striking. The history of the investment credit and rapid depreciation methods demonstrates that this form of tax incentive is most effective if it is left unchanged over a substantial period of time. They are effective incentives for increasing capital formation and economc growth. They should not be used as a mechanism for stabilizing the economy and in fact the various changes in the investment credit have historically proven to be destabilizing.

Recommendations of the Ad Hoc Committee

The following tax changes are recommended as the most effective means of immediately stimulating savings for long-term capital improvements:

(1) a 12 percent investment tax credit without a termination date;

(2) the permissible depreciation range under the ADR system should be increased to 40 percent from the present 20 percent;

(3) the cost of pollution control facilities should be allowed as an expense in the first year of operation; and

(4) certain technical changes should be enacted to make the investment credit and ADR more effective in stimulating productivity improvements in all sectors, including small businesses and those with low profit margins.

In addition, consideration should be given to adopting a simplified capital recovery system as a more permanent solution to our capital needs. The capital recovery system recommended would provide (see full statement for details) for recovery of all capital costs over a 5 or 10 year period. Finally, the President's proposal for a new accelerated depreciation system would constitute an interim step towards a satisfactory depreciation system if it were expanded to cover all new equipment and facilities over a several year period. This proposal and possible amendments to it are described in the detailed statement.

Timing

Of crucial importance is immediate action raising the investment credit to 12 percent and extending it beyond December 31, 1976 by removal of the termina-

tion date. The long lead time for a large share of the facilities covered by the credit require early action. Plans of some businesses are already being prejudiced by the December 31, 1976, terminal date in the present legislation.

Conclusion

All indicators point to the need to restore a proper balance between savings and consumption in United States tax policy. Such a balance would provide the long-term growth needed to provide sufficient jobs for a growing labor force, and the improved productivity needed to assure rising real wage rates and long-term price stability.

STATEMENT

The Ad Hoc Committee for an Effective Investment Tax Credit is a voluntary group of over 275 business firms and 51 supporting business associations. A list of the member companies and supporting associations is attached (see Appendix A).

The membership of the Ad Hoc Committee shares the belief that the critical economic concern facing this country today—and for the next ten years—is the formation of sufficient capital to meet the unprecedented projected requirements for job producing investments in American business and industry.

There are several factors which contribute to our conviction that substantial changes in Federal tax policy are necessary if we are to halt the ongoing deterioration of our relative position in the world economy. Such changes are necessary to ensure sufficient jobs for a growing labor force. They are necessary if we are to overcome the problems of energy and raw material shortages. They are essential if we are to maintain the viability of our free enterprise system. And, certainly they are essential if we expect to provide opportunities for achieving a rising standard of living for all the citizens of this country.

Changes in present tax policy are necessitated by such factors as:

The reduced rate of private sector investment in the United States (now the lowest in the industrialized world);

The low rate of productivity gains in United States manufacturing (also the lowest in the industrialized world);

The inferior position of United States industry in terms of capital recovery tax provisions, compared to industry in other industrialized nations (the United States ranks at or near the bottom);

The shocking decline in real corporate profits, resulting in reductions in business savings and increased reliance on debt financing;

Growing requirements for major investments in environmental protection and improvement.

These represent only a few of the economic indicators and known factors which point to the need for a revitalization of the United States economy through more realistic tax provisions for capital recovery. And let there be no question about it . . . these provisions are probably the most important single factor in determining the rate of saving and investment by business.

The Congress, by increasing the investment tax credit to 10 percent (11 percent in some cases) in the Tax Reduction Act of 1975, recognized these problems. Unfortunately, due to the December 31, 1976 termination date on this increase, it has had limited effect. The House of Representatives recognized the need for a lasting increase when it passed H.R. 10612 on December 4, 1975. The House Bill provides for an extension of the 10 percent investment tax credit to 1980. The House action is encouraging and has the support of the Ad Hoc Committee. However, we believe more substantial and permanent action is necessary.

The Ad Hoc Committee strongly urges that the Congress take the following actions as an immediate step toward improved savings and capital formation:

1. Increase the investment tax credit to 12 percent without a termination date and without basis reduction.
2. Increase the permissible range under the Asset Depreciation Range (ADR) System for depreciating capital assets from 20 percent to 40 percent.
3. Provide for a reduction in the depreciation period applicable to pollution control facilities, preferably allowing 100 percent cost recovery in the first year of use for such assets.
4. Enact the most urgently needed technical improvements in the capital recovery system (described later in the statement).

In addition, the Ad Hoc Committee supports other long-term and interim steps discussed hereinafter.

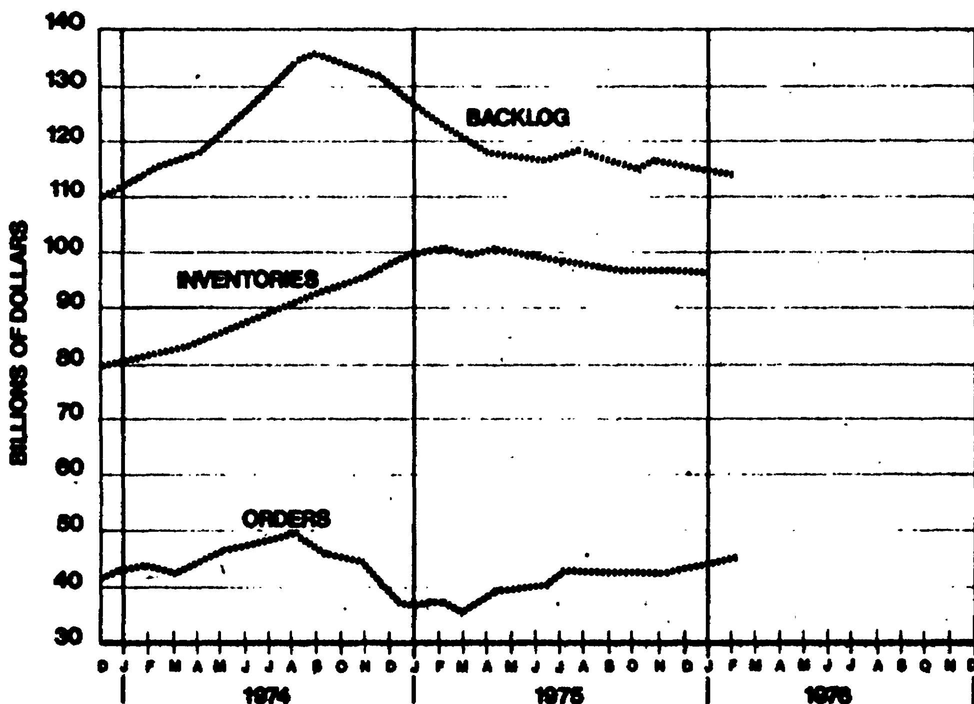
Present economic considerations warrant prompt and effective action

The need for these and other measures to stimulate savings and investment has never been more critical. Our economy has been subjected to a prolonged period of inflation which has seriously distorted the distribution of national income. Large Federal deficits have been regularly incurred, reducing total saving and creating enormous impact on the nation's financial markets and, at the same time, accelerating the shift of national resources from private investment in the economy to public sector expenditures.

And now, in addition to the problem of inflation, we find ourselves just beginning to come out of the most serious economic slump since the great depression of the 1930's. This economic crisis is further exacerbated by raw material and energy shortages which have contributed to both higher prices and declining production.

Although some of the recent economic indicators imply an upturn in the economy, it is apparent that the economy has not fully recovered. In fact, one of the leading indicators—durable goods orders, backlogs, and inventories—has remained neutral. This suggests that the prospect of recovery in the durable goods area continues to lag. This is particularly significant since durable goods often act as a bellwether indicator for industry as a whole.

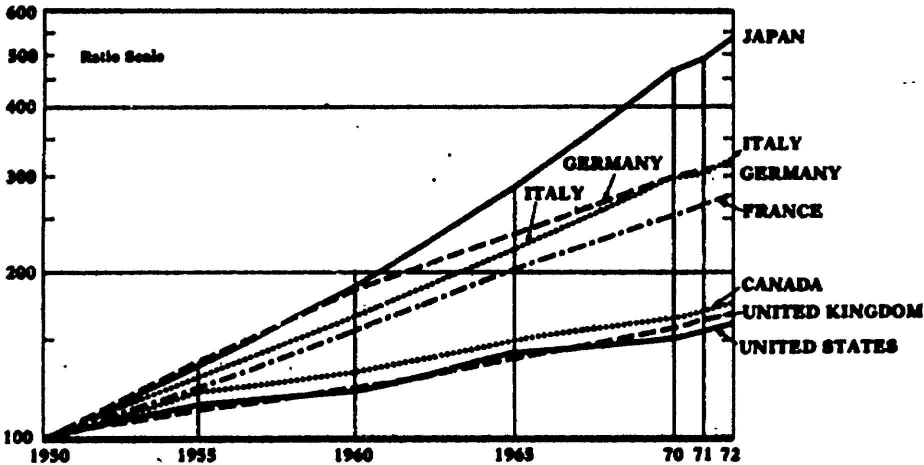
The following chart clearly indicates that the gap between durable goods orders and inventories is not closing. In addition, the backlog of orders continues to decline.



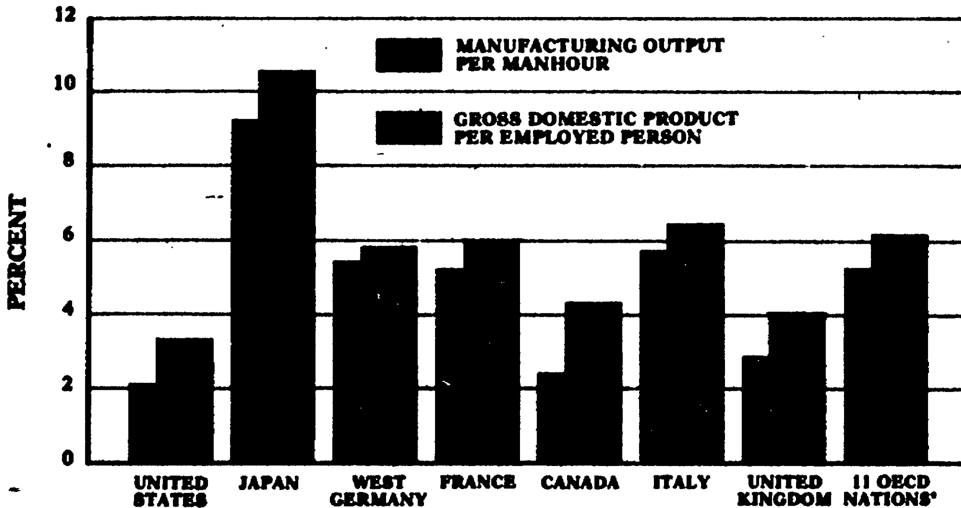
Productivity and other economic indicators

In reviewing some of the specific indicators which argue forcefully for more realistic capital recovery provisions, it is appropriate that we look at those by which we can measure United States economic performance compared to other industrialized nations—Canada, Sweden, France, West Germany, and Japan.

The United States has fallen dramatically behind our trading partners in many respects, the most important being manufacturing productivity. In 1974, we experienced a 2.2 percent decline in productivity—the first such decline, according to government sources, known to have occurred in the 200 year history of our country, and certainly the first since records of economic indexes have been maintained. The accompanying chart shows the changes in real GNP per employed civilian in the period 1950 to 1972, with the United States at the bottom of the scale in relation to other countries.



The following graph measures the same national economies in terms of productivity growth over the period 1960–73, with the United States again lagging behind all, and very far behind most.



This poor performance is not surprising in view of the level of United States investment during this period, and in view of the well established correlation between investment and real growth. The following table 1 illustrates that United States investment as a percent of real national output has lagged behind that of other nations—in fact, being only one-half the ratio in Japan and West Germany.

TABLE 1.—INVESTMENT AS PERCENT OF REAL NATIONAL OUTPUT, 1960-73 [1]

	Total, fixed [2]	Nonresidential, fixed
United States	17.5	13.6
Japan	35.0	29.0
West Germany	35.8	20.0
France	24.5	18.2
Canada	21.8	17.4
Italy	20.5	14.4
United Kingdom	18.5	15.2
11 OECD countries (1960-72)	24.7	19.4

[1] OECD concepts of investment and national product. 1973 estimated.
[2] Including residential.

Sources: OECD; U.S. Department of Treasury.

Capital formation is the major factor for increasing productivity. Without adequate capital formation, U.S. productivity will decrease and our competitive position in world markets will be eroded. In addition, a high rate of capital formation increases productivity and permits higher real wages and an increased standard of living without excessive inflation.

One of the most striking parallels is the relationship between capital investment and wage rates by industry. Figure 1 shows 1971 capital investment data and compares it with production worker average earnings by related industry groupings.

FIGURE 1.—CAPITAL INTENSITY AND WORKER EARNINGS

Industry	Capital per employee		Production worker average earinngs	
	CPE	Rank	Per hour	Rank
Group 1:				
Petroleum and coal	$87,190	1	$4.57	1
Chemicals	36,450	2	3.94	3
Primary metals	35,060	3	4.23	2
Paper	29,440	4	3.67	4
Stone, clay, and glass	20,550	5	3.66	5
Food	14,160	6	3.38	7
Rubber/plastics	14,140	7	3.40	6
Tobacco	12,690	8	3.15	8/9
Lumber	10,270	9	3.15	8/9
Miscellaneous	6,490	10	2.97	10
Furniture	5,210	11	2.90	11
Leather	2,530	12	2.60	12
Apparel	2,110	13	2.49	13
Group 2:				
Transportation equipment	12,080	1	4.41	1
Nonelectric equipment	11,640	2	3.99	3
Fabricated metals	11,540	3	3.74	5
Ordnance	10,560	4	3.84	4
Instruments	9,410	5	3.52	6
Electrical equipment	8,830	6	3.48	7
Printing	8,580	7	4.20	2
Group 3: Textiles	10,840		2.57	

Source: Department of Labor.

Reviewing this data during his testimony before the Joint Economic Committee in mid 1975, the then Secretary of Labor Dunlop concluded:

". . . creation of jobs through investment capital broadens opportunities, thus allowing more upward mobility in salary and skills as people are promoted and new jobs created . . . the most basic and far-reaching objective for national policy in this context should be to encourage development of new technologies and the formation of new capital. . . . Also, the increase in output and income implied by new capital formation means a higher level of living and income for all Americans, whether or not they are employed by the industries involved with new capital formation and productivity gain."

In the past the U.S. has had the highest capital-to-labor ratio in the world, however other nations have narrowed the gap significantly in the past two decades as the rate of investment per worker added to the labor force has fallen off in the U.S.

FIGURE 2.—*Gross nonresidential fixed investment per person added to civilian labor force*

[In 1958 dollars]

Period:	*Amount*
1956–60	$49,500
1961–65	55,300
1966–70	46,400
1971–74	[1] 41,000

[1] Estimate based on incomplete data for 1974.

Source: Statement of Paul W. McCracken before the Committee on Ways and Means, Jan. 29, 1975. Basic data from the Department of Commerce and Labor.

The evidence is overwhelming. If our economy is to perform at the level required to provide sufficient capital for jobs, for environmental protection, for energy independence, for government programs of security for the elderly and the disabled, for needed housing, for national defense, and for adequate research and development, these trends must be reversed.

Capital formation requirements (1975–85)

There have been a number of meaningful projections of capital requirements for the next decade, with conclusions falling in the range of $4 to $5 trillion. One method of calculating capital requirement utilizes as a goal the maintenance of the postwar average rate of increase in labor productivity and real wage rates while, at the same time, avoiding an unacceptable rate of unemployment. From previously cited comparisons with the record of other countries over the same period such a goal is clearly only a minimum. By projecting these rates in employment and the capital-labor ratio through 1985, it is seen that business capital outlays will have to be in the range of $2.37 trillion (in constant 1974 dollars). By adding capital outlays for housing, environmental protection and predicted government sponsored programs, the figure rises to $3.54 trillion in constant 1974 dollars. (See zero inflation Table 3 infra.) And finally assuming a conservative Federal deficit of $10 billion per year and a 3 percent inflation factor the total capital need rises to $4.3 trillion. (If the projection assumes a more realistic inflation factor of 5 percent the total would be $4.9 trillion.)

We cite this example to demonstrate that what we are talking about in terms of needed capital formation is not "pie in the sky". It is absolutely fundamental to this nation's continued existence as a major economic force in the world.

Other examples were summarized in Secretary of the Treasury Simon's statement to the Committee on Finance on March 7, 1976:

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

The following table 2 contained in the Treasury statement summarizes a number of other studies containing similar findings:

TABLE 2.—ACTUAL AND PROJECTED INVESTMENT AS A PERCENT OF GNP

	Average 1965–74	NYSE [1]	Bosworth Duesenberry Carron [2]	Friedman [3]	G.E. [4]	DRI [5]	Chase econometrics
Gross private domestic investment	15.1	16.4	15.5	15.8	15.8	15.7	15.9
Nonresidential fixed	10.4	12.1	11.3	11.5	11.4	11.0	11.8
Inventory	1.0	.3	.8	.8	.4	.8	.8
Residential	3.8	3.9	3.5	3.5	4.0	3.8	3.3

[1] The New York Stock Exchange, "The Capital Needs and Savings Potential of the U.S. Economy; Projections Through 1985", September 1974. Figures shown are based on cumulative projections in current dollars, 1974–85.
[2] Barry Bosworth, James S. Duesenberry, and Andrew S. Carron, "Capital Needs in the Seventies", The Brookings Institution, 1975. Figures shown are based on estimates for 1980 in current dollars from table 2-12, p. 39 (note the constant dollar 1980 figures in table 2-11 project gross private domestic investment as 15.8 percent of GNP).
[3] Benjamin M. Friedman, "Financing the Next Five Years of Fixed Investment" in President's Authority to Adjust Imports of Petroleum, Public Debt Ceiling Increase; and Emergency Tax Proposals; Hearings before the Committee on Ways and Means, House of Representatives, January 1975, pp. 710–726. Figures shown are based on 1975–79 averages of current dollar projections.
[4] Reginald H. Jones, "Capital Requirements of Business, 1974–85," Testimony submitted to Subcommittee on Economic Growth, Joint Economic Committee, May 8, 1974. Figures shown are based on cumulative projections in current dollars, 1974–85.
[5] Data Resources, Inc., Summer 1975, "Special Study: The Capital Shortage." Summary table on inside cover. 1985 data only, current dollars, standard forecast.
[6] Chase Econometrics August 1975. "The Next Ten Years: Inflation, Recession and Capital Shortage," 1984 data only, current dollars. Table, page No. 1 of 14. No recession run.

Savings required to meet capital needs

We know that we must have the capital for productive investments. The next question is, how do we generate sufficient savings to make such investment possible?

The postwar average rate of national savings has been 15.7 percent. At this average level, assuming a 3 percent inflation rate, there will be a $500 billion gap in capital formation through the year 1985. Assuming a more realistic 5 percent inflation factor, the capital formation gap could be a staggering $575 billion. The accompanying tables 3, 4 and 5 illustrate the required levels of private savings at varying rates of inflation. The United States has not been able to achieve these levels of savings in the past, and it is clear that extraordinary measures must be taken to make it possible in the future.

TABLE 3.—ESTIMATED CAPITAL REQUIREMENTS AND PRIVATE SAVING, 1975

[In billions of dollars]

Year	Capital requirements: Nonresidential fixed investment plus inventory accumulation	Capital requirements: Other capital outlays, including Government deficits	Total	Gross private saving	Saving gap
A. Zero inflation:					
1975	174.5	81.6	256.1	235.8	20.3
1976	181.6	84.7	266.3	244.7	21.6
1977	189.2	88.4	277.6	253.9	23.7
1978	197.2	92.3	289.5	263.4	26.1
1979	205.3	97.0	302.3	273.3	29.0
1980	213.9	102.3	316.2	283.6	32.6
1981	222.6	108.3	330.9	294.2	36.7
1982	232.0	115.2	347.2	305.3	41.9
1983	241.5	123.3	364.8	316.8	48.0
1984	251.5	132.7	384.2	328.7	55.5
1985	262.0	143.5	405.5	341.0	64.5
Total	2,371.3	1,169.3	3,540.6	3,140.7	399.9

Source: Norman B. Ture, Inc., prepared July 1975.

ESTIMATED CAPITAL REQUIREMENTS AND PRIVATE SAVING, 1975

[In billions of dollars]

Year	Capital requirements	Gross private saving	Saving gap
B. 3 PERCENT INFLATION			
1975	263.8	242.9	20.3
1976	282.5	259.6	22.9
1977	303.3	277.4	25.2
1978	325.8	296.5	29.0
1979	350.5	316.8	33.9
1980	377.5	338.6	38.9
1981	407.0	361.8	45.7
1982	439.8	386.8	53.9
1983	476.0	413.4	62.6
1984	516.3	441.7	74.6
1985	561.3	472.0	89.3
Total	4,303.8	3,807.5	496.3
C. 5 PERCENT INFLATION			
1975	268.9	247.6	21.3
1976	293.6	269.8	23.8
1977	321.3	293.9	27.4
1978	351.9	320.2	31.7
1979	358.8	348.8	37.0
1980	423.7	380.1	43.6
1981	465.9	414.3	51.6
1982	513.0	451.1	61.9
1983	565.9	491.5	74.4
1984	625.8	535.4	90.4
1985	693.5	583.2	110.3
Total	4,909.3	4,335.9	573.4

Source: Norman B. Ture, Inc.

Corporate profits and financial problems

The flow of internal funds cannot keep pace with nominal capital outlays since depreciation allowances are based on original cost and not on replacement prices. Due to inflation, real corporate profits have been overstated. For example, the Treasury has stated that nonfinancial corporations reported after tax profits of $60.1 billion in 1975 as compared with $37.2 billion in 1965. These figures, when adjusted for inflation, are $35.8 billion in 1975 and $35.6 billion in 1965. Thus, there has been no real increase in corporate profits over the last decade. However, the corporate tax is applied to the profits without adjustment for inflation, resulting in a rise in the effective tax rate on true corporate profits from 43 percent in 1965 to 51 percent in 1975.

Corporations have increasingly turned to borrowing to finance capital investment. Average outside financing was 30 percent in 1964. In 1974, outside financing increased to over 60 percent of total capital needs. This result can be attributed to the effect of inflation on capital needs and profits.

Secretary Simon, in his March 7 statement, summarized the financial effects of increased corporate borrowings as follows:

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

Due to these changes in corporate financing, the liquidity of corporate balance sheets is severely reduced. Therefore, corporations are far less able

to withstand even minor recessions, resulting in reduced confidence in lenders and investors. The final result is reduced corporate investment due to a reduction in available funds.

Capital recovery is key to business saving and investment

While recognizing there are various avenues that must be explored for increasing total capital savings, by both business and individual savers, it is the intention of the Ad Hoc Committee in this statement to address the question of business savings only.

Commerce Department figures show that business savings, as a percent of total national savings, increased from 48.1 percent of the total in 1947 to 65.9 percent in 1974. Consequently, business saving is now the largest factor to be considered in an examination of the issue.

In turn, the major factors in business savings are the capital recovery allowances of the Internal Revenue Code. In 1974, these allowances accounted for 58 percent of total savings—the major provision being depreciation.

International comparison of capital recovery systems

The low rate of capital investment and productivity increase in the United States is due, at least in part, to the fact that in recent years our capial recovery system ranks at or near the bottom among major industrial nations. This is illustrated by the comparison attached as Appendix C.

Figure 3 illustrates that with the exception of Japan where special factors apply, the U.S. requires substantially longer cost recovery periods for its machinery and equipment than its major trading partners.

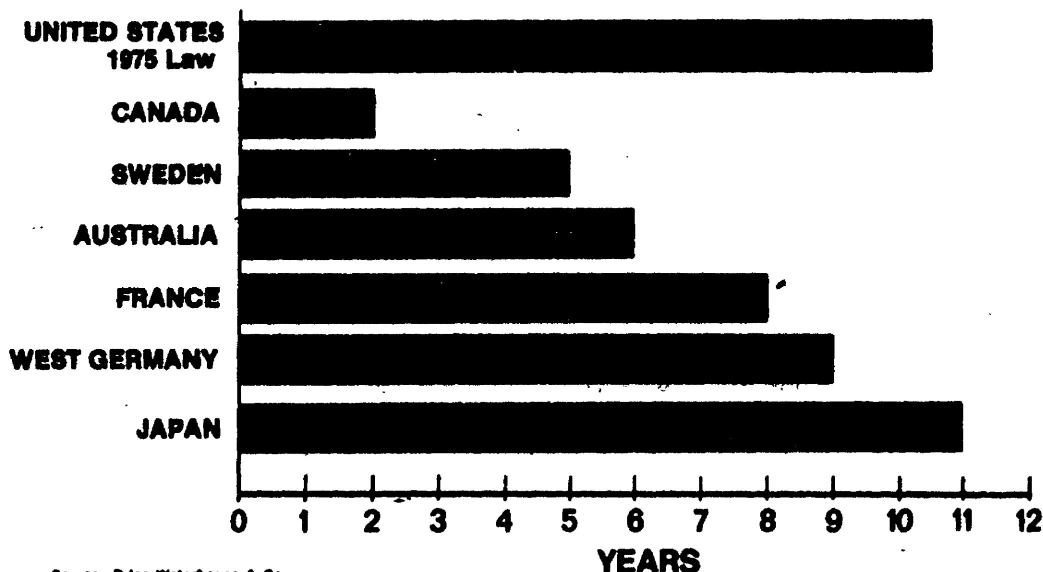


FIGURE 3

And of course, many of these nations have recently taken significant steps to liberalize their capital recovery systems.

Sweden will continue its investment reserve program under which 15 percent of pre-tax profits are placed in a reserve fund and deducted from taxable income. Investment expenditures are charged against the reserve fund.

Canada's Federal Budget contains provisions for a two-year write-off of the cost of new manufacturing and processing equipment and pollution control assets (reflected in Figure 3). Finance Minister Turner referred to the manufacturing

and processing write-offs as "a major contribution to strong investment performance which is improving productivity, enhancing supply, creating new jobs and helping to sustain the Canadian economy at a time when the economies of many other nations are faltering".

Australia has announced its intention to allow manufacturing and primary production industries to depreciate new plant and equipment at substantially higher than current rates.

When these and other revisions are all implemented, it will make the comparison between the United States' capital recovery system and those of other countries even more glaring—and we are already ranked close to the bottom of the list.

Impact of Tax Reduction Act of 1975

The recently enacted Tax Reduction Act of 1975 provided for a temporary increase in the investment tax credit from 7 percent to 10 percent (11 percent under certain prescribed conditions). While it has not been in effect long enough to fully evaluate its effectiveness, our surveys indicate that many companies find the two-year limit on the higher rate is too short a time for them to make investment decisions and to implement them. One and one-half to two years has proven to be the time necessary for the credit to be fully effective indicating that the lead time is considerable for many types of property covered by the credit. Consequently, we have to conclude that a significant number of potential investments which would have been stimulated if the 10 percent credit had been made permanent are instead still languishing for lack of a long-term policy of improved capital recovery.

The investment credit is not a viable counter-cyclical mechanism

The temporary nature of the 1975 amendments reflects the unfortunate tendency, ever since the investment credit was enacted in 1962, to utilize it as a counter-cyclical device. The Ad Hoc Committee is convinced that the credit is totally unsuited for such purposes, and that its effectiveness over the years has been hindered by the uncertainties of investors concerning its availability and applicability to particular capital investments.

Attached to this statement is a report entitled Policy Alternatives For The Investment Tax Credit which was prepared by Professors Roger H. Gordon and Dale W. Jorgenson of Harvard University (See Appendix D). This report discusses in detail the effects of the use of the investment credit for counter-cyclical policy. The report concludes that:

The value of the tax credit for stabilization depends on the ability of the administrator to forecast future trends. From the historical choice of credit rates, it appears that this ability was so poor as to make use of a flexible instead of a constant credit rate detrimental to stabilization. . . . Uncertainty facing the administrator seems to be too large to make a flexible policy worthwhile. For example, reduction or suspension of the investment tax credit in late 1964 would have required accurate anticipation of the course of the Vietnam buildup. In 1964 U.S. fiscal policy was headed in precisely the opposite direction. In that year a major tax cut was instituted and the effectiveness of the investment tax credit was enhanced. . . . The implications of the changing defense policy were not apparent to fiscal policy makers until considerable time had elapsed.

. . . The investment tax credit was repealed in 1969 and not re-introduced until 1971. In retrospect this change in policy was in precisely the wrong direction. The investment tax credit should have been increased very substantially in order to counter-balance the effects of the Vietnam de-escalation.

The tax credit, however, remains a powerful device to stimulate capital deepening. A constant fifteen percent credit rate for the next ten years would cause the capital stock in 1985 to be 12.5 percent higher than it would be under a seven percent rate. Thus our basic conclusion is that the choice of a rate for the investment tax credit should be based on long run objectives of capital deepening and desired average levels of demand for an extended period, and not on short run stabilization objectives.

It is clear from this and other studies that the credit is not a viable instrument for fine tuning the economy. Therefore, it should be used as a means to achieve long-range capital formation and economic goals. The various schemes for a variable investment credit are based on either invalid assumptions or are inconsistent with economic realities.

Historic effects of changes in depreciation provisions and the investment credit

There is no question that liberalized depreciation provisions and the investment credit have proven in the past to be effective in increasing employment and productivity, thus combating inflation and enhancing real growth. This fact can be illustrated in terms of capital investments, employment and Federal revenues.

1. Effects of changes in capital recovery provisions on investment in capital facilities, 1962-72:

Following enactment of the original investment credit and adoption of the reduced guideline lives for depreciation in 1962, new orders for machine tools increased rapidly by 251 percent—from $144 million in the last quarter of 1961 to $514 million in the first quarter of 1966. New orders for producers capital goods increased by 82 percent—from $8.9 billion in the fourth quarter of 1961 to $16.2 billion in the third quarter of 1966.

The suspension of the investment credit in the third quarter of 1966 was followed in the next two quarters by a sharp drop in new orders for machine tools and producers capital goods—$130 million and $2.8 billion, respectively.

Restoration of the credit in the second quarter of 1967 led to a rapid build up in orders—producers capital goods increased 36 percent from $13.8 billion in the first quarter of 1967 to $18.8 billion in the second quarter of 1969. Machine tool orders in the same period increased 70 percent from $328 million to $558 million.

The repeal of the credit in 1969 resulted in a drop of $2.7 billion in new orders for producers capital goods through the second quarter of 1970. Machine tool orders were off $417 million, almost 75 percent, from the second quarter of 1969 through the end of 1970.

Following enactment of the new investment credit and the Asset Depreciation Range (ADR) System in 1971, orders for producers capital goods increased by $4.5 billion from the second quarter of 1971 through the third quarter of 1972. Machine tool orders rose by $103 millon—almost 60 percent—in the same period, from $182 million to $285 million. The pattern is unmistakable. Capital facility investment is powerfully affected by changes in depreciation and particularly by changes in the investment tax credit.

2. Employment effects, 1962-72:

Employment in capital goods and machine tool manufacturing industries in 1962-72 also parallels changes in capital recovery tax provisions. Following enactment of the investment credit and adoption of the shorter guideline lives for depreciation in 1962, the number of employees in producers durable goods industries increased rapidly by 23 percent from 6.1 million in 1962 to 7.5 million in 1966. Suspension of the credit in the third quarter of 1966 slowed employment increases to only 2⅝ percent in 1967. Following restoration of the credit in the second quarter of 1967, employment increased to about 8 million in 1969.

With the repeal of the credit in 1969, employment dropped by about 900,000 jobs—roughly 11¼ percent—in 1971. After enactment of the new credit and the ADR in 1971, employment increased from 7.1 million to 7.8 million—about 10 percent—in 1973.

The number of employees in machine tool manufacturing alone rose by 41 percent or 34,000 from 1962 through 1967. Output and employment in this industry was adversely affected by the cutback in the space program in 1968; between 1967 and 1969, employment dropped by 5 percent or 5,800 jobs. Repeal of the investment credit in 1969 resulted in a much steeper drop in jobs, from 110,600 in 1969 to 78,400 in 1971, a decline of 29 percent. After enactment of the new credit and the ADR in 1971, machine tool employment increased by 3,700 jobs or by 4.7 percent in 1972.

The above discussion covers the capital goods sector only. Through the multiplier effect, the beneficial impact of the credit on employment in the capital goods sector was also reflected in higher employment throughout the economy by a factor of two to three times.

3. Revenue effects of changes in capital recovery allowances, 1962-72:

The investment tax credit and the shortening of tax lives have added an estimated $2.6 billion to Federal tax collections from all sources since 1962. In every year that the investment tax credit was in effect, Federal revenues were above the level they would otherwise have been, amounting to approximately $1 billion in 1972 alone.

Conversely, tax receipts fell each time the credit was removed. Suspension of the credit in 1966-67 and its repeal from 1969 until 1971 resulted in a $760

million decrease in Federal tax revenues below what would otherwise have been collected had the credit remained in effect.

These estimates follow from a calculation of the amount by which tax changes altered the cost of capital outlays resulting from enactment of the credit and issuance of the guideline lives in 1962, removal of the basis adjustment in 1964, suspension of the tax credit for two quarters in 1966 and 1967, its restoration in 1967, repeal in 1969 and reinstatement and approval of the Asset Depreciation Range in 1971. Each favorable change raised output, wages and profits, thereby expanding the Federal tax base. Conversely, each tax law change which increased the cost of capital outlays resulted in a lower level of output, wages and profits than would otherwise have occurred.

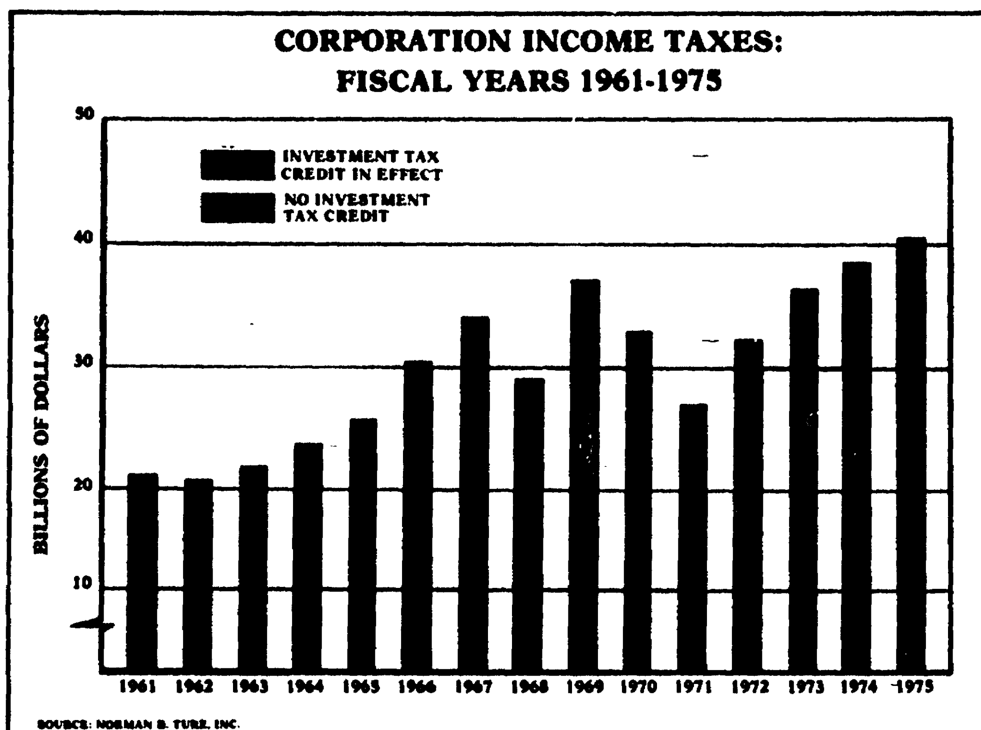


TABLE 6.—*Estimated change in Federal revenues resulting from tax credit and shorter tax lives, 1962–72 Calendar years*

Year:	*Millions*
1962	$160
1963	330
1964	50
1965	110
1966	(−50)
1967	140
1968	390
1969	(−230)
1970	(−480)
1971	440
1972	1,000
Total	2,620
Difference	(−760)
Net change [1]	1,870

[1] Net change differs from sum of individual changes shown due to rounding.

Source: Norman B. Ture, Inc.
Prepared July 1975.

The patterns of fluctuations in these key areas demonstrate:

1. that the investment credit accomplishes what its original proponents intended; and

2. that it can be fully effective in stimulating needed, long-term growth only if its basic provisions (particularly the rate of the credit) are permanent features of the tax code.

Recommendations of the Ad Hoc Committee

A. *Immediate action programs*

1. *ADR and investment credit rate.*—The Ad Hoc Committee recognizes that both individuals and businesses must be provided a tax climate favorable to a higher saving rate if the nation is to meet its capital demands. However, as cited earlier in this statement, a realistic examination of the historical record shows that a substantial part of the necessary additional saving will have to come from business. We advocate the immediate enactment of the following tax changes as the most effective means of stimulating business saving and capital formation:

(*a*) A 12 percent investment tax credit without a termination date and without basis reduction.

(*b*) An increase in the permissible range under the ADR System for depreciating capital assets from 20 percent to 40 percent.

The Ad Hoc Committee is convinced that enactment of these proposals would greatly fortify the economic recovery and place the economy on a significantly higher growth path. It would, we are confident, result in a substantial increase in private capital formation and as a consequence directly and indirectly increase employment throughout the economy. Resulting increases in investment, production, and employment, moreover, would generate additional tax revenues for the Federal government. These projected effects are summarized in the following tables which were prepared in mid 1975, prior to the recent extensive changes in the U.S. national income and product accounts published by the Department of Commerce.

Table 7 shows the estimated increase in capital outlays over three years if the ADR were extended to 40 percent and if a permanent 12 percent investment credit were enacted (for purposes of these estimates, it is assumed that the increased ADR was applicable as of the beginning of 1975). For the three year period, gross capital outlays would exceed those otherwise undertaken by $44 billion (measured in constant 1974 dollars).

TABLE 7.—ESTIMATED INCREASE IN CAPITAL OUTLAYS WITH 12 PERCENT INVESTMENT CREDIT AND 40 PERCENT ADR, 1975–77

Year	Additional capital outlays (billions of 1974 dollars)	
	Annual	Cumulative
1975	13.2	13.2
1976	14.4	27.6
1977	16.8	44.4

Source: Norman B. Ture, Inc., prepared July 1975.

The increase in the amount of capital in place in the economy would have a powerful effect in increasing total employment throughout the private sector while continuing the postwar trend of increasing real wage rates. Table 8 shows the number of full time equivalent employees in the private sector in excess of the number who would otherwise be employed. By the third year, there would be 1,580,000 more jobs than if these proposals were not enacted.

When viewed in terms of projected Federal revenue gains by the third year (discussed in following paragraphs), this employment impact would represent a spectacular improvement over the public service job programs now being promoted in the Congress. We believe that such programs should be a last resort and that the private sector should be given the opportunity and the policy tools to generate new employment through investments in productive plant and equipment. In addition to the obvious advantages of private sector growth, there have been studies which conclude that the multiplier effect of private sector manufacturing payrolls is substantially greater than public service payrolls.

TABLE 8.—*Increase in business sector full time equivalent employees with 12 percent investment credit and 40 percent ADR over number otherwise employed*

Year:	*Additional employees*
1975	530,000
1976	1,010,000
1977	1,580,000

Source: Norman B. Ture, Inc., Prepared July, 1975.

The additional capital inputs and employment in the business sector would result in a substantial increase in the GNP originating in this sector (i.e., gross business product). As shown in Table 9, gross business product, in constant 1974 dollars, would be $51.6 billion greater in the third year than it would be if these proposals are not enacted. Over the three year period, it is estimated these proposals would result in a cumulative increase of more than $139 billion in constant dollar business GNP over the levels that will otherwise be reached.

TABLE 9.—INCREASE IN GROSS BUSINESS PRODUCT WITH 12 PERCENT INVESTMENT CREDIT AND 40 PERCENT ADR OVER GBP LEVELS OTHERWISE ATTAINED

Year	Billions of 1974 dollars	
	Annual	Cumulative
1975	26.3	26.3
1976	61.5	87.8
1977	51.6	139.4

Source: Norman B. Ture, Inc., prepared July 1975.

These increases in investment, employment and business GNP will generate additional Federal tax revenues at existing tax rates. These additional revenues will more than offset the initial impact revenue losses, which are estimated by the Treasury Department without adjustment to reflect the increase in investment, output, and employment that would result from enactment of these proposals. As Table 10 shows, substantial increases in Federal tax revenues, over and above the revenue gains which otherwise occur, would be realized by enactment of the proposed extension of ADR to 40 percent. In the third year, off-setting the initial impact revenue loss against the increase in taxes resulting from the increase in income, a net revenue gain of $9.6 billion would be realized. For the three years taken together, a net increase of approximately $22 billion in Treasury tax revenues would be realized.

TABLE 10.—ESTIMATED REVENUE EFFECT OF INCREASING THE INVESTMENT CREDIT TO 12 PERCENT AND ADR TO 40 PERCENT, 1975–77

Year	Initial impact		Net effect	
	Annual	Cumulative	Annual	Cumulative
1975	−3.0	−3.0	5.2	5.2
1976	−5.7	−8.7	7.6	12.8
1977	−7.3	−16.0	9.6	22.4

Source: Norman B. True, Inc., prepared July, 1975.

2. *Pollution control facilities.*—Environmental requirements have caused a major drain on capital funds which otherwise would have been used for production facilities. For example, the Fifth Annual Report of the Council on Environmental Quality states on page 221 that estimated expenditures for pollution control were $8.2 billion for operating and maintenance and $6.0 billion for capital expenditures in 1973 alone. By 1982, these costs are estimated to reach $26.7 billion for operating and maintenance and $19.7 billion for capital expenditures.

In order to alleviate this drain on business capital, the Ad Hoc Committee recommends that the total cost of such facilities be allowed as an expense in the first year of operation.

In this connection, existing tax incentives in the Code for the installation of pollution control facilities (found in Sections 103(c)(4)(F) and 169), while somewhat helpful, have been interpreted in a manner that has drastically reduced their effectiveness. This is due in large measure to the restrictive definition imposed by the Internal Revenue Service upon the phrase "air or water pollution control facilities," particularly as applied to in-plant process changes undertaken to prevent pollution from occurring. The result has been that many expenditures made primarily because of environmental regulations have been ruled to be ineligible for the existing incentives. Accordingly, the Ad Hoc Committee recommends that, accompanying the enactment of the proposed provision permitting the one year write-off of such expenditures, there be enacted a reasonable and workable definition of pollution control facilities to be applied under both the existing and the proposed tax provisions. Such definition should include modern pollution control techniques required to meet the standards set by cognizant environmental agencies.

A suggested definition is:

"The term 'air or water pollution control facility' means any facility (including buildings and equipment) the primary purpose of which is to abate, contain, control, or prevent actual or potential pollutants, wastes or heat from contaminating the atmosphere or bodies of water."

3. *Availability of the investment credit.*—Due to the limitation of the investment credit to 50 percent of tax liability in excess of $25,000, many companies are unable to fully utilize the investment credits otherwise available to them. This problem was recognized by Congress in the Tax Reduction Act when the 50 percent limitation on the amount of tax against which the credit can be applied was increased for public utilities. There is no reason why this relief should not be provided to similarly situated companies in other industries.

The Ad Hoc Committee urges that public utilities be allowed to use investment credits against 100 percent of their tax liability on a permanent basis and that other taxpayers be allowed to use investment credits against 75 percent of their tax liability.

Unfortunately, this amendment would provide little or no relief for loss and marginal profit companies. These companies must depend on the carryover of investment credits. The carryover provisions would be improved by adopting the following provisions:

(*a*) The use of investment credit carryovers prior to present year credits.

(*b*) An increase in the carryover period to 10 years.

Finally, to recognize inflation and assist small businesses, the $25,000 tax base against which the investment credit can be used in full should be raised to $150,000.

4. *Applicability of the investment credit.*—There are two amendments which would improve the effectiveness of the investment credit by broadening its applicability. First, it should be applied to buildings used primarily for the manufacture, sale or distribution of goods. Clearly plant is as important to our economy as equipment and should be eligible for the investment credit.

Second, the seven-year life requirement for full investment credit should be reduced to three years. This would make the investment credit more effective and would simplify the complex problems with varying levels of credit and recapture of credits in future years.

5. *Progress payments.*—The new progress payment provisions for investment credits should be applied to depreciation. The concept of allowing the deduction at the time for payment is equally applicable to depreciation.

In addition, the progress payment provision should be improved by:

(*a*) removing the phase-in limitation, and

(*b*) making the progress payment election an annual rather than a permanent election.

6. *Depreciation convention.*—The full year convention contained in the original ADR proposals should be adopted in place of the half year convention finally adopted. This would make ADR more effective and simplify its operation.

B. *Administration's accelerated depreciation program*

The President, in his State of the Union Message on January 19, 1976, proposed a new accelerated depreciation program. The proposal needs to be less restrictive to be effective. However, if Congress considers this type of proposal to be attractive, it could with certain modifications, be made effective as an interim measure.

Specifically, the proposal provides for accelerated depreciation to encourage construction of new facilities or expansion of old facilities in areas experiencing unemployment in excess of 7 percent. Such facilities could be depreciated over one-half their normal life in the case of buildings and over 5 years in the case of equipment placed in the facilities. However, the depreciation over the shorter life would be restricted to the straight line method. Qualifying investments would still be eligible for the full investment tax credit. The new depreciation rules would apply to projects begun in the one year period from January 20, 1976 through January 19, 1977.

If this proposal is to be an effective short range measure, it should be modified to apply to any facility or equipment the construction of which is begun during at least a three year period. The restrictions, with respect to new facilities and high unemployment areas, should be removed because they would be economically disruptive.

C. *Long-range reform of depreciation system*

The United States is the last industrial nation to move away from an actual life system of depreciation. The adoption of the ADR system has moved the United States to a more logical system of cost recovery. However, even with ADR, our depreciation system remains overly complex and cumbersome. The Ad Hoc Committee advocates the expansion of ADR as an immediate but interim step towards achieving an effective capital recovery system.

Immediate study should be given to the adoption of a simplified capital recovery system which would provide economic incentive for investment and eliminate many of the technical and administrative problems of ADR.

As a long-range objective, the Ad Hoc Committee recommends a "capital recovery system" which would be an alternative to existing depreciation methods and would contain the following features:

1. Machinery and Equipment (i.e., Section 1245 property) would be subject to an accelerated five-year write-off.
2. Industrial buildings used in the process of manufacturing, extraction, transportation, communications, etc. (i.e., part of Section 1250 property) would be subject to an accelerated ten-year write-off.
3. No salvage values would be used.
4. Taxpayers would elect deductions of 0 to the maximum allowed for any year and unused deductions would be carried forward indefinitely.
5. The system would be applicable as costs are incurred.
6. A full year convention could be applied for all costs.

Timing

Of crucial importance is immediate action raising the investment credit to 12 percent and extending it beyond December 31, 1976 by removal of the termination date. The long lead time for a large share of the facilities covered by the credit require early action. Plans of some businesses are already being prejudiced by the December 31, 1976, terminal date in the present legislation.

Conclusion

There could be no more appropriate time for the Congress to review present tax provisions and tax policy in terms of national needs. Changes are definitely needed. We recognize the strong pressures on the Congress to emphasize consumption in tax policy. Yet, no nation in history has ever achieved or maintained significant economic strength without a major emphasis on capital savings and capital investment. The eventual result of overemphasis on consumption and neglect of the capital sector is bound to be reduced production of consumer goods, higher prices for those goods produced, and reduction in quality because of the inability to maintain sufficient research and development programs.

However, if our tax laws are modified to help assure a satisfactory ratio between savings and consumption, increased production, output of goods and services and higher real income for workers will result. In addition there will be larger revenues to Federal, state and local governments to maintain needed public services.

There are certainly many revisions that deserve consideration, and we strongly urge that changes to liberalize the capital recovery features of the tax laws be given very high priority. More specifically, we recommend the enactment of the changes discussed in this statement.

69-460 O—76——pt. 4——14

MEMBERSHIP OF AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT, MARCH 19, 1976

AMP Inc.
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Consumers Power Co.
Container Corporation of America
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Continental Machines, Inc.
Continental Oil Co.
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Copper Range Co.
Crouse-Hinds Co.
Cyclops Corp.
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Dana Corp.
Dean Foods Co.
Deere & Co.
De Laval Turbine Inc.
Dennison Mfg. Co.
The Detroit Bank & Trust Co.
Diamond Shamrock Corp.
Dibrell Brothers, Inc.
DoAll Company
R. R. Donnelley & Sons Co.
Dresser Industries, Inc.
ESB Inc.
E-Systems, Inc.
Eagle-Picher Industries, Inc.
Earth Resources Co.
Eaton Corp.
Echlin Mfg. Co.
Economics Laboratory, Inc.
Electronic Memories & Magnetics Corp.
Elgin National Industries, Inc.
Emerson Electric Co.
Emery Industries, Inc.
Esmark, Inc.
Evans Products Co.
Ex-Cell-O Corp.
Exxon Corp.
FMC Corp.
Federal-Mogul
Federal Paper Board Company, Inc.
Federated Department Stores, Inc.
First National Bank of Chicago
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Franklin Electric Co., Inc.
Fruehauf Corp.
Fulton Industries, Inc.
Fuqua Industries, Inc.
Gannett Co., Inc.
Gardner-Denver Co.
Garlock, Inc.
General Cinema Corp.
General Dynamics Corp.
General Telephone & Electronics Corp.
The General Tire & Rubber Co.
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Globe-Union, Inc.
Gould, Inc.
Great Northern Nekoosa Corp.
Greyhound Leasing and Financial Corp.
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MEMBERSHIP OF AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT, MARCH 19, 1976—Continued

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Lance, Inc.
Land O'Lakes, Inc.
Lear Siegler, Inc.
Leaseway Transportation Corp.
Longview Fibre Co.
Louisiana-Pacific Corp.
Lucky Stores, Inc.
Macmillan, Inc.
Manufacturers National Bank of Detroit
Marquette Cement Manufacturing Co.
Maryland Cup Corp.
Masonite Corp.
Michigan General Corp.
Michigan National Corp.
Midland-Ross Corp.
Milton Bradley Co.
Mobil Oil Corp.
Modine Manufacturing Co.
Mohasco Corp.
Monsanto Co.
Moore McCormack Resources, Inc.
Morton-Norwich Products
NL Industries
NVF Co.
Nalco Chemical Co.
National Distillers & Chemical Corp.
National Gypsum Co.
National Presto Industries, Inc.
National-Standard Co.
National Starch and Chemical Corp.
Newmont Mining Corp.
Norris Industries, Inc.
Olin Corp.
Otis Elevator Co.
Owens-Illinois, Inc.
Oxford Industries, Inc.
Pantasote Co.
Parker Hannifin Corp.
Perkin-Elmer Corp.
Peter Paul, Inc.
Phelps Dodge Corp.
Philip Morris Inc.
Phillips Petroleum Co.
Pittsburgh-Des Moines Steel Co.
Portec, Inc.
Potlatch Corp.
PruLease Inc.
Public Service Electric and Gas Co.
Raytheon Co.
Reed Tool Co.
Reeves Brothers, Inc.
Reliance Electric Co.
Rockwell International Corp.
Rohm and Haas Co.
Rohr Industries, Inc.
Roper Corp.
Rubbermaid, Inc.
The Rucker Co.
Russell Corp.
Safeway Stores, Inc.
St. Joe Minerals Corp.
St. Regis Paper Co.
Sangamo Electric Co.
Scott, Foresman & Co.
Scott Paper Co.
G. D. Searle & Co.
Sears, Roebuck and Co.
The Signal Companies, Inc.
Southwest Forest Industries, Inc.
Square D Co.
Stanadyne, Inc.
Standard International Corp.
Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
The Stanley Works
Stauffer Chemical Co.
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Sunbeam Corp.
Sundstrand Corp.
SWECO, Inc.
TRW, Inc.
Tecumseh Products Co.
Texas Eastern Transmission Corp.
Texas Industries, Inc.
Texas Instruments, Inc.
Texas Gulf, Inc.
Thiokol Corp.
Time Inc.
The Timken Co.
Todd Shipyards Corp.
Tropicana Products, Inc.
Tyler Corp.
UV Industries

MEMBERSHIP OF AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT, MARCH 19, 1976—Continued

Uarco, Inc.
Unarco Industries, Inc.
Union Carbide Corp.
Union First National Bank of Washington
U.S. National Bank of Oregon
Universal Leaf Tobacco Co.
Universal Oil Products Co.
V. F. Corp.
VSI Corporation
Valley National Bank of Arizona
Van Dorn Co.
Vulcan Materials Co.
Wallace Murray Corp.
Warner-Lambert Co.
The Warner & Swasey Co.
Wean United, Inc.
Weil-McLain Co., Inc.
Western Electric Co., Inc.
Western Publishing Co.
Wheelabrator-Frye Inc.
Whirlpool Corp.
The Williams Companies
Winn-Dixie Stores, Inc.
Zayre Corp.

SUPPORTING ASSOCIATIONS

Air-Conditioning & Refrigeration Institute
American Boiler Manufacturers Association
American Chamber of Commerce Executives
American Consulting Engineers Council
American Dental Association
American Feed Manufacturers Association
American Land Development Association
American Machine Tool Distributors Association
American Meat Institute
American Pipe Fittings Association
American Textile Machinery Association
American Trucking Associations, Inc.
Apartment Owners & Managers Association of America
Associated General Contractors of America
Dairy and Food Industries Supply Association
Edison Electric Institute
Expanded Shale Clay & Slate Institute
The Ferroalloys Association
Foodservice and Lodging Institute
Foreign Credit Interchange Bureau
The Gummed Industries Association, Inc.
Imported Hardwood Products Association
International Quorum of Motion Picture Producers
Mechanical Contractors Association of America
Meat Machinery Manufacturers Institute
Narrow Fabrics Institute, Inc.
National Air Transportation Associations
National Association of Building Manufacturers
National Association of Business & Educational Radio, Inc.
National Association of Coin Laundry Equipment Operators
National Association of Manufacturers
National Canners Association
National Concrete Masonry Association
National Industrial Distributors Association
National Ocean Industries Association
National Paper Box Association
National Ready Mix Concrete Association
National Tank Truck Carriers, Inc.
National Wool Growers Association
Northeastern Lumber Manufacturers Association
Packaging Machinery Manufacturers Institute
Portland Cement Association
Printing Industries of America, Inc.
Railway Progress Institute
Rubber Manufacturers Association
Screen Printing Association International
Shipbuilders Council of America
United Fresh Fruit & Vegetable Association
Woodworking Machinery Manufacturers of America
Woodworking Machinery Distributors Association

APPENDIX B

DURABLE GOODS

[In billions of dollars]

	New orders	Shipments	Backlog	Inventories
1973: December	41.5	40.2	111.0	79.4
1974:				
January	42.5	40.8	112.6	80.5
February	43.2	41.0	114.8	81.9
March	42.1	40.7	116.0	83.0
April	44.1	41.2	117.8	84.1
May	46.7	42.5	122.0	85.7
June	46.8	42.8	126.1	87.3
July	47.7	44.1	130.0	89.3
August	49.4	44.8	134.3	91.0
September	46.4	45.0	135.7	93.2
October	45.1	46.5	134.2	94.7
November	43.2	44.8	132.7	95.8
December	37.8	40.5	129.9	98.0
1975:				
January	36.1	40.1	125.9	99.1
February	37.0	39.7	123.2	100.1
March	35.5	38.6	120.1	99.9
April	38.8	40.6	118.2	99.8
May	39.2	39.9	117.5	99.4
June	39.7	40.5	116.8	98.8
July	41.7	41.2	117.2	98.2
August	42.7	42.5	117.4	97.2
September	42.2	43.3	116.4	96.6
October	42.4	43.9	114.8	96.2
November	42.0	42.4	116.3	96.0
December	42.8	43.7	115.5	95.8
1976:				
January	43.3	44.6	114.2	95.7
February, preliminary	44.3	45.3	113.2	

Source: Department of Commerce.

APPENDIX C

COMPARISON OF COST RECOVERY ALLOWANCES

The following table summarizes a comparison of cost recovery allowances for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the foreign countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants or deductions generally permitted. The deduction in the United States have been determined under the double declining balance method without regard to the limited first year allowances for small business.

It is common practice in many countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to a rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowances presented in the table below.

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of cost of assets)		
		1st taxable year	1st 3 taxable years	1st 7 taxable years
United Kingdom	1	100.0	100.0	100.0
Canada (see 6, 31)	2	50.0	100.0	100.0
Netherlands (see 10, 17, 29)	5	14.0	58.0	108.0
Sweden (see 18)	5	60.0	95.7	130.0
Italy (see 10, 11, 12)	6	19.6	67.9	100.0
France (see 7, 8, 9, 28)	8	31.3	67.5	94.9
West Germany (see 20, 21, 22)	9	16.7	49.6	88.8
Belgium (see 2, 3, 4, 5)	10	20.0	48.8	89.0
Japan (see 13, 14, 15)	11	34.5	56.9	81.4
Australia (see 1)	6	50.0	70.0	110.0
United States, 1975 law (see 2, 23, 24, 25, 26, 27, 30)	10.5	29.5	60.7	94.5

Source: All data courtesy of Price Waterhouse & Co.

FOOTNOTES

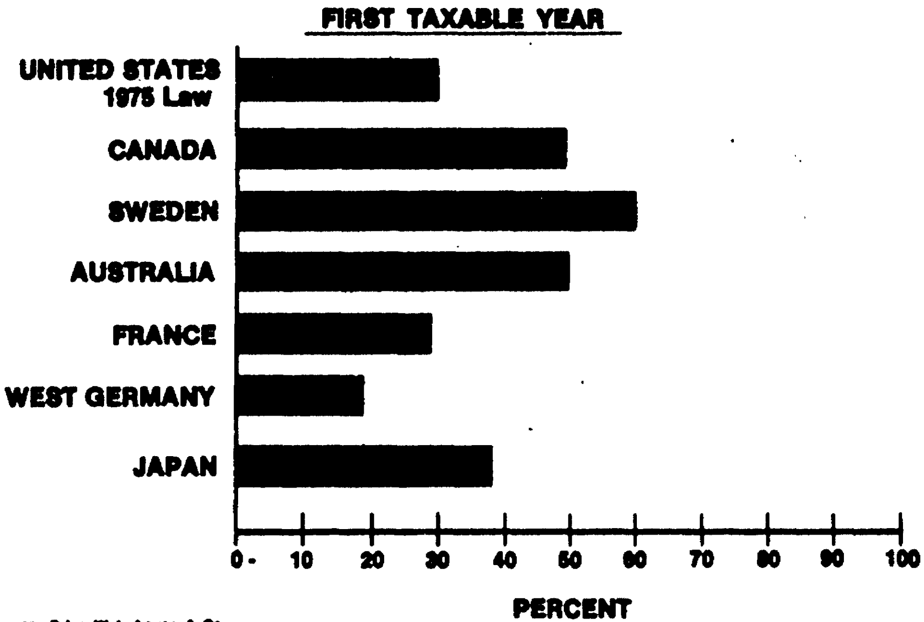
[1] Depreciation in Australia is based on an estimate of its effective life and taxpayers, at their option, may elect to use either the prime cost (straight line) method or the declining balance method. This computation is for assets acquired after January 1, 1976, and assumes that currently proposed legislation is enacted.
[2] Double declining balance method.
[3] Full year allowance in first taxable year.
[4] Although not considered, installation costs are allowed as current deduction which reduces recoverable base cost.
[5] Method changed to straight line in fifth taxable year. Straight line rate applied to original cost for fifth, sixth and seventh taxable years.
[6] Machinery and equipment acquired for manufacturing and processing of goods in Canada can be written off over two years (50 percent per year).
[7] 250 percent declining balance method.
[8] Although not considered, effect may be given to multiple shift operations by reducing service life of assets used under shift conditions.
[9] Method changed to straight line in sixth taxable year.
[10] Straight line method.
[11] Includes additional foreshortened allowances of 15 percent, 15 percent and 15 percent in first, second, and third taxable years respectively.
[12] In terms of a law introduced on December 5, 1975 companies may revalue the carrying value of assets and the related accumulated depreciation and place the resulting credit to a tax-free reserve. The assets which may be revalued include machinery and equipment if acquired before December 31, 1972.
[13] Modified double declining balance method; 18.9 percent per Japanese Government rate table, salvage built into rate.
[14] Depreciation in addition to ordinary depreciation in 13 above is allowed to give effect to multiple shift operations. Depreciation multiplied by factor of 1.28 gives effect to 8 hours of daily average excess usage of an item of machinery and equipment.
[15] Includes special first year allowance of 25 percent; allowance reduces recoverable base cost in second and succeeding taxable years.
[16] Reserved for later information.
[17] Depreciation periods are fixed by agreement. With multiple shift operations, a five year life is normal.
[18] Modified declining balance method—30 percent rate plus additional 30 percent allowance in first taxable year (such additional allowance does not reduce recoverable cost); accumulated cost recovery may not be less than 20% of cost for each year asset is in service. A special investment allowance of 10 percent will apply to investments made from October 15, 1975 to December 31, 1976 and is deductible from taxable income for state income tax purposes. The allowance is granted for expenditure on machinery and equipment acquired for use in business, agriculture or forestry, provided a purchase agreement has been signed after October 15, 1975 and delivery made before the end of 1976. The allowance is available only if the claim is made in the appropriate tax return. Losses resulting from the allowance may not be carried forward.

As an alternative to the investment allowance, mainly for small businesses or those not making profits, an investment grant will be available under the same conditions. The investment grant is not taxable income and will be 4 percent of the purchase cost of up to S.Kr. 500,000 for each financial year. An investment grant may be claimed in one financial year and an investment allowance in another, but not both in the same year.
[19] Reserved for later information.
[20] The average cost recovery period for machinery and equipment in West Germany is 8 to 10 years to which additional allowances are permitted for multiple shift operations: 25 percent of allowance for two shift operations and 50 percent of allowance for three shift operations. Allowances may be further increased when plant is located in certain areas such as Berlin and areas bordering on iron curtain countries. The above table sets forth cost recovery allowances based on an average cost recovery period of 9 years. The double declining balance method is used. A 25 percent additional allowance for two shift operations is taken into account beginning with the fifth year when the method is changed to straight line. The corporate depreciation rate thus computed is slightly over the maximum 20 percent rate permitted on a declining balance method to reflect that:

(a) The straight line method produces more depreciation than does the double declining balance method for certain short-lived assets; and

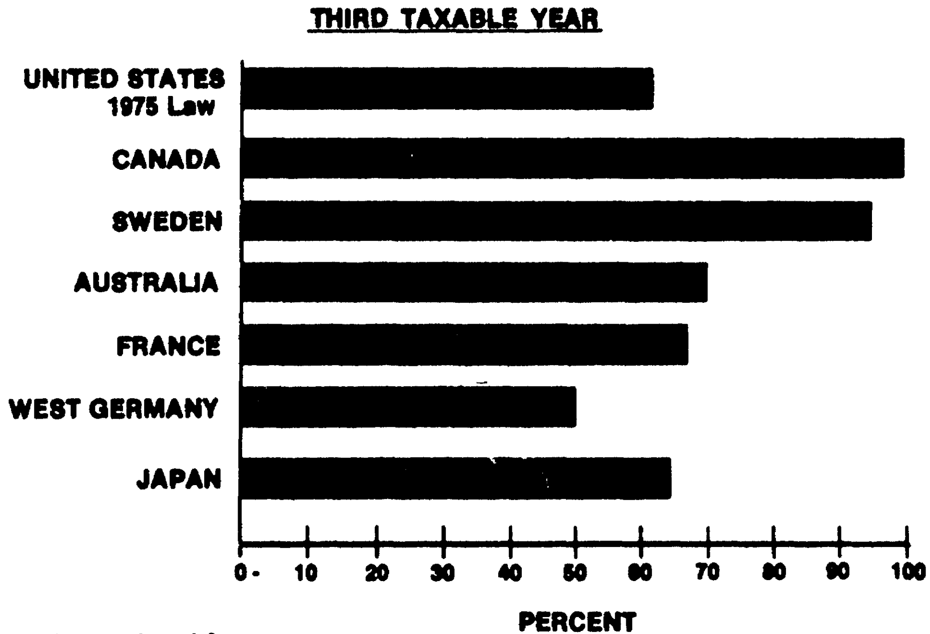
(b) Items of machinery and equipment costing under U.S. $320 can be expensed.
[21] Full year allowance in first taxable year for assets acquired in first half of such year; half year allowance for assets acquired in second half.
[22] Method changed to straight line in fifth taxable year. See 20 above.
[23] With investment credit but without ADR.
[24] Without either investment credit or ADR.
[25] With both investment credit and ADR.
[26] Includes 14 percent allowance equivalent to 7 percent investment credit at effective 50 percent income tax rate. Credit does not reduce recoverable base cost.
[27] 13 year recovery period reduced by 20 percent and rounded to nearest one-half year. Double declining balance method.
[28] Machinery and equipment purchased between June 30, 1974 and July 1, 1975 limited to 200 percent declining balance method applicable to an asset with an 8 year life.
[29] Additional 4 percent investment allowance permitted in first and second years.
[30] Includes 20 percent allowance equivalent to 10 percent investment credit (temporary credit enacted in the Tax Reduction Act of 1975) at effective 50 percent income tax rate. Credit does not reduce recoverable base cost.
[31] The Federal Government has recently enacted an investment tax credit of 5 percent of the cost of new buildings, machinery and equipment acquired between June 24, 1975 and June 30, 1977 inclusive to be used in manufacturing and processing and other specified activities. Taxpayers will be permitted to apply the credit to the extent of their federal income taxes up to $15,000 plus one-half of the amount by which their federal tax otherwise would exceed $15,000. Any unused credit may be carried forward for up to five years. For tax depreciation purposes the capital cost of the property acquired will be reduced by any investment tax credit received. The effect of this credit is relatively small in view of the 2 year write-off allowed in Canada (see footnote 6) and the reduction in basis for depreciation purposes. In the first taxable year the 50 percent aggregate cost recovery would be 52.5 percent with full recovery still allowed in the 2nd year.

AGGREGATE COST RECOVERIES ALLOWABLE FOR TAX PURPOSES IN THE UNITED STATES AND IN SELECTED FOREIGN COUNTRIES ON MACHINERY AND EQUIPMENT



Source: Price Waterhouse & Co.
March 12, 1976

AGGREGATE COST RECOVERIES ALLOWABLE FOR TAX PURPOSES IN THE UNITED STATES AND IN SELECTED FOREIGN COUNTRIES ON MACHINERY AND EQUIPMENT



Source: Price Waterhouse & Co.
March 12, 1976

APPENDIX D*

94th Congress, 1st Session } COMMITTEE PRINT

JOINT SEMINARS

ENCOURAGING CAPITAL FORMATION THROUGH THE TAX CODE

BEFORE THE

TASK FORCE ON TAX POLICY AND TAX EXPENDITURES

AND THE

TASK FORCE ON CAPITAL NEEDS AND MONETARY POLICY

OF THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

September 18, 1975—AN EVALUATION OF EXISTING TAX INCENTIVES

September 19, 1975—AN EVALUATION OF NEW PROPOSALS TO REDUCE THE CORPORATE INCOME TAX BURDEN

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE
59-067 O WASHINGTON : 1975

*Appendix D which included a statement entitled "Policy Alternatives for the Investment Tax Credit," by Roger H. Gordon, Princeton University, and Dale W. Jorgenson, Harvard University, Feb. 1975, was made a part of the official files of the committee.

Senator HARRY F. BYRD, JR. The next witness will be Mr. W. M. Hofacre, vice president-finance of the Daniel International Corp., speaking on behalf of The Associated General Contractors of America. We welcome you and you may proceed as you wish.

Your statement will be published in full in the record and you may summarize it if you wish.

STATEMENT OF BILL HOFACRE, VICE PRESIDENT—FINANCE, DANIEL INTERNATIONAL CORP., ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. HOFACRE. I am Bill Hofacre from the large international construction firm located in Greenville, S.C., Daniel International Corp., representing the AGC.

Today I might take just a few minutes to state the AGC is an association of over 8000 members in the construction industry. The construction industry represents variously from 12 to 15 of the gross national product. So, we are attempting to speak for a very large group and a very large segment of the economy.

We have submitted our position paper on various items.

We want to emphasize 3 major points today from that paper. These represent both our concern for immediate tax implications of legislation before you or proposals before you, and also our most firm convictions concerning the long-range prospects and impact on the industry.

The first point we wanted to make concerns the economic conditions which are causing the hardship to our industry and to our employees. The latest statistics show on current dollar expenditure basis, expenditures have returned to the 1973 level. However, we feel those figures are misleading.

For example, if you take out the Alaska pipeline work and several large power plants, particularly the nuclear power work, you can get an entirely different picture of the capital expenditures. On the basis, we think employment figures are the better indicator of the problems we face.

In that regard, our latest available data on the construction industry discloses a national unemployment rate of 15 percent. We get reports from some of the large urban areas of 50 percent and higher unemployment. That represents in numbers over 650,000 people out of work. That would be in the direct construction industry. I would assume there would be an impact on subsidiary and feeding industries that have put other people out of work.

Capital spending appropriation plans are reported to be improving, but the actual spending outlays are still sometime off.

Many construction firms are now in marginal financial condition, and that is owing to the low business activity of 1975 and thus far in 1976.

With the above in mind, the poor economic conditions faced by our industry, we want to emphasize that we are not here to request the one-shot, pump-priming help. We feel for the good of both construction companies and their employees no new tax legislation should be

enacted that would discourage or impede the recovery of capital spending.

Our recommendations have been made with long-term requirements in mind. We also believe consistency is important, and I think the construction industry more than any other gets the end of the whiplash or changes in the tax laws that variously speed up expenditures by corporations or speed them down by anticipation in the law, and it has a very marked effect on the construction industry.

The second point we would like to make is the need for accelerated capital cost recovery under tax law.

You have had lots of testimony on this obviously, but no other aspect of the tax law is as great an inducement to capital spending as a quick recovery of capital costs.

Specifically, we support the 12 percent investment tax credit, and we feel that that should be extended to apply to industrial buildings as well as equipment. It should also be made refundable. We feel that would eliminate the present discrimination against the new companies and those first in financial difficulty that is in the present law.

We favor an increase in the asset depreciation range to 40 percent. We also would recommend that pollution abatement equipment be allowed as an expense item. We feel there can be a serious loss of jobs that will result from pollution control and OSHA regulations as they are attempted to be carried out by some of the older plants, particularly in the northeast. That is developed in our paper.

The final and third item we would like to make, which is the most immediate and single most harmful proposal now in front of you with respect to its impact on the construction industry—and this is elimination of $20,000 to $25,000 earned income exclusion which is allowed individuals under section 911.

The previous testimony of Mr. Foster Parker of Brown & Root is unqualifiedly supported by our members of most of the companies in the construction industry who assign employees, commonly called tax equalization. This is because the extra living allowances, education payments and those types of payments are taxable under U.S. law, so even where the host country would have a low tax rate for an individual, he would still have a burden to pay the U.S. tax.

So, in contrast to the extra cost of American companies, foreign firms not only have no similar added cost but generally receive favorable subsidies to support their overseas activities.

The need to offset cash to the Mideast is well known, and the majority of the money in the Mideast by the oil companies, I think, obviously will stay there in the form of construction capital goods. To shut American firms out of that market is a real possibility if section 911 is repealed.

Obviously related to that is any other restrictions of rules that now allow foreign tax credits against U.S. taxes. There are many fine English, German, Italian, Japanese firms that are now competing effectively against us. Their technical competence and the advantage they would receive under repeal of 911 would enable them to take over the majority of those construction projects.

As previously testified to by Mr. Parker, that would not only eliminate the overseas employment and profit opportunities to the construc-

tion industry but would cause a greater loss of domestic employment through lost subcontracts.

Those are the three major parts of our presentation. We would like to touch briefly on several others that have come before you.

The proposals to eliminate the DISC corporate form and the Western Hemisphere Trading Corp. forms would be a direct loss to the construction industry. We can now use the DISC corporate form for selling design services and engineering services which create domestic jobs, and we can use the Western Hemisphere trading form for trading activities with others in this hemisphere.

Second, we cannot eliminate the cost to construction of engineering by hiring local nationals in most of our work. If the Mideast area is developing as the largest single area for construction by American firms, the less developed countries probably range less. In those two areas, it is not possible to hire the kind of skills we require. We do that to a great extent in the developed countries.

With regard to the capital formation, our industry is made up of a large number of small- and middle-size firms. There is not one single company that has more than 1 percent of the construction industry total sales. We feel that the coming capital shortage will fall first on those small- and middle-size firms, not on the giants of American industry, so we see definite problems facing us in the future.

I think the final point we would like to make is our belief shared by several others who have testified that the accelerated capital cost recoveries, the awarding of ITC's, does in the end result create greater tax payments and I would like to make one more point. It is in the area of job creation. We feel this is most important as it not only takes the worker off the tax-supported payments he may be receiving, it gets him working and generating the FICA taxes that have become very critical to the Nation and put into that system.

Thank you very much.

Senator BYRD. Thank you very much. Senator Curtis.

Senator CURTIS. You have made a very good statement here.

In reference to the earned income exclusion, if that were removed, would it seriously handicap American construction firms in their efforts to be competitive for these jobs in foreign lands?

Mr. HOFACRE. Very definitely. I think the pricing right now and I will cite again the Mideast where there, the capital spending and pricing is so close, it could tip the scales on immediate contracts being awarded. I think Mr. Marker has testified that it is the American firms designing in and specifying American materials that generate a lower part of the iceberg.

Senator CURTIS. I think that is very true. If an American firm is building something abroad, it is not only that original export of materials and machines that is involved. Rather through the years, considerable business is apt to flow over the same routes because of replacements, banking and finance arrangements made during the period of construction, the personal acquaintance of the foreigner with a business entity in this country, and so on. For these reasons, the benefit to this country when an American contractor gets a job abroad does not terminate when the construction is over. It sets up a flow of business communications involving financing, insurance, replacement

parts, expansion and updating of plants and all of that are very, very apt to come back to the original contractor or at least to the country.

Mr. HOFACRE. The companies in countries in the Middle East might prefer American design. It is difficult to award to a foreign concern and expect them to use American replacements because their dimensions are different. It requires an American design and construction company to pull that home.

Senator CURTIS. I have always been concerned about the high unemployment in the construction industry. Does that remain uniform pretty much throughout the industry generally or are there some types of construction where the unemployment in the last few years has been more profound than at other times?

Mr. HOFACRE. In the last few years?

Senator CURTIS. Yes.

Mr. HOFACRE. There will always be a greater amount of unemployment in the industry—seasonal and so on. Obviously, in the last year, the housing part of it, construction industry has suffered significantly. Presently, the industry's building section of the economy is suffering. There is a lot of unemployment there.

Senator CURTIS. I certainly think you are entitled to the tax principles for which you have spoken. You do represent an industry that not only has some problems dealing with seasons and when construction cannot go on, but I suppose there are times when there is an excessive amount of building being completed. Perhaps there will be some communities which overbuilt with houses. I am sure there are some cities that are overbuilt on office space. Those are some of the problems more peculiar to your industry than perhaps some others.

Mr. HOFACRE. We have our own peaks and valleys in the best of times, and in the worst of times, it is more severe.

Senator CURTIS. Thank you.

Senator BYRD. You cited the unemployment in the construction industry which is high. What one or two things could this Congress do or could this committee do to help your industry the most to help to create jobs.

Mr. HOFACRE. This body would be the investment tax credit, making that permanent to level out the expenditures of American industry. I think that is very important and the combination of the investment tax credit and some forms of accelerated cost recovery. Those two together, working into the financial analysis figures that industry uses to determine expansions, new plants, and so on.

Senator BYRD. Which do you feel is the more overall helpful—accelerated depreciation or the investment tax credit?

Mr. HOFACRE. I would say the investment tax credit of the two.

For the record, we might comment, in the powerplant construction, it is going to hinge significantly on the rates that are allowed by the various State regulatory agencies. That is not obviously directly under your proceedings, but I would put that in there that that will be a major determinant in powerplant construction in the coming years.

Senator BYRD. The amount of depreciation that can be taken is an important factor, obviously.

Mr. HOFACRE. Yes; it is very important.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Hofacre follows:]

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA PRESENTED BY BILL HOFACRE

My name is Bill Hofacre, and I am Vice President-Finance of the construction firm of Daniel International Corporation. I appear before you today as a member of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America (AGC). The AGC is composed of more than 8,200 of the leading contractors in the United States and Puerto Rico. Our members account for more than two-thirds of the total contract work of building, highway, heavy and utilities construction performed in the United States and Puerto Rico. Construction typically accounts for 11 to 13 percent of this country's total gross national product. It is estimated in excess of 4½ million people are employed in direct construction activities. Additionally, there are unknown thousands of small firms and sole proprietorships with millions of employees who derive a significant part of their livelihood from supplying the construction industry with goods and services.

More than ever this year our members are keenly interested in the proceedings of your Committee. It is fully reported and widely known that the construction industry has been severely hurt by the recent economic recession. Unemployment in the construction industry has been as high as 21 percent nationally, and in certain regions much, much higher, with more than 650,000 unemployed in January of this year. Recovery in the industry has been very slow, and most economists are not predicting a turn-around until several months into 1977. The Bureau of Labor Statistics reports that the Southeast United States showed further losses of 27,000 construction jobs in January, 1976. That is in addition to the hundreds of thousands already unemployed, and is typical of other sections of the country. For many construction firms, a first quarter 1977 turnaround may come too late.

I cite the above to demonstrate the inability of the construction industry at this time to withstand the adverse impact that several of the tax law changes now proposed by the House and others would have on our industry firms and their employees. In fact, the economic conditions in the construction industry point out the need to adopt certain tax law changes that will have a stimulative effect on construction activities. We believe the adoption of a permanent basis of our following recommendations would make for a healthy construction industry, as well as benefit the entire U.S. economy. Such changes would lead to a more efficient and competitive industrial base. Their adoption on a permanent basis would eliminate the upsetting impact caused by periodic changes in the law. Frequent changes result in greater activity just before benefits are to be withdrawn and create a postponement of activity anticipating new benefits to be enacted, with disruptive effects particularly on the planning of construction projects.

CAPITAL COST RECOVERY

Generally, the area of most importance to the construction industry, our clients, and through jobs creation to our employees, is the capital cost recovery allowed by tax law. This is true not only because it enables our customers more economically to modernize and expand their operations but also because it permits our members to retain funds required for their own capital needs. More than any other tax legislation, improved capital cost recovery would spur the capital outlays of American business. Increased capital spending is a vital part of the continued recovery in our national economy, and is essential to make U.S. industry more competitive in the world market.

The investment tax credit is a major factor in encouraging industry to modernize and expand its facilities. The benefits of this are significant, especially in the areas of jobs creation, improved productivity, a more efficient and competitive international trade posture; and, finally, greater profits and greater tax payments complete this very beneficial circle. A 12 percent permanent investment tax credit, we believe, is required to enable this long term program to be carried out. For a more specific analysis of the investment tax credit, we commend to your attention the testimony being presented to your Committee by the Ad Hoc Committee for an Effective Investment Tax Credit. The AGC endorses their findings and recommendations. We are pleased to note that rec-

ommendations for improvement in investment tax credit rules have been made to Congress by spokesmen for many groups, indicating the broad support for improvement in this area.

Furthermore, we recommend the credit be made refundable to firms with insufficient tax liability to use the benefit. Present laws now discriminate against new businesses and those in financial difficulty. We support an extension of the investment tax credit base to include buildings primarily used for the manufacture, sale or distribution of goods. This extension would not only stimulate new construction and create additional employment in our industry, but would contribute, with the purchase of new equipment, in making American industry more productive and competitive.

Consistent with the benefits and objectives of the investment tax credit, would be liberalization of depreciation allowances. For these same reasons, we favor an increase in the asset depreciation range to 40 percent and the restoration of full accelerated depreciation provisions to industrial buildings and plants. The construction industry especially needs an increased ADR rate, since the adverse conditions under which construction equipment is used greatly shorten its useful life. Outdoor use, unpredictable weather, and varying soils, rock, and subsurface conditions wear out construction equipment much faster than the equipment of most other industries.

To ease the burden on those companies that must bear the major cost of pollution abatement equipment and to protect the vitally needed jobs older plants provide, we recommend such costs be allowed to be deducted fully in the year expended. In many instances older plants, particularly in the industrial Northeast, will have to be closed, unless there is favorable tax treatment, thus creating employment problems in the heavily populated areas. We further request that investment tax credit be applicable to the capital cost involved in pollution abatement equipment.

FOREIGN TAX CREDITS AND INCOME EXCLUSIONS

The construction industry, including its engineering activities, is in ever-increasing technical and price competition for foreign work. Previous testimony to this Committee, by Foster Parker of the Brown and Root Corporation, has clearly shown that our overseas work improves our country's balance of payments position and creates, rather than exports, jobs. That construction must be done on location is obvious. The alternative to perform such work in the United States does not exist. Moreover, American design and construction firms will specify American materials and services, whereas foreign competitiors will specify and procure from their home country sources. In order that substantial benefits not be lost to the American economy, we strongly urge you not to pass legislation that would reduce our international competitive posture. Specifically, we refer to proposals to reduce or eliminate the present overseas compensation exclusion of $20,000 or $25,000, the foreign tax credit on a per country basis, and Domestic International Sales Company and Western Hemisphere Trading Corporation rules.

The construction industry requires these allowances in order to remain competitive against foreign companies, who have an advantage in receiving direct government subsidies and tax benefits significantly better than ours and who can use a workforce that earns substantially less than the American counterpart. We request that your Committee investigate earnestly the loss of jobs in the United States and the many other adverse consequences that would result from reducing our country's engineering and construction firms' ability to compete in foreign markets.

LIMITATION ON ARTIFICIAL ACCOUNTING LOSSES

Being in the construction business, we are especially concerned with the proposed, so-called, Limitation on Artificial Accounting Losses rules. These would discourage investment in such vitally needed areas as new real estate construction (particularly housing and facilities for production and distribution), marginal production of oil and gas, and in equipment leasing. The leasing of equipment, in effect, now provides capital to firms both large and small that may not be able to raise their requirements any other way. Existing tax rules in this area, which would be altered by the proposed LAL restrictions, were

originally passed for very legitimate reasons, and the need for such rules still exists today. The country's requirements for housing at a reasonable price, and for increased gas and oil production, and the problems of capital formation are denied by hardly any informed commentator. There should be no revocation or restriction of rules that are encouraging investment in these critical areas, unless alternative solutions are evident. Demands for "tax reform" should not result in adverse tax rules that will work against needed construction and more employment. Real estate improvements result only when return on investment compensates for the risks assumed.

CAPITAL GAINS TAXATION

The present capital gains tax laws operate to tax inflation as a profit. This is widely recognized, yet individuals are still required to pay too large a part of their capital sales as taxes. Their alternative is to stay in investments that are not suited to their changing needs, especially during their retirement years. Similarly, companies are required to pay as tax much of the capital raised through disposition of outmoded plants and equipment, seriously depleting the cash needed to finance replacement facilities.

Together with the necessity to stop expropriation of savings through taxing purely inflation-caused gains, is the need to create greater savings for capital formation. This has traditionally been accomplished through the incentive of lower tax rates on capital gains.

Accordingly, AGC favors a reduction in the capital gain tax rate. This would aid in mitigating the effects of inflation. To encourage greater savings by the majority of Americans, the Committee should consider a capital gains exclusion or the deferment of taxes where the proceeds are reinvested in a similar manner. Greater savings would also be reinvested in a similar manner. Greater savings would also be encouraged if less restrictive rules governing capital loss carry-backs and reduction of current income were available. It would be appropriate to apply limitations to these various items, consistent with the objective to encourage greater savings through investments by persons of modest income and wealth.

CAPITAL FORMATION

Capital formation, we wish to emphasize, is of primary concern to the construction industry. The capital requirements of our country have been projected by different organizations which have made studies of merit. All of these, though disagreeing as to degree, do not disagree as to substance, that a serious capital formation problem will exist over the next 10 years. Debt financing, favored in the recent past owing to the bias in our tax laws, can no longer provide the required funds.

The AGC supports the revision of tax law to encourage greater savings by middle and modest income earners, and reduced taxes through reduced government expenditures. Equity investments could be increased by allowing dividends to be tax deductible to corporations or permitting recipients to gross up and take a tax credit, by increasing the dividend exclusion and providing a limited interest income exclusion.

The present proposal before your Committee to limit non-business interest deductions to a total of $12,000 would tend to stymie equity investments by individuals at a time such investments are most needed. Thus, we submit that this proposal should not be enacted.

CONCLUSION

Several of our above recommendations, if adopted, would result in less direct taxes being paid, but, the remainder involve only a postponement of the tax liability. In all cases, however, we feel the ultimate result will be greater tax revenues raised through greater corporate and individual earnings. The resulting more efficient operations and the significant creation of jobs will assure that desirable end. Undoubtedly, the most important benefit would be the creation of jobs, putting Americans back to work, removing many from tax-supported payments, and generating much needed FICA payments by employees and employers.

In closing, we refer you to the interview with Mr. Denis Healy, Britains' Chancellor of the Exchequer, in the March 29, 1976 issue of BUSINESS WEEK. After having passed through an economic slump more serious than that of the

United States, Britain's Labor Government is turning their direction from social expenditure to greater industrial investment. The need for industrial regeneration is not only cited by Mr. Healy as an item of high priority, it is stated by him to be the same as the problem faced by the United States. May we learn our lesson from Britain, and take action long before the rundown of our industrial plant and worker's morale reaches the depth from which Britain now suffers.

On behalf of the Associated General Contractors and its members, I thank you for this opportunity to present our views. Also, I have been requested to state that the foregoing expression of views relating to Foreign Tax Credits and Income Exclusions has the full support and concurrence of the National Constructors Association and the American Consulting Engineers Council, whose interests are represented by the International Engineering and Construction Industries Council.

Senator BYRD. The committee will stand adjourned until 10 o'clock Monday morning.

[Whereupon, at 12:35 p.m., the committee was adjourned to reconvene at 10 a.m., Monday, April 5, 1976.]

TAX REFORM ACT OF 1976

MONDAY, APRIL 5, 1976

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 10:07 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Walter F. Mondale presiding.

Present: Senators Ribicoff, Mondale, Curtis, Hansen, and Packwood.

Senator MONDALE. The meeting will come to order.

The first witness is Mr. James Needham, chariman of the board, The New York Stock Exchange.

STATEMENT OF JAMES J. NEEDHAM, CHAIRMAN OF THE BOARD, THE NEW YORK STOCK EXCHANGE, ACCOMPANIED BY DONALD L. CALVIN, VICE PRESIDENT, NYSE, AND DR. WILLIAM C. FREUND, VICE PRESIDENT AND CHIEF ECONOMIST, NYSE

Mr. NEEDHAM. Thank you, Mr. Chairman.

With me today are Donald L. Calvin, vice president of the exchange on my left, and Dr. William C. Freund, vice president and chief economist of the exchange, on my right.

We appreciate this opportunity to present to the committee our views on the investment-related elements of the tax reform measures you are considering.

This country has experienced a long siege of business recession and inflation from which we are beginning to emerge. And while many Americans, particularly those who are standing on unemployment lines even as we sit relatively comfortably in this hearing room, would still not describe the immediate outlook as rosy, there does seem to be a cautious optimism and growing confidence in the country's economic prospects.

The deliberations of this committee, and the actions you and your congressional colleagues will take in the weeks ahead, are almost certain to play a crucial role in determining whether public confidence in the economy will deepen and spread—and take firm root once again.

In the area of investment tax reform the initiatives proposed by the Treasury Department are, by and large, very encouraging.

Unfortunately, the initiatives taken by the House of Representatives in H.R. 10612 are not at all encouraging. I share the concerns expressed by Chairman Long about that bill's anti-investment thrust and about its likely damaging impact on job formation.

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Members of this committee may be acquainted with the findings of the New York Stock Exchange's 1975 "Census of Shareowners."

Briefly, that study indicated that the number of individual Americans who own corporate stocks or mutual fund shares declined from an estimated 30.8 million in early 1970 to an estimated 25.2 million in mid–1975.

There is no way to regard that as a happy development, or even as an inconsequential one.

The goal of developing a broad base of public ownership of American business has been eagerly pursued in this country for nearly a quarter century.

And while that goal may never have been specifically enunciated as a matter of national economic policy, the Government has generally seemed to support it.

The more senior members of this committee will recall that the most rapid and prosperous period of national economic expansion since World War II occurred simultaneously with the most dramatic advances in public shareownership.

Interestingly enough, the two countries whose economic growth in recent years has been most internationally admired are those in which shareownership seems to have been making the greatest strides forward, West Germany and Japan.

Back in the halcyon days of shareownership in this country, one of my predecessors at the New York Stock Exchange coined the phrase "People's Capitalism," to help describe individual shareownership to foreigners.

I recently came across his account of a meeting with Nikita Khrushchev in which the flamboyant Soviet leader grudgingly acknowledged that if "People's Capitalism" really worked, the idea probably had some merit within what he regarded as the confines of a private enterprise economy.

Interestingly enough, people's capitalism is a phase that is still used overseas, usually to identify an economic system that not only makes it possible for millions of private citizens to acquire an equity interest in corporate enterprises, but that actually encourages them to do so.

Unfortunately, as our 1975 shareownership studies show, people's capitalism has been taking something of a beating in the United States in recent years, partly because of the deep national economic dislocations we have experienced; partly because of a growing institutionalization of the market; partly—let us not be too coy to acknowledge—because of mismanagement of securities industry operational and financial problems during the late 1960's; and partly—let us also not hesitate to recognize—because of unrealistic national investment tax policies.

We can readily identify improvements or accommodations relevant to three of those problems:

The recession seems to have bottomed out and we appear to be on the road back to recovery, with inflation at least temporarily under restraint.

The securities industry has taken comprehensive steps to correct the deficiencies that led to the industrywide paperwork and financial problems of the late 1960's.

Earlier this year, New York Stock Exchange member firms showed they could handle sustained unprecedented high trading volume levels without undue operational or financial strains.

Despite some feeling that institutions have access to services and prices not generally available to individuals, the markets can, as they are now structured, accommodate the legitimate needs of both types of investors, and they will be able to continue to do so in the future if we avoid mandating any structural biases that will disadvantage investors of modest means.

To date, however, the tax laws have not been modified in any way that would reverse long-standing Federal policies that militate against investment risk-taking by millions of individual Americans.

Specific evidence is needed that it is not the intent of Congress to use tax policy to restrain public participation in the securities markets and in the ownership of American business.

The American people are entitled to know from their elected representatives whether it is the policy of the U.S. Government to encourage them to commit some part of their available savings to securities investments, or whether it is normal policy to discourage widespread participation in private enterprise capitalism.

A reading of the materials now before this committee suggests that unanimity does not now exist on this question. It would seem that the administration, as represented by the proposals advanced by Treasury Secretary Simon, takes the affirmative view, while H.R. 10612 appears to be headed in the opposite direction.

If it is the purpose of this committee to chart a fair and realistic course, then I would respectfully suggest that the formulation and enunciation of a national policy toward individual public investment in corporate equities would be an appropriate starting point.

The exchange is no stranger to the specific investment tax policy issues under consideration. We have expressed our views vigorously and often to various congressional committees and to appropriate representatives of the executive branch.

Attached to my statement is a series of concise position papers presenting the exchange's views on seven key issues.

I would just like to summarize these positions very briefly:

First, we support the aims and much of the design of the Treasury's program to revamp the tax treatment of capital gains and losses.

In general, the Treasury's approach is to provide sufficiently fair treatment of gains to overcome investors' tax-based reluctance to undertake risk investments.

We have some specific problems with the Treasury's proposed treatment of capital losses.

In any event, we believe certain modifications might be adopted in the interest of better encouraging urgently needed capital formation and spurring more efficient allocation of capital.

Accordingly, we recommend:

(a) Retain the 6-month holding period as the qualifying basis for long-term capital gains tax treatment.

(b) Adopt the type of sliding-scale capital gains deduction plan proposed by the Treasury, but with the scale to come into play at 50 percent after 6 months' holding, and increments above that level to begin after 1 year.

(*c*) Modify the tax structure to place a 25 percent cap on the effective capital gains tax rate.

(*d*) Raise the net capital loss deduction from $1,000 to $5,000—rather than to $4,000 as provided in H.R. 10612 and as recommended by the Treasury—and couple it with a 3-year loss carryback.

(*e*) Restore 100 percent deductibility for all net capital losses.

Secondly, we strongly endorse the Treasury's plan to integrate corporate and personal income taxes and, thus, to phase out double taxation of corporate income.

Beyond helping reduce the existing tax bias toward increasingly dangerous reliance on debt financing, Secretary Simon's imaginative proposal would establish a major new incentive for saving and investment, with predictable improvements in the allocation of capital, productivity, job formation, and overall economic growth.

Third, we believe that both ESOP and BSOP, the administration's broadened stock ownership plan, offer important practical and psychological boosts to the concept, if you will, of people's capitalism.

Both plans are giant steps toward reversing the decline in individual shareownership and would encourage millions of Americans who have the means to participate in securities investment to do so.

We would suggest, however, that individuals earning $25,000 a year or less should be eligible for the full benefits of BSOP, rather than setting the upper limit of full eligibility at $20,000 as proposed by the Treasury.

We also believe a provision should be included in the plans to permit an individual to withdraw funds, without penalty, on retirement or in the case of specified personal hardships, as can be done under the Individual Retirement Act.

In addition, we believe it would be appropriate, subject to limitations, to permit the sale of stock before the end of the 7-year holding period without penalty, if the proceeds of the sale are reinvested in another stock.

Mr. Chairman, the supporting document that we furnished the committee on these two proposals is going to be amended. I have concluded that it is not in the interest of furthering the purposes of broadened shareownership to establish an income limit for eligibility for the deduction. The plan should operate similar to the IRA plan and the Keogh plan, with a maximum set as to how much you can take, regardless of what your income is above that level.

So, we will submit an amendment.

Senator MONDALE. That will be received and made a part of our record.

[The following was subsequently supplied for the record:]

In the first of three recommended modifications to BSOP, it was proposed that "the upper income limit for eligibility for the full deduction ($1,500) should be $25,000, not the $20,000 proposed by the Treasury."

Upon reconsidering this proposal, I found no rationale in generally accepted principles of tax policy for limiting eligibility for the deduction. Accordingly, I am sending my position on BSOP to provide that a deduction of the lesser of $1,500 or 15% of compensation be provided to *all* taxpayers regardless of income size.

Tax equity demands that there be no discrimination among taxpayers as to the types of deductions for which they are eligible. The unfairness of allowing deductions for some taxpayers and not others would be immediately apparent if

individuals above a certain income could not deduct medical expenses or charitable contributions. In principle, this is no different from providing a BSOP deduction for some taxpayers and not others.

In the present tax code, the principle of equality of tax treatment for qualified investment deductions is adhered to under Self-Employed Retirement Plans, Individual Retirement Accounts and Employees' Pension and Profit-Sharing Trusts. Under each of these plans, deductions are available either to the individual or to his employer for investments in his behalf, regardless of size of income but with a cap on the size of the tax deduction.

Two other modifications in BSOP proposed in my written statement are unchanged.

Mr. NEEDHAM. Thus, my recommendations for strengthening BSOP are as follows:

First, provide a deduction of the lesser of $1,500 or 15 percent of compensation for all taxpayers regardless of income size.

Second, provide for the withdrawal of funds before the 7-year limit without being subject to the proposed penalty tax; (*a*) upon retirement and (*b*) in case of specified hardships such as long-term unemployment, the death of the primary wage earner of a household, or disability.

Third, a rollover provision should permit the sale of stock before the 7-year holding period without penalty if that money is reinvested in another stock. Some limitation on the number of rollovers might be provided.

Fourth, the exchange has long urged repeal of the withholding tax on interest and dividends paid to foreign investors, especially with regard to portfolio holdings.

This tax, which is not a major revenue producer, is discouraging foreign investment in this country at a time when it is most needed.

Its repeal, also recommended by the Treasury Department, would generate additional tax revenues on profits and income flowing from expanded foreign investment in this country, more than offsetting any initial decline in tax receipts.

Fifth, as I stated to the House Ways and Means Committee last month, the exchange supports proposals to increase the exemption from the Federal estate tax from $60,000 to $200,000.

We believe the larger exemption is fair and appropriate because of the large inflationary factor that has affected estate values since the smaller dollar exemption was established nearly 35 years ago.

A larger exemption is crucial to avoid compelling the sale of small family farms and businesses as, in many instances, the only means of satisfying Federal estate tax requirements.

Sixth, the exchange shares Secretary Simon's concern about the provision in H.R. 10612 limiting the permissible deduction for nonbusiness interest to $12,000 per year plus the amount of the taxpayer's net investment income and long-term capital gains.

This provision threatens to penalize homeowners who have taken on mortgages at the high rates that prevailed in recent years—and also to stifle venturesomeness by investors seeking to finance long-term projects with borrowed funds—particularly in situations where essential periods of development are likely to cause a lag in their realization of investment income.

If this provision aims at alleged interest-deduction abuses in connection with certain types of tax shelters, it actually would throw a much wider net.

Tax-shelter problems should be dealt with directly, rather than by imposing a blanket limit on deductible interest and disadvantaging many taxpayers who are not targets of the provisions in the House bill.

Finally, we believe it is appropriate to recall to the committee's attention a proposal we presented to the Financial Markets Subcommittee some time ago to permit broker-dealers to establish tax stabilization reserves.

Under this proposal, broker-dealers would be permitted, each year, to set aside a small portion of profits, tax-free, up to a prescribed minimum, in a loss reserve fund.

That fund could be drawn upon, in bad years, to ease the critical capital problems attributable to the cyclical nature of the securities business.

The effect of such a plan, which is similar to reserve arrangements already permitted for other financial intermediaries, would be to reinforce the ability of broker-dealers to provide essential services to investors in both good and bad times.

Perhaps the most urgent and delicate task facing the Nation today is to nurture the kind of public confidence in the economy that can accelerate our return from the nether regions of recession and promote full-scale economic recovery.

To do that, the private sector will have to create hundreds of thousands, indeed millions, of new jobs. To develop new job opportunities, American business must be able to tap long-dormant capital resources and new sources of investment funds both at home and abroad.

To unlock those funds and make them available to business and industry, we must have investment tax policies that stimulate risk-taking by the very substantial number of Americans who have the means to take risks.

Affirmative congressional action to use imaginative tax policies to encourage widespread, direct public participation in the recovery process will help put to rest the concerns of millions of Americans about their Government's determination to protect their way of life and to expand economic opportunities for all.

The Senate Finance Committee has led such action in the past and we hope you will do so again.

We, in turn, stand ready to assist you in your efforts.

Mr. Chairman, with your permission, I would like to hand in a number of submissions for the record, most of which I believe the staff is familiar with.

Senator MONDALE. Very well, that will appear in the record.[1]

Thank you very much, Mr. Needham.

Senator Curtis?

Senator CURTIS. The House bill, as it relates to the holding period, would not only be changed but would be changed retroactively.

Do you have any comment on that?

Mr. NEEDHAM. Change the direct——

Senator CURTIS. Change the holding period retroactively.

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[1] See p. 1792. Documents entitled "The Capital Needs and Savings Potential of the U.S. Economy," "The Need for Equity Capital," "Demand and Supply of Equity Capital," and "International Implications of a U.S. Capital Shortage," all prepared by the New York Stock Exchange, were made a part of the official files of the committee.

Mr. NEEDHAM. Yes; I think with respect to the second point, the retroactive nature of the proposal, that is patently unfair.

You know, people make investment decisions, most of them, on a long-term basis and I think it would be unfair to do that.

I am not even sure it is constitutional.

Senator CURTIS. Well, it seems to me that this committee must do something about that. The sophisticated and large purchaser of stock, even though it upsets his plans, has learned about the decision of the Ways and Means Committee but there will be thousands and thousands of individuals, small purchasers of stock, that have never obtained that information at all, and they may be confronted with it the first time when they go to make out the tax return next year.

Mr. NEEDHAM. There is no question about that. That is why I say it is patently unfair.

Mr. CURTIS. I feel that it is also something that we should do to be consistent.

In the absence of some very extreme situations, the Congress does not grant tax relief or leave people with injustices retroactively.

I think if we hold to that plan, there is much to be said for treating the taxpayer in the same manner.

That is all, Mr. Chairman.

Mr. NEEDHAM. If I may take a minute, there is a strange mood on the House committee and I don't know how to characterize it except to say they are doing a number of things. We have addressed a number of them, which in my view represent, perhaps, an extreme position with respect to the tax laws of this country.

Senator CURTIS. That's all, Mr. Chairman.

Senator MONDALE. Senator Ribicoff?

Senator RIBICOFF. No questions, thank you.

Senator MONDALE. Senator Hansen?

Senator HANSEN. Mr. Needham, I think you have made a fine statement. I have proposed that there be a sliding scale of capital gains deduction planned; as a matter of fact, I will have an amendment in to do that so I am delighted to know that, as I knew earlier, that you have supported that proposal.

I wanted to ask you about the brokerage industry stabilization reserve.

You point out the number of investors have dropped from about 30 million down to 25 million, was it?

I am rounding the numbers.

Dr. FREUND. Yes.

Senator HANSEN. I know a lot of firms on the New York Stock Exchange have fallen on hard times, a lot of them have gone out of business and there have been a lot of losses.

Would this brokerage industry stabilization reserve concept provide sufficient backup to have averted largely what has happened to members on the exchange in the last several years, or how much of an impact would this have been if it had been adopted?

Mr. NEEDHAM. If it had been adopted some years ago I am persuaded that some of the firms who have gone out of business in the last year would not have had to go out of business.

They would have had adequate capital resources to sustain the shock as we refer to it, in the move from the fixed commission rates to competitive rates.

With respect to the situation if the law were adopted now, I think what it would do, is it would assure the separateness of the securities industry.

We are confronted in the securities industry with great demands for the services and capital of that industry at this time. All of our studies indicate that.

While we have no fear as to the immediate ability of firms to be able to discharge that responsibility, we do feel that they together with other financial intermediaries should be treated the same, such as banks, which as I recall pay an effective tax rate of somewhere around 15 percent.

Many of our members pay substantially more.

Senator HANSEN. They are able, as I recall, to set aside a certain percentage of their loans in an account reserved for bad debts or bad loans and they can do that before taxes and that is what your proposal is here.

I think it makes good sense.

Mr. NEEDHAM. Thank you very much.

I am glad it appeals to you. This matter, as you undoubtedly know, Senator, is being dealt with in another context in various places in Washington.

Various studies of the applicability of the Glass-Stiegal Act as to certain activities of banks; we have a lawsuit against the Comptroller of the Currency; the SEC is making a study.

I think that prophecies as to what will come out of those studies are not always wise to make, but I would like to make one, that it is in the national interest for there to be a separate securities industry as distinguished from a unit of the banking industry.

So, it is very important to do everything you can to shore up the capital of that industry right now.

Senator HANSEN. No further questions.

Senator MONDALE. Senator Packwood?

Senator PACKWOOD. As I listened to the testimony, Mr. Needham, over the past 3 weeks, every industry has been indicating—today was the first one on securities, really—but the others have been industries that are capital-short, the electrics, coal, railroads, airlines. They have got to have more capital.

They all are advocating in one form or another certain kinds of tax incentives.

Then we had some people from the housing industry in wanting certainly no limitation on deductions of nonbusiness interest but some further incentives to put money in the thrift institutions.

There is obviously so much capital to go around. It seems to me we are almost getting to the place where we are chasing our tail.

We want to help everybody to give everyone a preference. I wonder if it wouldn't be better to go back to square one and eliminate the preferences and let the capital go without too much government direction or incentive?

I would be curious about your views.

Mr. NEEDHAM. Senator, if you would allow me just a little bit of license to answer that question.

I couldn't agree with you more. I would like to make suggestions.

If you repeal the capital gains and all provisions that go with it, you repeal entirely the corporate income tax and entirely the estate tax and see what happens in that free market system with capital. I think you will get entirely different results.

But, of course, there are those in Congress who probably feel that that would be too much of an immediate drain on the revenues of the Treasury Department and there are those who philosophically would find that totally unacceptable.

Senator PACKWOOD. You say repeal the capital gains; you would have that taxed at normal income rates?

Mr. NEEDHAM. No; I wouldn't tax it at all. [Laughter.]

Senator PACKWOOD. Oh, not tax it at all.

Mr. NEEDHAM. That is why I asked for a little license.

Senator MONDALE. And that would cost a little bit. [Laughter.]

Mr. NEEDHAM. But I do think that you put your finger on the problem. Many of the witnesses who have appeared have appeared cloaked, as I am, with some degree of self-interest.

I think that one of the suggestions we make, in addition to tax relief for American citizens, will assist in the capital formation process and that is the elimination of the withholding tax required to be paid by foreigners on interest and dividends in the United States.

We have been arguing that battle for many years now.

I think, too, and this came up when I testified before the Joint Economic Committee, that even if we did all of this, it might not be enough to meet the capital requirements of certain industries such as the energy-related industries, and something more might be needed.

As I recall in the dialog that occurred in that committee hearing, Senators Javits and Humphrey were wondering if it would be necessary to create some Manhattan-type project or TVA, or something of that nature where the Government would put up the seed money and the private sector would then pick it up from there.

I think in terms of certain industries the issue is bigger than what we are discussing here today, and may call for some extraordinary help from the Federal Government.

Senator PACKWOOD. We start hearings in the Banking Committee next week on the President's $100 billion energy-funding package which is not a far cry from what you just made reference to.

I have no other questions, Mr. Chairman.

Senator MONDALE. The staff has asked me to propound a question in behalf of the chairman, Senator Long.

Senator Long has expressed an interest in a proposal to adjust the basis of property for inflation in computing capital gains.

I think you testified in favor of that.

Would you comment on your position?

Mr. NEEDHAM. Well, I think, Mr. Chairman, the thrust of the recommendations with respect to a scaling down of the capital gains tax rate is to take into account the inflationary impact in determining the tax.

Now, one alternative is to reduce the rate of tax; the other alternative is to step up the basis of the underlying asset.

It seems to me that the advice you might receive from the Internal Revenue Service would be extremely helpful here because to me, as a former practitioner, the method of adjusting the tax basis of the property is an extremely complex one for many individuals, particularly individuals in the lower asset value categories.

So, it might be far simpler administratively to adjust the rate itself.

Senator MONDALE. All right.

Mr. NEEDHAM. But I would defer to the IRS on that. That is really an administrative matter.

Senator MONDALE. Let's total up your various recommendations. Your recommended estate tax exemption, I believe, is $200,000; I favor some adjustments in the estate tax, but I think your proposal would cost about $2.5 billion.

Your recommendation to integrate individual and corporate taxes—a recommendation which endorses Secretary Simon's proposal—would cost about $15 billion when fully effective.

Mr. NEEDHAM. $15 billion? I have the numbers——

Senator MONDALE. I am not talking about feedback; I am just talking about the initial cost to the Treasury. With regard to the proposed 25-percent cap on capital gains, I think the effective capital gains rate is about 30 percent now on corporations, isn't it?

It would be a 5-percent reduction. What would that cost now?

Mr. NEEDHAM. Is that mainly the minimum tax or——

Senator MONDALE. I am referring to the cap on effective capital gains taxation.

What would that cost?

Mr. NEEDHAM. There shouldn't be any loss at all.

Senator MONDALE. Well, the present effective corporate capital gains tax is about 30 percent, isn't it?

Mr. NEEDHAM. Corporate? Excuse me, I was focusing on merely the individual.

Senator MONDALE. Yes; the corporate tax.

Mr. NEEDHAM. Let me go over our numbers here, Senator, if you will allow me to.

We have been very careful with these. I believe they have been corroborated at least with other witnesses on the outside.

Our proposal for the estate tax exemption results in a revenue loss of $2.1 billion.

Senator MONDALE. I doubt that. I think you are low.

Mr. NEEDHAM. I don't think so, Senator, but, of course, we will be glad to get together with whatever staff members developed the numbers you have and we can reconcile the two numbers.

Our annotation is directly from the Library of Congress, I had forgotten that. If you like, we would submit the testimony from before the House side where those annotations and other comments are included.

[The information subsequently supplied follows:]

The estimate that increasing the Federal Estate Tax exemption from $60,000 to $200,000 would result in revenue loss of $2.1 billion based on 1974 levels, was made in a memorandum from the Economic Division of the Library of Congress Congressional Research Service in August 1975 (based on estimates from the Department of Treasury) appearing in the Congressional Record of January 23, 1976, at page S. 435.

Senator MONDALE. It is about $2.4 billion; is it?

Mr. NEEDHAM. $2.1 billion. The withholding taxes, our estimate is, of course, based on what the Treasury has; it is $210 million in 1973.

Retaining the 25-percent alternative tax on the first $50,000, that is a revenue loss of $200 million.

Senator MONDALE. What have you got——

Mr. NEEDHAM. I don't have the corporation number here. We have not focused on the capital gains tax on corporations. I don't think that is in our testimony. I don't recall the number.

Senator HANSEN. Mr. Chairman?

Senator MONDALE. Yes. Go ahead.

Senator HANSEN. I seems to me there is a basic inconsistency in doing what Government—the Federal Government—has been doing where we recognize the inflationary factor and from time to time cost-of-living increases are applied, for all Federal employees and we have been able to slip through a little benefit for Members of Congress, but we don't talk too much about that.

We have tried different mechanisms and we have not been successful every time, you know, but occasionally we upped our own wages a little without trying to alert the voters too much.

On that side, we recognize, and as Dr. Friedman and other economists have said, we ought to index a lot of these things, recognizing that inflation is a fact of life and yet I think that the capital gains tax completely overlooks that fact of life. Belatedly the Secretary of the Treasury has said it is a fact.

I don't know what the figures are. I have seen all kinds but I understand when the—well, I won't speak of capital gains now, but going back to the $60,000 lifetime exemption or exclusion. I believe that was passed in 1942?

Mr. CALVIN. Yes.

Senator HANSEN. I think most people would agree if we were to just keep even, not give any added benefit, if we were to keep even with that $60,000, then that would buy, in terms of today's purchasing power of the dollar—it would take at least $200,000, maybe $210,000 to buy the same amount.

Mr. NEEDHAM. That is right.

Senator HANSEN. But the concept of capital gains entirely overlooks this. If some little storekeeper who has had a mom and pop grocery store for many, many years, sells out, he gets slugged with a big tax even if he gets a good sale.

If a homeowner sells a house he had for 30 years and he gets an offer and he goes home and talks with his wife and he says, "Gee, we can get two or three times as much as our house cost us," it sounds like a great idea, and they go merrily along the way until they try to replace it and then the moment of truth arrives and they find that they have been hit and they have been hurt badly.

Don't you agree that we are a little bit ambivalent on this issue when we authorize a cost-of-living increase for Federal employees on the one hand but fail to take a parallel fair measure for property owners and self-employed people on the other?

Mr. NEEDHAM. Well, Senator, you will forgive me if I beg the question. I personally happen to believe that elected officials and most

Federal employees are not receiving adequate compensation at this time so if I may answer it——

Senator HANSEN. I have some constituents who do not agree with you, sir. [Laughter.]

Mr. NEEDHAM. Well, I am sure they don't, but they don't spend as much time down here and they don't meet the people so they are not aware of the dedication and the skills that we are fortunate to possess in our Federal Government.

Senator HANSEN. I would like to get a——

Senator MONDALE. There is no time limit on this particular subject matter. [Laughter.]

You might flesh out the details a little in a written submission.

Mr. NEEDHAM. What I might do is get with my Finance Committee on Executive Compensation. But, seriously——

Senator MONDALE. You can tell them you were a smash here today. [Laughter.]

Mr. NEEDHAM. Being up in that airplane too long may have done something to me.

The point I think that I would like to make at this point, just for the record, is that when we talk about these proposals we tend to confuse the policy issue from the operating problem and it seems to me that—although I was quite young at the time—imposition of the estate tax was really a very important policy issue for the Government to decide.

Now, when we view it we tend to look at it in terms of its operating impacts if we were to change it. That is to say, would it increase or decrease revenues and, therefore, have an impact on Federal deficit.

It just seems to me that is the wrong way to make an operation decision.

I think the testimony by Secretary Simon on this point in the context of the withholding tax on dividends and interest, was in the short-term you give up perhaps $200 million in the revenue flow but on the long term it generates jobs and better opportunities for Americans and perhaps even increased standards of living.

So, I think that it is very important in these discussions to focus on the policy questions and then, after you have made tenative conclusions with respect to the policy questions, to come back and review them from a revenue operating point of view. The exchange in its appearances before this and other committees of the Congress dealing with complex matters of this nature has always supported that approach.

Senator HANSEN. Thank you.

Senator MONDALE. Thank you very much, Mr. Needham.

Mr. NEEDHAM. Thank you.

[The summary statement of Mr. Needham and submissions of the New York Stock Exchange follow. Oral testimony continues on p. 1825.]

SUMMARY OF STATEMENT BY JAMES J. NEEDHAM, CHAIRMAN, NEW YORK STOCK EXCHANGE, INC. BEFORE THE SENATE FINANCE COMMITTEE APRIL 5, 1976

The deliberations of this Committee, and the actions you and your Congressional colleagues will take in the weeks ahead, are almost certain to play a crucial role in determining whether public confidence in the economy will deepen and spread—and take firm root once again.

In the area of investment tax reform, the initiatives proposed by the Treasury Department are, by and large, very encouraging. Unfortunately, the initiatives taken by the House of Representatives in H.R. 10612 are not at all encouraging. I share the concerns expressed by Chairman Long about that Bill's anti-investment thrust and about its likely damaging impact on job formation.

The New York Stock Exchange's 1975 "Census of Shareowners" indicated that the number of individual Americans who own corporate stocks or mutual fund shares declined from an estimated 30.8 million in early 1970 to an estimated 25.2 million in mid-1975. There is no way to regard that as a happy development, or even as an inconsequential one.

To date, the tax laws have not been modified in any way that would reverse long-standing Federal policies that militate against investment risk-taking by millions of individual Americans. If it is the purpose of this Committee to chart a fair and realistic course, then I would respectfully suggest that the formulation and enunciation of a national policy toward individu..' ·ublic investment in corporate equities would be an appropriate starting poin.. Attached to my statement is a series of concise position papers presenting the Exchange's views on seven key issues. I would just like to summarize these positions very briefly:

Capital Gains and Losses.—We support the aims and much of the design of the Treasury's program to revamp the tax treatment of capital gains and losses. But we have some specific problems with the proposed treatment of capital losses and we believe certain other modifications might be adopted. Accordingly, we recommend:

(*a*) Retain the six-month holding period as the qualifying basis for long-term capital gains tax treatment.

(*b*) Adopt the type of sliding-scale capital gains deduction plan proposed by the Treasury—but with the scale to come into play at 50% after six months holding, and increments above that level to begin after one year.

(*c*) Place a 25% cap on the effective capital gains tax rate.

(*d*) Raise the net capital loss deduction from $1,000 to $5,000 and couple it with a three-year loss carryback.

(*e*) Restore 100% deductibility for all net capital losses.

Integration of Corporate and Personal Income Taxes.—We strongly endorse the Treasury's plan to integrate corporate and personal income taxes and, thus, to phase out double taxation of corporate income.

Stock Ownership Plans.—We believe that both ESOP and BSOP, the Administration's Broadened Stock Ownership Plan, would encourage millions of Americans who have the means to participate in securities investments to do so. However, individuals earning $25,000 a year or less should be eligible for the full benefits of BSOP. Also, permit withdrawal of funds, without penalty, on retirement or in the case of specified personal hardships. Subject to limitations, permit the sale of stock before the end of the seven-year holding period, without penalty, if the proceeds are reinvested in another stock.

Withholding Tax on Foreign Portfolio Investment.—Repeal the withholding tax on interest and dividends paid to foreign investors, which is discouraging foreign investment in this country at a time when it is most needed. Repeal is also recommended by the Treasury.

Estate Tax Exemption.—The Exchange supports proposals to increase the exemption from the Federal Estate Tax from $60,000 to $200,000. It is crucial to avoid compelling the sale of small family farms and businesses.

Limitation of Deduction of Non-Business Interest.—The exchange shares Secretary Simon's concern about the provision in H.R. 10612 limiting the permissible deduction for non-business interest to $12,000 per year plus net investment income and long-term capital gains. Tax-shelter problems should be dealt with directly, rather than by disadvantaging many taxpayers who are not targets of the provision in the House Bill.

Brokerage Industry Stabilization Reserve.— It is appropriate to recall to the Committee's attention our proposal to permit broker-dealers to establish tax stabilization reserves. Each year, broker-dealers would be permitted to set aside a small portion of profits, tax-free, up to a prescribed minimum, in a loss reserve fund. It would be drawn upon, in bad years, to ease the critical capital problems attributable to the cyclical nature of the securities business. Such a plan is similar to reserve arrangements already permitted for other financial intermediaries.

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To develop new job opportunities, American business must be able to tap long-dormant capital resources and new sources of investment funds both at home and abroad. We must ban investment tax policies that stimulate risk-taking by the very substantial number of Americans who have the means to take risks.

Affirmative Congressional action to use imaginative tax policies to encourage widespread, direct public participation on the recovery process will help put to rest the concerns of millions of Americans about their government's determination to protect their way of life and to expand economic opportunities for all. The Senate Finance Committee has led such action in the past and we hope you will do so again. We, in turn, stand ready to assist in your efforts.

POSITION OF THE NEW YORK STOCK EXCHANGE TO REVISE THE TAX TREATMENT OF CAPITAL GAINS AND LOSSES

The New York Stock Exchange supports the basic thrust of the Treasury's program to revamp the tax treatment of capital gains and losses.[1] However, we believe modification of the Treasury's program is necessary if its intent of promoting capital formation and the efficient allocation of investments is to be fully realized.

Though reform in this area is long overdue, it is especially critical at this time. The precipitous drop in individual shareownership offers vivid proof of the need to raise incentives if adequate amounts of risk investment are to be forthcoming. Disenchantment with equity investment at this juncture in economic history is particularly serious. Recent financial developments have demonstrated the need for a strong equity base to weather economic storms.

Massive infusion of equity capital is the only antidote to restore the badly weakened corporate capital structure to financial health. True, institutions will supply substantial amounts of equity investment, but not enough to do the job. According to NYSE estimates, over the 1974–1985 period, individuals will *sell* a cumulative total of almost $80 billion in equities. This drain on the flow of equity investment must be eliminated if the equity needs of corporations are to be met. The prospects for this are poor in light of a history of 18 straight years of net sales of equity by individuals.

In this era, when relatively high-yielding, low-risk investments are available to the individual investor as never before, he is not going to opt for equity investment, unless the potential after-tax return is commensurate with the additional risk.

SLIDING SCALE HOLDING PERIOD AND THE ALTERNATIVE TAX RATE

The issues of a sliding scale holding period and the 25% alternative tax rate are intertwined and should be examined together.

The Exchange agrees that a sliding scale holding period is an effective approach to unlocking funds tied up in less productive investment, so they may flow into more promising ventures. Further benefits would flow from the stimulation of new investment that would arise from the cut in the tax penalty on realized capital gains. These are the two major reasons why the Exchange has, in fact, been advocating a sliding scale plan for some time. However, coupling elimination of the alternative tax to a sliding scale plan, as the Treasury proposes, would be counter-productive in that it would intensify the lock-in effect for many taxpayers.

Sliding Scale.—A properly constructed sliding scale plan could overcome a major weakness of the present capital gains tax system—the powerful incentive it provides to hold appreciated assets in order to preserve investment values. Though this may be wise investment strategy, its encouragement is poor economic policy, particularly in a dynamic society. Because capital is limited, it is crucial that it be constantly redeployed to satisfy changing needs. To the considerable extent that current tax provisions discourage capital redeployment, they hinder economic efficiency.

The Exchange agrees with the Treasury that an effective sliding scale capital gains tax should provide for small but frequent changes in the sliding scale intervals to minimize the development of a new lock-in. The proposed one-point-

[1] The Treasury's proposal is discussed on page 52 of Secretary of the Treasury Simon's March 17, 1976 testimony to the Senate Finance Committee.

a-year increase in the size of the capital gains deduction is the right formula for minimizing the tendency under sliding scale plans to lock-in as a new holding period interval approaches.

Despite conceptual agreement with the proposed plan, the Exchange believes it should be modified to give added encouragement to capital mobility, particularly in the early years of holding. There appears to be no rationale for waiting five years before the sliding scale comes into play.

If better investment alternatives arise, redeployment of capital invested for relatively short periods of time is just as desirable as redeployment of capital held in very long-term investments. Therefore, the Exchange recommends that the scale start to slide above 50% after the first year of holding and the deduction increase one percentage point each year for 25 years. Thus, after one year the deduction would be 51% and after 25 years it would be 75%, compared with the 70% proposed.

25% Alternative Rate.—Elimination of the 25% alternative rate on the first $50,000 of gains would run at odds with the objective of the sliding scale deduction plan. Rather than easing the lock-in, it would intensify it for individuals in tax brackets over 50%. For example, an individual in the 70% bracket would have to hold an asset for 19 years to match the 25% capital gains rate which now applies to the first $50,000 of gains after six months. In the 60% tax bracket, the wait would be 13 years.

The only explanation offered for this striking anomaly in a plan designed to improve investment mobility is that preserving the 25% alternative in conjunction with a sliding scale would "require complex 'stacking' and allocation rules." While tax simplification is desirable, in a tax system with so many varying and conflicting goals, simplicity, unfortunately, is not always achievable. In fact, some recommendations in the Treasury's tax revision plan would increase complexity in pursuit of what it deems are important goals.

Even more desirable—and certainly less complex—than retaining the 25% alternative rate on the first $50,000 of gains, would be to structure the sliding scale so that in no case would the effective tax rate exceed 25%. Only a relatively small amount of capital gain is taxed at rates in excess of 25%, and the revenue yield is insignificant. But for those affected, high tax rates provide a severe impediment to capital mobility.

SIX-MONTH HOLDING PERIOD

H.R. 10612's proposal to lengthen from six-months to one year the holding period for qualification for long-term capital gains tax treatment would directly thwart the objectives of encouraging capital mobility and risk investment. The major justification for a holding period requirement rests on the questionable assumption of a need to distinguish between "speculation," which is deemed to be undesirable, and investment. Even if one accepts that rationale, no valid objective would be accomplished by lengthening the holding period. Speculators turn over assets and rely on an accumulation of many small gains. The nature of their risky operations dictates that they not contemplate long-range advantages, but capitalize on the immediate situation. Thus, no speculator would contemplate holding an asset for as long as six months to garner a tax advantage.

CAPITAL LOSSES

Net Capital Losses.—The Exchange concurs with the need to boost the net loss deduction to provide long overdue recognition of the reality of inflation. However, it recommends that the deduction be raised to $5,000 rather than the $4,000 provided for in H.R. 10612. An increase to $5,000 would restore the relationship between the deduction and median family income to what it was in 1942, when the current $1,000 limit was adopted.

As things stand now, moderate income investors are most likely to suffer from the stringent loss limit, since, typically, they have few prospects for offsetting loss carryovers against future gains.

In addition to an increase in the loss deduction, the Exchange suggests a three-year loss carryback (the treatment afforded corporations) be provided for individuals. This would encourage investors locked into losses to realize them and switch into more promising investments.

Sliding Scale on Capital Losses.—The Treasury proposes that the same sliding scale applied to long-term capital gains be applied to net losses. For example, on an asset held for 15 years, each $100 of realized loss would qualify for only a $40 net loss deduction. The major rationale offered is for symmetrical treatment of gains and losses as it "accords with the trend set by the Tax Reform Act of 1969." A further reason is that it would simplify the loss carryover system.

The Exchange believes that the treatment of long-term losses in the 1969 Act (50% deductibility) rests on a misperception of the nature of losses. To extend this principle further would seriously compound the error. Despite the seeming evenhandedness of similar treatment of gains and losses, the two cannot be equated. To do so is to create an injustice for those who have been unfortunate enough to incur losses. An investment loss is just as harmful to financial well-being as a casualty loss, for which full deductibility (less $100) is provided.

From an investment point-of-view, each dollar of loss on an asset is more damaging if it is incurred over a long period of time than over a short period. The real loss consists not only of the actual dollar loss, but income foregone if the holding had been switched earlier to another asset. An individual taking a quick loss might recoup it by transferring the remaining capital to a profitable alternative investment. By contrast, the individual who has held a losing investment for many years has foregone possible appreciation by not shifting. Thus, lowering the write-off on long-term losses flies in the face of investment realities.

A sliding scale on losses presumes the loss was incurred over the period the asset was held. This may be far from reality, given the nature of the equity markets. For example, a stock holding may have appreciated over a long period of time, say 10 years. Then, a severe market slump (as in 1973–1974) in a relatively brief time sends the value of the holding below the original purchase price. Is it fair to reckon the holding period from the day of purchase for purposes of computing the deductible portion? Far from a theoretical construct, this was a reality that faced millions of investors during the recent bear market, when the NYSE Common Stock Index closed out 1974 at its lowest level since the end of 1962.

An investor committing capital has no preconceived notion of precisely how long that investment will be held. To him, a loss is a loss, no matter how quickly or slowly it was incurred—and if the concept of investment is to be justified to millions of people with modest investible funds, the possibility of losses should not be compounded by the prospects of inequitably tax treatment if losses are indeed incurred.

Based on investment realities, the erroneous concept of symmetry of treatment of investment gains and losses should be abandoned. A sliding scale applied to highly appreciated long-term holdings would ease the lock-in and encourage capital mobility; applied to large losses, it would have the opposite result. Stringent treatment of losses would also inhibit investment in new and risky ventures and those with no prospects for immediate retunrs. Thus, the Treasury's proposal to apply a sliding scale to the net loss deduction is inconsistent with its broad objective to encourage risk investment. Accordingly, all losses should be afforded the same treatment for purposes of the net loss deduction. That is, 100% deductibility.

CONCLUSION

The New York Stock Exchange supports the aims and much of the design of the Treasury's programs to revamp the tax treatment of capital gains and losses. However, it believes that modifications in that program are required to better encourage capital formation and more efficient allocation of capital. Toward that end, the Exchange recommends the following:

Adopt a sliding scale capital gains deduction plan, such as that proposed by the Treasury; but with the scale starting at 50% after the first six months and sliding above 50% after one year of holding, not five.

Structure the sliding scale plan, or otherwise modify the capital gains tax, so as to place a 25% cap on the effective tax rate.

Retain the six-month holding period for qualification for long-term capital gains tax treatment.

Raise the net loss deduction from $1,000 to $5,000 and couple it with a three-year loss carry-back.

Restore full deductibility for all investment losses.

Position of the New York Stock Exchange To Integrate Corporate and Personal Income Taxes

The New York Stock Exchange strongly endorses the Treasury's plan to integrate the corporate and personal income taxes.[1] Our long standing concern over the adverse effects of double taxation of corporate income was underscored in recent years by the dangerous build-up of corporate debt and the inability of corporations to balance it with new equity financing. A heavy contributing factor was the bias in favor of debt financing that is built into the current tax system. The Exchange developed a plan to ease the problem by enabling corporations to deduct a portion of dividends paid. The Treasury's proposal combines this approach with a credit to stockholders for a portion of the corporate income tax allocable to their dividend receipts. After a five-year phase-in period, the double taxation of corporate earnings would be ended completely. In effect, that portion of corporate income which flows to stockholders in the form of dividends would be taxed at the stockholders' personal income tax rates; the portion retained by the corporation would continue to be taxed at the corporate income tax rate.

SHORTCOMINGS OF THE PRESENT TAX PROVISIONS

Taxation of both corporate income and of dividends paid from that income offers a classic example of what a good tax should *not* be. It is neither fair nor logical and has a great influence on business financing decisions and dividend policy. It favors unincorporated over incorporated business and, among corporations, debt over equity financing and earnings retention over dividend payments. It impedes the flow of resources from low to high rate-of-return uses and discourages capital-intensive activities.

The distorting effects of the present tax provisions stem, first, from the very heavy tax bite out of each dollar of distributed profits and, second from the fact that interest is a deductible expense, while dividends are paid from after-tax corporate earnings.

Burden on Profits.—Of each profit dollar that ultimately flows to the shareowner in the form of dividends, on average, two-thirds goes to pay personal and corporate income taxes, leaving a net return of 34¢ on the corporate profit dollar.[2] An investor in the 70% tax bracket has a net return of only 16%. Net returns are further eroded by state and local income taxes.

The "double-dip" into profits creates a bias in favor of earnings retention rather than dividend payouts. Frequently, this "locked-in" capital cannot be used as productively by the corporation as it would if it were invested in another enterprise. If earnings were paid out rather than retained, they would ultimately flow to the capital markets and be bid away by those corporations that could most efficiently use the funds. Thus, the tax-induced bias toward earnings retention slows the redistribution of the existing capital pool for use in plant modernization and expansion and for the development of new, more advanced technology and helps perpetuate inefficiency.

Heavy profits taxes also serve to dampen new equity investment, because of the extraordinary high returns corporations must earn to provide shareholders with after-tax rates of return competitive with other types of investment. Moreover, because returns on all types of investments are interrelated, heavy taxes on corporate income tend to depress investment returns in general. In turn, lower investment returns dampen the incentive to save, so less capital is forthcoming.

In sum, double taxation of corporate income has a three pronged effect on corporate capital spending. First, new equity investment required to form a sound financial base for physical expansion is discouraged. Second, by lowering the overall saving incentive, less investment capital is made available. Third, by encouraging earnings retention, capital is not efficiently deployed.

Bias Toward Debt.—Under the corporate income tax, interest on debt is a deductible expense, while dividends must be paid from after-tax earnings. From the corporation's point-of-view, it is more desirable to incur one dollar of interest

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[1] The Treasury's proposal is discussed on page 37 of Secretary of the Treasury Simon's March 17, 1976 testimony to the Senate Finance Committee.

[2] The arithmetic is as follows: Typically, a corporation pays 48¢ of each profit dollar in corporate income taxes for each 52¢ in dividends it sends out. The average tax rate paid by individuals on dividend income is about 35%—or an additional 18¢ of the original profit dollar. Thus, 66¢ goes to Federal taxes.

expense than to pay out one dollar in dividends. The following table graphically demonstrates why corporate financial managers have been willing to chance carrying extremely heavy debt commitments.

COMPARATIVE COSTS DEBT VERSUS EQUITY FINANCING

	Equity	Debt
Pretax profit	$1,000,000	$1,000,000
Interest		500,000
Taxable income	1,000,000	500,000
Tax	480,000	240,000
Aftertax profit	520,000	260,000
Dividends	500,000	
Retained earnings	20,000	260,000

If a corporation has $1 million in pre-tax profits and interest payments of $500,000, its taxable gross profit would be $1 million less $500,000—and its tax bill would be 48% of $500,000, or $240,000, leaving net after-tax earnings of $260,000. However, if, instead of paying interest on outstanding debt, the same corporation paid $500,000 in dividends, its tax liability would be 48% of the full $1 million of gross profits—or $480,000. After paying $500,000 in dividends, net after-tax earnings would be an insignificant $20,000. In this highly simplified example, the corporation, in effect, would pay a penalty of nearly a quarter-million dollars—25% of its gross profits—for not being in debt.

If the discrimination against dividends were done away with, corporate management would weigh debt versus equity financing strictly on the economic merits. More equity financing would result and the corporate financial structure would be strengthened. Corporations would be in a better situation to withstand temporary reverses and could better take the risks associated with new product development and long-range expansion programs.

A PRAGMATIC SOLUTION

There is little argument among tax authorities as to the general effects of the current provisions for taxing corporate profits and dividends. Virtually all would agree that integration of the corporate income tax and the personal income tax on dividends is the ideal solution to the double taxation problem. However, they part company, first, on the practicability of such a move, and, second, on mechanics.

The Treasury has offered an eminently practical plan to integrate corporate and personal income taxes. Elements of two basic approaches to easing double taxation of dividends are combined, so as to offer some of the benefits of each. Combining a 50% deduction to the corporation for dividends paid with a partial credit to stockholders for the corporate income tax allocable to dividends establishes a sensible balance between the incentives to retain earnings and to pay out dividends.

The first approach, is used alone, would replace the bias in favor of earnings retention with one in favor of completely paying out dividends; the second would leave too strong an incentive for earnings retention.

CONCLUSION

The New York Stock Exchange supports the Treasury's plan to phase out double taxation of corporate income. It provides a practical approach to reconciling conflicting economic and tax policy objectives. Despite its seeming complexity, it should prove simple in execution. Data necessary to calculate the tax credit could be furnished on Form 1099, which the corporation is already required to send to dividend recipients. Taxpayers would merely need to transpose two numbers to appropriate lines on the income tax form.

Benefits flowing from the Treasury's proposal would be considerable. The corporate financial structure would be more solidly based. American corporations would be more competitive in world markets. A major new incentive for saving and investment would be provided. Not only would more capital be forthcoming, but the existing capital pool would be more efficiently used. New and better paying jobs would be created and productivity would increase, accelerating economic growth. More comfortable capacity levels would help dampen inflation. The ulti-

mate return from the Treasury's proposal would be rising living standards for all Americans.

POSITION OF THE NEW YORK STOCK EXCHANGE ON THE PROPOSED BROADENED STOCK OWNERSHIP PLAN

The Exchange finds much to favor in the Treasury's proposed Broadened Stock Ownership Plan (BSOP).[1] Under it, money invested in equities would be deductible from taxable income, subject to a $1,500 per-year maximum (or 15% of income, whichever is greater) for individuals earning $20,000 per year or less. Deductibility would be phased out on a sliding scale for persons earning between $20,000 and $40,000 per year. The plan would also exempt income earned through the purchase of equities from income taxation until the equity is sold. Upon such sale, funds would be subject to the normal capital gains tax. There is, however, a requirement that the funds would have to remain invested for at least seven years. Premature withdrawals would be discouraged by subjecting them to a penalty tax.

BSOP would provide an excellent vehicle for extending stock purchase plans beyond employees who are carried by ESOP's. In addition, it would enable people covered by ESOP's to diversify their holdings, since it is risky to put all one's economic eggs—job, pension and investments—into one economic basket. In complement, BSOP and ESOP would offer important, practical and psychological benefits which would encourage millions of Americans to participate in securities investment. However, several modifications of the BSOP proposal would strengthen it considerably.

First, the upper income limit for eligibility for the full deduction should be $25,000, not the $20,000 proposed by the Treasury.

Second, the Treasury's proposal should provide for the withdrawal of funds before the seven-year limit without being subject to the proposed penalty tax; (a) upon retirement and (b) in case of specified hardships such as long-term unemployment, the death of the primary wage earner of a household, or disability, as is provided for in the Employee Retirement Income Security Act.

Third, a roll-over provision should permit the sale of stock before the seven-year holding period without penalty if that money is reinvested in another stock. (Some limitation on the number of roll-overs might be provided.) This would be similar to the provision which now applies to sales of private residences. A rollover would be consistent with the objective of achieving greater capital mobility to promote sound, efficient, long-term economic growth.

POSITION OF THE NEW YORK STOCK EXCHANGE TO ELIMINATE THE WITHHOLDING TAX ON INTEREST AND DIVIDENDS PAID TO FOREIGNERS

The New York Stock Exchange joins the Treasury in urging elimination of the withholding tax on interest and dividends paid to foreigners, especially on portfolio holdings.[2] As we have stated in previous testimony, the present tax discourages foreign investment at a time when it should be encouraged. In reality, the tax produces comparatively little revenue for the Treasury, both on an absolute and relative basis, especially when the costs of collection are taken into account. In fact, the net gain to the economy from repealing this tax—in terms of increased job opportunities and higher incomes—would more than offset any loss to the Treasury.

The Withholding Tax Discourages Foreign Investment.—The present withholding tax acts as an impediment to foreign portfolio investment. Under present law, a 30% tax is imposed, at the source, on the gross amount of dividends and interest paid to foreign investors. Though tax treaties modify this basic rate somewhat, it is still higher than the rates in many other industrialized nations. It is little wonder that foreign investors will limit their participation in the U.S. securities markets as long as the withholding tax reduces the yield on U.S. corporate securities held by nonresidents.

Actions Taken by Other Countries Have Altered Investment Capital Flows.—Other countries have moved aggressively to attract foreign capital by re-

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[1] The Treasury's proposal is discussed on page 32 of Secretary of the Treasury Simon's March 17, 1976 testimony to the Senate Finance Committee.

[2] The Treasury's proposal is discussed on page 59 of Secretary of the Treasury Simon's March 17, 1976 testimony to the Senate Finance Committee.

ducing their withholding tax rates. With the exception of Germany, none of the Common Market countries has a withholding tax on interest; and among themselves, withholding on dividends is being eliminated: Japan enacted legislation early in 1974 which exempted from income taxation interest on foreign currency debt securities issued by Japanese corporations to nonresident investors, and Canada has recently called for an exemption from the normal withholding tax on interest paid to nonresidents on Canadian public and private debt securities.

The German experience with withholding taxes provides confirmation, though in reverse, of the impact that the elimination of withholding taxes can have on foreign investment flows. In 1969, when the deutsche mark was strengthening markedly and investment funds were flowing in, the German government levied a withholding tax on foreign-owned German bonds in order to reduce foreign inflows of capital. And the withholding tax did help to discourage foreign demand for German debt securities. It is reasonable to expect that the elimination of such taxes would encourage foreign investment flows here at home.

A New York Stock Exchange Study on U.S. Capital Needs Foresees a Capital Shortage.—Exchange economists estimate that the present saving potential in the U.S. economy through 1985—from all domestic sources—is something over $4 trillion. Over this same period, private sector capital demands are likely to reach a cumulative total of $4.5 trillion. In other words, the domestic savings capacity of the economy may well be insufficient to finance the capital required to provide adequate housing, modernize plant and machinery, develop domestic energy sources, and improve the environment. In our view, the withholding tax on foreign receipts from portfolio investments has become the wrong tax at the wrong time. In this period of long-term capital scarcity here, the U.S. should actively encourage the inflow of capital from abroad.

Removal of the Withholding Tax Will Have a Minor Revenue Impact.—Total income from withholding taxes in 1971, the most recent year for which a full set of data is available, amounted to just over $211 million, or about 0.1% of total federal tax collections in that year. However, to collect this sum, an enormous amount of paperwork had to be generated. According to the Internal Revenue Service, over 636,000 detailed documents were filed with withholding agents in 1971 in order to administer the tax—on average, one lengthy form and internal audit for every $330 of tax receipts.

The ultimate tax loss could, in fact, be considerably less than $211 million, as a portion of this total represents inter-corporate dividends paid by subsidiaries to their foreign parent companies. If the tax on inter-corporate dividend income were retained, the maximum Treasury loss would be considerably less. Unfortunately, no precise estimates of the magnitude of inter-corporate dividend flows are available to us.

Overall Gain to the Economy from Repeal of the Withholding Tax Will be Significant.—As greater income and profits are generated in the U.S. economy from expanded investment in this country, income tax receipts will increase on a direct basis. If a 15% pretax rate of return on invested capital is assumed—the median rate of return in the manufacturing sector—then every $1 billion of additional investment capital generated from abroad could eventually produce about $150 million in additional profits every year, resulting in approximately $75 million in additional tax revenues to the U.S. Treasury. A conservative estimate suggests that the annual gains from aggregate new foreign investment of $2–$2.5 billion would more than offset any loss in tax revenues. In addition, the added investment from abroad would have a beneficial impact on the U.S. balance of payments and improve the United States' position as the premier international financial market.

Arguments for Retention of the Withholding Tax Have Little Merit.—Though the House Ways and Means Committee approved repeal of the withholding tax in early October of last year, the full House subsequently voted against its elimination. In the floor debate prior to the vote in the House, a number of arguments were raised by opponents of repeal. In our view, the validity of many of these arguments is questionable. The Exchange has prepared a paper rebutting the arguments.

CONCLUSION

The New York Stock Exchange joins with the Treasury and other concerned groups in urging repeal of the withholding tax on foreign portfolio investment. Elimination of the tax would promote foreign investment—adding to the nation's

capital resources and buttressing the country's balance of payments. Furthermore, repeal would ease the way for U.S.-based multinational corporations to raise capital abroad for use here or elsewhere—reducing their demand on domestic sources of funds. Enlarged tax receipts from the additional profits and income generated by expanded foreign investment will more than offset any initial decline in tax proceeds from withholding—especially when the burdensome costs of collection are considered. Finally, elimination of the tax should strengthen the U.S. capital markets and increase their importance in the international financial community as U.S. securities became competitive with Eurodollar and Eurobond instruments.

Position of the New York Stock Exchange to Increase the Federal Estate Tax Exemption to $200,000

The New York Stock Exchange supports the numerous bills already introduced in both the House and the Senate to raise the exemption under the Federal estate tax from $60,000 to $200,000.

As Senator McGovern stated in the Senate on January 27, 1976, when he introduced S. 2875 to raise the estate tax exemption to $200,000 and to provide an alternative formula for land valuation:

> "In that year (1942) Congress established that adjusted gross estates of $60,000 or more would be subject to this tax. The tax then became progressive as the estate became larger. In that day and in that age this exemption was sufficient to exclude estates of most average working Americans.
>
> Since 1942, however, land values have increased over 200 percent, stocks have increased tremendously in value, many homes have doubled and tripled in value. With today's inflated prices, we can all testify that $60,000 buys much less now than once it did.
>
> In any event, the Federal estate tax, if only because of inflation, has changed from a tax on the estates of the rich to a tax on the estates of the middle class."

The basic factor here is simply that the values of all types of property have increased dramatically in the U.S. since the $60,000 exemption was established in the estate tax in 1942. For example, the index of residential construction costs increased from 50.5 in 1942 to 181 in July, 1975. Similarly, the Consumer Price Index (for urban wage earners and clerical workers) for all items increased from 48.8 in 1942 to 166.3 in December of 1975.

Stock prices show an even greater increase from 1942 to 1976, with the New York Stock Exchange Index rising from 5.93 to 54.84 and the Dow Jones Industrial Stock Average rising from 119 to 1002 on March 25.

Farmers also have been particularly penalized by the low exemption because farm values have increased so that wives of farmers frequently are compelled to sell portions of a family farm to pay the Federal estate tax on a relatively small farm.

The purpose of the estate tax is primarly to reduce concentration of wealth and only incidentally to raise revenue. Most people are normally unaware of estate tax rates and are somewhat shocked to discover the high rate, applicable at relatively low dollar amounts. For example, the estate tax rate for an estate in the $100,000–$250,000 range (after the $60,000 exemption and any marital deduction) is $20,700 plus 30% of any amount in excess of $100,000. The intent to reduce concentration of wealth perhaps once a generation with respect only to relatively large estates, would be beter achieved if the $60,000 exemption were increased to $200,000 so that the tax would not apply to estates which under today's dollar values are small or medium-sized estates.

Loss of Revenue. It has been estimated that increasing the specific exemption from $60,000 to $200,000 would result in revenue loss of $2.1 billion *based on 1974 levels*. We believe that the increase in property values (particularly in stocks which constitute a large percentage of estates) subsequent to 1974 (on which estimate of revenue loss was based) will provide a larger estate tax base and resulting larger revenues than the revenue estimated on 1974 levels. Any revenue loss might be minimized by phasing in the increase in the deduction in steps over a period of years. More importantly, the increased deduction is needed as a matter of simple equity to catch up with inflated values, regardless of revenue, and to prevent an unreasonable taking of private capital.

There is broad support in both parties in both the House and the Senate to increase the estate tax exemption. In the House over 75 bills have been introduced

with over 145 sponsors to increase the Federal estate tax exemption. Bills to increase the exemption to $200,000 have been sponsored by more than 106 members and to $185,000 by an additional 23 members.

In the Senate 19 bills sponsored by 30 Senators have been introduced to increase the estate tax exemption. Seventeen Senators have sponsored bills to raise the estate tax exemption to $200,000; and ten additional Senators have sponsored bills to raise the exemption to $150,000.

CONCLUSION

The New York Stock Exchange supports the proposals to increase the exemption under the Federal estate tax from $60,000 to $200,000 because we believe that the larger dollar exemption is necessary under present dollar values to adjust for the large inflation in estate values since the $60,000 exemption was adopted in 1942. A larger exemption is particularly necessary to preserve family farms and family ownership of small businesses, without compelling the sale of farms or businesses to satisfy Federal estate taxes.

POSITION OF THE NEW YORK STOCK EXCHANGE TO ELIMINATE THE PROPOSED LIMITATION ON DEDUCTION OF NONBUSINESS INTEREST

Section 163 of the Internal Revenue Code presently permits a taxpayer who itemizes deductions to deduct all interest paid on indebtedness, but limits deduction of interest on *investment* indebtedness to $25,000 per year, plus the taxpayer's net investment income and long term capital gain, plus ½ of any interest in excess of these amounts. Any remaining amount of investment interest may be carried over to future years.

H.R. 10612 includes a provision (in Section 206) which would limit the permissible deduction for *nonbusiness* interest to $12,000 per year, plus the amount of the taxpayer's net investment income and long-term capital gains. The deduction for "*personal interest*" cannot exceed $12,000 for any year, even where the taxpayer has investment income or long-term capital gains for the year in excess of any deduction for interest on investment indebtedness. No carryover is permitted for any personal interest which is disallowed. In the case of "*investment interest*" (on funds borrowed to acquire or carry investment assets) the taxpayer may deduct this against any part of the $12,000 allowance which is not used up by deductions for "personal interest", then against net investment income, and then against long-term capital gains. Any remaining investment interest may be carried forward and deducted in future years. Long-term capital gains which are offset by interest are treated as ordinary income in computing the 50% capital gains deduction, the alternative capital gains tax and the minimum tax on tax preferences.

Secretary of the Treasury Simon, in his testimony before the Senate Finance Committee on March 17, 1976, opposed the $12,000 limitation because it is an arbitrary limit, would deter individuals from purchasing assets with borrowed funds and could have the effect of disallowing deductions for home mortgage interest.[1]

The N.Y.S.E. recommends that the proposed limitation on deduction of nonbusiness interest be *eliminated* because:

(1) As a matter of general tax fairness, no limitation should be placed on the amount of nonbusiness interest which a taxpayer may deduct because such a limitation would in effect place a government limitation on the amount of nonbusiness debt incurred by individuals. Also, any capital gains resulting from appreciation in the value of any property financed by the borrowing will be taxed without any ceiling on the amount subject to tax.

(2) Such a limitation on deduction of personal interest would unfairly penalize home-buyers by including interest payments on home mortgages, particularly in an era of high interest rates. Mortgages incurred at the 9% rates prevailing within the last few years would quickly be up against the deduction ceiling.

(3) Many long-term investments are financed by borrowed funds without any investment income during initial development years. A taxpayer may borrow large sums for *investment* in real estate or a new business venture (in which

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[1] Page 76.

he had no proprietary interest) but receive no investment income for many years. Such investment is highly desirable to provide needed capital for economic development and growth, but such investment would be seriously deterred if all nonbusiness interest in excess of $12,000 plus investment income and capital gains were not deductible (even though interest could be carried forward as a deduction in future years).

If there are abuses in the deduction of interest in certain types of tax shelters, they should be dealt with directly rather than by an omnibus limit on deductible interest.

POSITION OF THE NEW YORK STOCK EXCHANGE TO PERMIT SECURITIES FIRMS TO ESTABLISH LOSS RESERVES

The New York Stock Exchange proposes that securities firms be permitted to establish, within limits, tax-free loss reserves in profitable years to soften the effects of the sharp cyclical business swings on the stability of the securities industry. Securites firms have played a key role in the development of this country by directing capital to corporations and local governments via underwriting of new security issues, and by maintaining active, liquid markets in outstanding securities. The U.S. capital markets' ability to meet the challenge in the years ahead of supplying unprecedented amounts of capital to finance industrial expansion and modernization, home construction, domestic energy development, environmental cleanup and pollution controls, and myriad other private and public needs will depend largely on the health and efficiency of the securities industry.

BACKGROUND

The securities industry is among the most cyclical of U.S. industries. Swings in stock trading volume are even wider than those in demand for autos, steel, and other durable goods industries which are generally thought of as being highly cyclical. Securities industry cyclicality is reflected in the swings in the profit margins on commission income generated by securities transactions in the decade 1965–1974. As can be seen in the table below, margins varied from −2.9% in 1969 to 13.8% in 1967.

Pretax profit margins on Securities Commission income, 1965–74

	Percent		*Percent*
1965	11.0	1970	−1.0
1966	10.8	1971	11.8
1967	13.8	1972	10.5
1968	9.9	1973	13.3
1969	−2.9	1974	0.1

Source: NYSE, *Income and Expense Reports.*

Because of this erratic profit performance, the securities industry has found it difficult and costly to attract capital. In their attempt to maintain capacity during downturns, firms are forced into a high leveraging of equity, further adding to riskiness. Despite these efforts to keep capacity intact, events have pushed the industry into a pattern of continual contraction and expansion of facilities. Securities firms are handicapped in building a strong capital base, because they are not permitted to establish tax-free loss reserves in profitable years to draw on in cyclical downturns. Securities broker-dealers risk their capital in underwriting securities, in carrying an inventory to make markets in securities and in margin loans to customers to finance securities purchases.

By contrast, cyclical instability in other financial sectors (commercial banks and savings and loan associations) that prefrom intermediary functions similar to the securities industry's, is cushioned by provisions for loss reserves in the tax law. This gives other financial intermediaries a competitive advantage over securities firms. These firms, on average, have been taxed in recent years at a rate more than double that paid by banks and savings and loan associations.

The availability of standby funds to soften the impact of the banking industry's recent financial reverses underscores the role reserves can play in smoothing the effects of the wide swings in the securities industry cycle.

CONCLUSION

The securities industry's inherent instability is magnified by present tax provisions. Unlike other financial industries, it is not permitted to set aside in stabilization reserves a portion of pretax earnings in prosperous years to help maintain facilities during inevitable cyclical downturns. While loss carrybacks are available to securities firms as they are to all businesses, they do not provide capital when it is most needed to keep industry capacity intact. To remedy this problem, the New York Stock Exchange recommends the following plan:

> Securities broker-dealers be permitted to establish stabilization reserves from pretax income at a level of 5% of a base composed of margin loans and trading and underwriting positions. To control the rate of accumulation, additions to reserve accounts should not exceed either 50% of the permissible amount of reserves as of the close of the taxable year—whichever is lower.

Capital market efficiency depends substantially on the health of the securities industry. Therefore, improving its financial strength would serve the public interest, particularly at a time of unprecedented need for long-term financing.

THE NEW YORK STOCK EXCHANGE RESEARCH REPORT: STABILIZATION RESERVES—A ROUTE TO EASING CYCLICAL PROBLEMS IN THE SECURITIES INDUSTRY (DECEMBER 10, 1973)

INTRODUCTION AND SUMMARY

A basic precept of good tax policy is that taxpayers who are similarly situated should be accorded similar treatment. This paper examines the argument that securities brokerage firms perform important financial intermediary functions and should, therefore, be accorded similar tax treatment granted to other financial intermediaries.

This argument is bolstered by a number of important related factors, such as the high degree to which stock trading has become institutionalized and the widely recognized need to strengthen the U.S. capital markets.

Distinct from considerations of tax equity and growing competition among various financial institutions is the urgent need to moderate the extreme cycles to which the securities industry has been subject. The efficiency of the U.S. capital markets depends substantially on the intermediary services offered by brokerage firms. It is, therefore, clearly in the public interest to strengthen firms' ability to offer those services in a healthy competitive climate.

A comparison of effective tax rates shows that brokerage firms presently are taxed as much as twice the rate on banks and savings and loan associations—and this is clearly inconsistent with the historical precedents and the intent of Congress in permitting other financial intermediaries to set aside pretax income as reserves against various business contingencies.

While brokers' underwriting activities, margin loans, and trading activities related to market-making are clearly important intermediary functions which can be easily impaired by cyclical downturns, there is no provision under current tax policy to permit brokerage firms to establish reserves against this seriously destabilizing process.

All of these factors combine to point to the need for revising tax policy to extend the concept of reserves to the securities industry. Substantial public benefits can be derived from strengthening the U.S. capital markets at a time when the needs for long-term financing are unprecedented.

To realize these important objectives, stabilization reserves should represent 5% of a base composed of margin loans and underwriting positions, and market-making trading positions. This level of reserves, which for 1972 would have totaled $502 million, flows directly from the need to strengthen the securities industry's capital and the size and character of its recent losses.

BACKGROUND ON TAX TREATMENT OF FINANCIAL INTERMEDIARIES

The favorable tax treatment extended to financial intermediaries stems from the widely held belief that the process of intermediation is an important element in fostering real growth and investment in our national economy.[1] This process

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[1] For further discussion and background, see R. W. Goldsmith's study prepared for the SEC's *Institutional Investor Study Report*, Supplementary Volume 1.

centers on the ability to mobilize funds by offering various types of claims to the public; the reduction in the riskiness of such claims via the diversification of large asset portfolios; and the efficient processing of claims and assets, based on economies of scale.

The most visible form of preferential tax treatment is loss reserves—or funds which are set aside from pre-tax income and accumulated in reserve accounts. The levels which these accounts may reach in relation to certain loans or deposits are generally limited by statutory ratios. Ostensibly, the purpose of these reserves is to serve as protection against losses from loans or other types of investments. Actual losses, however, are insignificant in relation to loss reserves which, in fact, serve a far more important purpose. Banks, for example, view them as an extension of their capital base and as insurance against the impact of "local" and cyclical downturns.[2] Savings and loan associations (SLAs), on the other hand, apparently look upon loss reserves as simply an incentive for engaging in a specialized and risk-oriented type of business.[3] These arguments were clearly summarized some time ago by Professor Harry G. Guthman, who asserted that such non-taxed retained earnings should serve as "shock absorbers" for losses. He further stressed that reserves should be related to the riskiness of portfolios, which, in turn, should be the basis for taxing all financial intermediaries.[4]

Historical background

The history of the taxation of financial institutions suggests a clear Congressional intent to extend favorable treatment to them.[5] Examples involving the origins of the preferential treatment of banks and SLAs illustrate the development of its rationale.

Commercial Banks.—The precedent for allowing banks generous loss reserves that are unrelated to actual losses is rooted in a long-standing government policy to permit them to build up capital funds. Beginning in 1945, concern grew in the banking community over the falling ratio of capital funds to assets (exclusive of cash and U.S. government securities) which, presumably, made loan portfolios riskier. But given the prevailing high tax rates and the likely detrimental effects of adding to the capital base by increasing retained earnings (and reducing dividends in an industry then considered a kind of regulated utility), the idea of permitting larger loss reserves as a means of increasing capital funds began to gain acceptance. A 1947 Internal Revenue Service ruling thus allowed banks to maintain loss reserves at a level three times the average annual ratio of losses to loans during any previous consecutive 20-year period. Since the banks were thus able to include the heavy-loss period of the 1930's in their calculations, this ruling amounted to a sizeable tax subsidy.[6]

Savings and Loan Associations.—The early history of the tax treatment of SLAs also reflects the idea of using tax policy to encourage financial intermediaries to accumulate a strong capital base. Until 1951, SLAs paid no federal taxes at all, while between 1952 and 1958 they were taxed at an average rate estimated at 0.4%.[7]

Subsequent revisions of the Federal tax code were aimed at equalizing the tax treatment of financial institutions along less generous lines, without, however, altering the underlying principle of special consideration for intermediary activities. This philosophy continued to be reflected in the 1969 Tax Reform Act where the impact on financial institutions was largely restricted to further equalizing their tax burdens in light of the competition among institutions for savings funds and in lending activities.[8]

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[2] See *The Adequacy of Bad Debt Reserves for Banks, A Preliminary Study*, Carter H. Golembe Associates, Inc., Washington, D.C., 1972, pp. 13–18.

[3] John Valentini, "Taxation of Savings and Loans," *Federal Home Loan Bank Board Journal*, December 1972, p. 17.

[4] "Prospects for Financial Institutions . . . as seen by the Commission on Money and Credit" *Harvard Business Review*, March–April 1962, p. 164.

[5] *Tax Reform Studies and Proposals*, U.S. Treasury Department, February 5. 1969, Part 3, pp. 466–467.

[6] *Private Financial Institutions*, published by the Commission on Money and Credit, Prentice-Hall, Inc., Englewood Cliffs, N.J., 1968, pp. 390–395.

[7] *Private Financial Institutions*, pp. 401–406.

[8] *Tax Reform Studies and Proposals*, pp. 458–459. It should be noted that the 1969 Act provides for the gradual elimination of the preference feature from loss reserves for commercial banks by 1987. However, the Carter H. Golembe study (footnote 2) suggests that the banking industry is working to modify that provision. In addition, Kane (p. 11 of his paper cited in footnote 9) indicates that, due to the diversified nature of their business, banks have available other tax preferences so that a phasing out of the loss reserve preference would have little impact on their effective tax burden.

Tax burdens of financial institutions and brokerage firms

Against this background, it is instructive to compare the effective tax rates since the mid-1960's on three important financial intermediaries and the securities industry (Tables 1 and 2). The basis for these inter-industry comparisons is a widely accepted U.S. Treasury definition of an income base designated as "economic income". That definition adjusts reported income to derive the sum of explicit receipts less explicit expenses (including payments to depositors of mutual institutions). Specifically, the income base is taken as the sum of the following items: taxable income reported to the IRS; tax-exempt interest received; loss reserve deductions in excess of recorded losses; and loss carry-overs used in the current year. Implicit tax payments and subsidies and tax deferrals are ignored.[9] The effective tax rate is calculated simply by dividing recorded income tax payments by economic income.

TABLE 1.—FINANCIAL INSTITUTIONS' INCOME TAX AS A PERCENT OF ECONOMIC INCOME, 1965-71

Year and source	Commercial banks [1]	Mutual savings banks [2]	Savings and loan associations [1]
1965—SOI	23.0	3.3	15.2
1966—SOI	23.0	6.1	16.9
1967—FDIC and FHLBB	22.0	3.4	13.2
1968—Kane	21.5	5.6	15.8
1969—Kane	19.0	4.7	17.0
1970—Kane	23.0	NA	21.0
1971—Kane	19.0	NA	21.0

[1] Data for 1965 to 1967 are from Treasury study cited in (2). The 1968-71 tax ratios were calculated by Edward J. Kane (see footnote 9).

[2] "Tax Reform Studies and Proposals," pt. 3, U.S. Treasury Department, Feb. 5, 1969, p. 460.

Note: SOI—"Statistics of Income"—Internal Revenue Service. FDIC—Federal Deposit Insurance Corp. FHLBB—Federal Home Loan Bank Board. NA—Not available.

Data on effective tax rates (Table 1) suggest that the 1969 Tax Reform Act established approximately tax equality between banks and savings and loan associations at about a rate of 20% in relation to economic income, in accordance with the apparent intent of Congress. (Mutual savings banks apparently continue to receive relatively more favorable treatment, although recent data to demonstrate that is lacking.)

The disparity between the tax burdens of brokerage firms and other financial intermediaries is eye-opening. In recent years, brokerage firms have been taxed, on average, at a rate more than twice that of banks and savings and loan associations.

TABLE 2.—BROKERAGE INDUSTRY INCOME TAX AS A PERCENT OF ECONOMIC INCOME, 1965-71

Year	12-Firm sample [1]	Industry aggregate [2]
1965	NA	40.9
1966	NA	43.2
1967	48.1	42.3
1968	50.5	47.8
1969	46.7	46.1
1970	45.5	NA
1971	45.6	NA

[1] The sample firms are Bache, Dean Witter, Paine Webber, Merrill Lynch, Reynolds, Donaldson Lufkin, First Boston First of Michigan, Jas. H. Oliphant, A. G. Edwards, Hayden Stone, and Dain Kalman & Quail. Dean Witter data were not available for 1967 and 1968.

[2] This "Statistics of Income" classification includes all broker/dealers other than pure commodity firms. Between 1965 and 1969, the total number of firms in this group varied from 2,251 to 3,348. Tax rates were computed using the tax liability before investment credit and foreign tax credits in the numerator; and gross taxable receipts and ordinary income less ordinary business expenses in the denominator.

Note: NA equals not available.

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[9] Edward J. Kane, *Federal Income Tax Burdens of Commercial Banks and Savings and Loan Associations: A Study in Legislative Relations*, 1972, p. 6. (Kane is Everett D. Reese Professor of Banking and Monetary Economics, The Ohio State University.)

The 12-firm NYSE sample is a representative cross-section of institutional, retail and regional member firms. These firms were chosen because consistent financial data on their operating results were readily available from prospectuses and SEC 10K forms. The base used in computing their aggregate tax ratios is consistent with the U.S. Treasury's definition of economic income.

As a test for the presence of bias in the sample results, Federal tax percentages were calculated for all corporate broker/dealers, and it was concluded that the sample figures are a fair measure fo the size of the average tax burden of brokerage firms.

The conclusion that broker/dealers are taxed inequitably, compared with banks, SLAs and other financial institutions, must be tested on the basis of whether brokerage firms perform intermediary functions similar to those of financial institutions.

BROKERS/DEALERS AS FINANCIAL INTERMEDIARIES

In analyzing the intermediary role of broker/dealers, it is necessary at the outset to determine whether their underwriting and principal trading activities conform with the essential characteristics of financial intermediation.

Most important, a financial intermediary brings together suppliers and users of capital via brokerage mechanisms and contractual arrangements that satisfy the needs of both. The centralization of financial marketing permits the pooling of funds to provide liquidity to lenders and cost efficiencies to borrowers. In addition, the interposition of intermediaries tends to reduce the risks to lenders. These characteristics are readily apparent in underwriting, trading, margin loans and, probably, in certain other activities of brokerage firms. Because of their relative importance, the analysis is restricted to underwriting and trading, where the firm is trading as principal in an issue as market-maker or positioning stock as port of a transaction.

As underwriters, broker/dealers raise capital for borrowers and equity issuers while simultaneously providing liquidity to lenders in the form of marketable instruments. On the one hand, the underwrite provide users of capital with funds—efficiently and at a reasonable cost. On the other hand, the underwriter's reputation, after-market trading activity and wide distribution of financial claims significantly reduce investors' market risks.

In 1972 alone, underwriters raised some $42 billion in capital funds—about one-third of total U.S. business investment for the year. And, underwriting activities will loom still larger as the U.S. capital markets are called upon to raise many billions of dollars in new investment funds needed to develop new energy sources and pollution-control equipment, to expand tight manufacturing capacity, and for other new technologies. Obviously, the securities industry will be called upon to expand its historically pivotal intermediary role between investors and new, innovative corporations and industries.

The trading activity of broker/dealers acting as principals in securities plays a vital role in helping to maintain orderly securities markets. In their intermediary functions as market-makers and block-positioners, broker/dealers take positions at risk, thereby supplying liquidity to lenders and investors. Their willingness to hold positions for subsequent distribution serves to smooth the price movements of securities and enables investors to realize actual saving and offers potential savings to capital users.

The economic significance of trading and market making is self-evident if the preservation of strong U.S. capital markets is considered to be in the public interest. The steady institutionalization of the securities markets, highlighted by the fact that institutions now account for approximately 70% of the dollar value of public volume traded on the New York Stock Exchange, underscores the importance of the broker/dealers' intermediary trading function. Huge concentrated institutional portfolio holdings have resulted in the dependence of portfolio managers on market-makers and block-positioners for asset liquidity. Another significant development is the increase in foreign holdings of U.S. securities and rising foreign participation in U.S. markets.[10] To encourage such foreign participation by strengthening U.S. capital markets would seem desirable, especially in view of the large dollar balances currently held abroad.

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[10] *Recommendations Regarding Foreign Access to the U.S. Securities Markets*, NYSE, July 1973, pp. 20–21.

Certain existing regulations recognize the economic importance of the broker/dealer's intermediary functions. For example, block positioners, specialists and other market-makers are specifically exempted from the Federal Reserve Board's Regulation U, which regulates the extension of bank credit for the purchase of securities. Similarly, New York Stock Exchange rules which prohibit potentially manipulative trading exempt trading activities that contribute to the orderly maintenance of the market.

IMPLICATIONS OF SECURITIES INDUSTRY CYCLICALITY

As noted earlier, the preferential tax treatment of financial intermediaries stems from Congressional concern for their stability. To date, however, that concern has tended to overlook the problems of stability, risk and capital-raising ability inherent in the cyclical nature of the securities business.

Lack of industry stability

The effects of cyclical business swings on the stability of the securities industry have been well-documented. Despite continuous efforts to maintain adequate capacity levels, the industry has been characterized by continual contraction and expansion of facilities to meet frequent, and often abrupt, changes in business conditions. For example, the branch office networks operated by NYSE member firms, a vital part of the securities distribution process in connection with underwriting, expanded by 21% between the end of 1965 and the end of 1968—and then contracted by 15% during the next two years. In 1971, the branch office network again began to expand.[11]

A more dramatic example of instability was the disappearance of more than 120 NYSE member firms during the 1969–70 downturn.[12] (Of course, some new firms also joined the NYSE during this period.) An undocumented, but presumably much larger, number of non-NYSE firms also either went out of business or merged with other organizations during that period.

The question of financial stability can be placed in sharper focus by comparing the profitability of broker/dealers with the performance of other important financial intermediaries over the most recent 5-year period for which IRS data are available (Table 3).

TABLE 3.—PROPORTIONS OF FIRMS IN SECURITIES INDUSTRY AND OTHER FINANCIAL INSTITUTIONS REPORTING PRETAX NET INCOME, 1965–69

[In percent]

	Broker/dealers	Commercial banks and trust companies	Savings and loans	Mutual savings bank
1965	64	91	84	92
1966	63	90	83	81
1967	60	92	86	80
1968	78	92	88	87
1969	49	91	82	79

Source: "Statistics of Income—Corporations", Internal Revenue Service.

Relative to commercial banks and trust companies, SLAs and mutual savings banks, a consistently smaller and more variable percentage of securities firms are profitable.[13] It is significant that during the prosperous 1965–1967 period, little more than 60% of the brokerage firms were profitable. Even during the boom year of 1968, when the ratio of profitable brokerage firms rose to 78%, each of

[11] NYSE *Fact Books*.
[12] NYSE Secretary's Office.
[13] To have a consistent basis for comparing brokerage firms with other types of financial intermediaries, only corporate brokerage organizations were included. This should not introduce any bias into the figures, however, since SOI reporting brokerage firms represent the bulk of NASD members. For example, in 1969, SOI reporting broker/dealers represented 75% of that organization's membership.

the three other types of financial intermediaries continued to have a higher proportion of profitable organizations. In 1969, when the most recent cyclical downturn began, the ratio of profitable brokerage firms dropped precipitously while the three other types of intermediaries experienced mild declines. By comparison, the steady 90% or higher proportion of banks and trust companies reporting profits during the 1965–1969 period represents a pillar of industry stability.

Securities industry riskiness and capital problems

Variability of earnings is, of course, a key measure of risk, and in the securities industry, this is exacerbated by cyclical changes have a relatively minor impact on other financial intermediaries. As a result, securities industry capital is costly and scarce, forcing firms into a high leveraging of equity capital and adding further to industry riskiness.

The securities industry's position among high-risk enterprises was confirmed in a 1970 study undertaken by National Economic Research Associates, Inc. (NERA), in the course of its study of brokerage commission rates for the NYSE.[14] NERA measured risk by rate of return and the variability of returns over time. They examined all 61 Standard and Poor's industry groups and selected the top quartile in terms of average return on equity over the 1961–1968 period. A special study of the variability of returns of these 15 presumably riskiest industries indicated that only two, radio and television broadcasting, and publishing, had greater variability than the securities industry. (Variability was measured as the standard deviation in return on equity between 1961 and 1968.) The results for the 15 industries studied are presented in Table 4.

TABLE 4.—*Standard deviation of return on equity, 1961–68*

Industry	*Standard deviation*
Radio and TV broadcasting	5.9
Drugs	2.6
Autos	3.4
Soft drinks	2.5
Packaged foods	.6
Office and business equipment	.9
Confectionery	.7
Electric household appliances	1.9
Securities Commission business	4.2
Construction and materials handling equipment	3.3
Radio and TV manufacturers	3.0
Cigarette manufacturers	[illegible]
Publishing	5.9
Corn refiners	1.2
Biscuit bakers	1.6
Electrical equipment	2.5

Source: National Economic Research Associates, Inc., *Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates*, vol. II, sec. VIII-4, July 1970.

As a consequence of extreme riskiness, the securities industry has always found it both difficult and costly to attract capital. The severity of the current cyclical downturn has aggravated the problem, coinciding with a quickening pace of industry change which further stresses capital-intensive activities. The pressure for additoinal capital has prompted most firms to continue leveraging their equity far beyond the prevailing levels in other industries, thereby further increasing the riskiness of their operations.

THE NEED FOR STABILIZATION RESERVES

A very strong case for stabilization reserves can be made on the basis of tax equity alone. A second compelling argument is the need to dampen the impact of

[14] National Economic Research Associates, Inc., *Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates*, Volume 1, Section VIII, July 1970.

the industry's cyclical swings. The likelihood of increasingly direct competition between brokerage firms and other financial intermediaries, owing to the changing structure of the securities industry, reinforces the need for a stabilizing mechanism.

Tax equity and cyclicality

The relationship between the cyclical character of the securities industry and present tax policy toward the industry has not generally been recognized. The fact is, however, that cyclically induced instability is heightened by current tax treatment of the industry.

Tax preferences which favor other financial intermediaries raise their rates of return over those of brokerage firms conducting similar activities. Apart from clearly violating the principle of tax equity, this severely reduces the attractiveness of investment in brokerage firms. At the same time, the favored institutions, obtaining capital at lower cost, are able to invest in relatively less promising projects. Thus, the tax laws tend to distort the allocation of resources among financial intermediaries and reduce the over-all efficient use of capital in ways that are harmful, not only to the securities industry, but to the economy as a whole.

As indicated, the importance of the intermediary functions engaged in by brokerage firms argues for a tax policy that would dampen the effects of cyclical swings. At present, relative to other financial intermediaries, the securities industry's tax burden serves instead to magnify instability, because the earnings taxed away in prosperous years are not available to cushion losses during downturns. In effect, the industry pays a tax on its capital. Obviously, the ability to set aside reserves, to be drawn upon during deficit years, would play an important role in stabilizing the financial position of brokerage firms. Moreover, to the extent that such reserves would help attract additional outside capital to the securities industry, their beneficial impact would be multiplied.

More competitive business environment

Brokerage firms have always competed for savings dollars with other financial intermediaries. However, the growing aggressiveness of such institutions as banks and insurance companies, combined with the structural changes in the securities industry, are transforming the character of that competition. Bank automatic investment plans and variable insurance policies compete directly for the securities industry's traditional agency business. Continuing intense competition for the management of pension funds and other large portfolios and the ability of many institutions to gain membership on regional stock exchanges add new dimensions to the competitive environment.

With the declining profitability of the brokerage business, brokerage firms have increasingly been forced to diversify into leasing, real estate and other investment activities. Many of these new areas, in which capital-rich institutions are already active, require the commitment of considerable amounts of principal capital. In the securities industry's traditional areas of business, the advent of fully competitive commission rates promises further dramatic intensification of competition.

The growing intensity of competition, overlaid on the securities industry's extreme susceptibility to cyclical business swings and its changing business mix, make abundantly clear the urgent need for more equitable tax treatment. *In the absence of constructive tax policy changes, the quality and depth of the vital intermediary services offered by brokerage firms are likely to erode. More important, failure to strengthen the U.S. capital markets may portend serious over-all consequences for our national economy.*

LEVEL OF STABILIZATION RESERVES AND THEIR TAX IMPACT

A responsible effort to develop a viable program of stabilization reserves for the securities industry must begin with the measurement of a base or portfolio of eligible intermediary activities, since reserves must be related to the value of such a base. An appropriate level of reserves can then be defined with reference to the securities industry's capital funds and in terms of the character and size of its losses in recent years. After identifying an appropriate level of reserves, their tax impact can be estimated.

Reserve base

A reserve base composed of margin loans and corporate trading and underwriting positions is consistent with a conservative interpretation of broker/dealer intermediary functions.

Margin loans, by facilitating the trading activities of large numbers of individuals, add to the liquidity of capital markets. In this connection, it should be noted that banks are permitted to include in their reserve base loans to brokerage firms.

Long and short trading positions are both essential in market making and block positioning. Other types of trading, such as options and arbitrage positions should also be included in the reserve base. The inclusion of underwriting positions requires no additional discussion. A firm's own investment positions, however, should be excluded. The calculation of an appropriate reserve base for NYSE member firms is shown in Table 5.

The major components of the reserve base—margin loans and trading positions—seem less volatile than one might assume, so that fewer than 12 observations per component may be adequate for measuring the average annual value of the base.

TABLE 5.—NYSE FIRMS' 1972 RESERVE BASE

[In millions of dollars]

	Margin loans	Trading and investment positions in corporate securities		Corporate underwriting positions
		Long	Short	
	(1)	(2)	(3)	(4)
January	5,700	2,336	604	112
February	6,180	2,189	497	79
March	6,620	2,415	539	23
April	7,010	2,296	562	102
May	7,200	2,244	526	107
June	7,510	2,543	526	168
July	7,660	2,471	540	136
August	7,780	2,538	525	214
September	7,800	2,326	544	86
October	7,800	2,446	512	226
November	7,890	2,801	609	222
December	7,900	3,085	672	65
Total	87,050	29,690	6,656	1,540
Average for year	7,254	[1] 2,522	555	128
Adjusted average	7,254	[2] 2,179	[2] 470	128
Base for 1972 (sum of cols. 1, 2, 3, and 4)		10,031		

[1] Includes an average inventory of $48,000,000 for 28 specialists that filed joint regulatory report only in January, June, and December.

[2] Long and short positions are reduced, respectively, by 13.6 percent and 15.3 percent to eliminate investment portfolios. These adjustment factors represent the ratios of investment positions to the respective total positions reported in the 1972 NYSE income and expense reports. The adjustment, therefore, is designed to exclude investment positions of member firms from the rest of the base.

Source: Margin data are from a monthly survey conducted by the NYSE. The trading and underwriting positions were extracted from the monthly joint regulatory reports.

The data used in estimating a reserve base of $10,031 million for NYSE member firms in 1972 have some important properties which should be noted.[15]

The $7,254 million in average outstanding margin loans represents virtually all margin activity in the securities industry, since non-NYSE firms do very little margin business.

The Joint Regulatory Reports, initiated in 1972, contain financial data on every type of NYSE member firm. The filing requirements, however, depend on whether a firm does business with the public. Firms that carry public accounts, including most specialist firms, must submit financial reports on a monthly basis. The remaining firms are required to file only in June and December. In contrast, the Income and Expense (I&E) Reports are submitted at year-end, and only by firms that do business with the public.

[15] In the absence of more complete industry data, all calculations and estimates apply to NYSE firms only.

Level of Reserves

The objective of strengthening the securities industry's capital base, as a key step in easing instability, provides a logical starting point for calculating an appropriate level of reserves. It is also logical to consider recent losses of brokerage firms, in attempting to arrive at an appropriate reserve level.

A first step, therefore, is to relate the level of reserves to capital funds. The NYSE's Income and Expense Reports indicate that member firms had an average of $3,712 million in capital funds during 1972.[16] If, then, the much less risky banking industry's judgment, that reserves should represent about 13–14%[17] of capital funds (i.e., equity and debt), is accepted as adequate for brokerage firms, NYSE members would have needed approximately $500 million in reserves during 1972.

The nature and distribution of losses to which the securities industry is exposed suggests, however, that reserve funds of this magnitude would cushion, but not insulate, NYSE firms from their impact. That is because losses tend to be concentrated within different types of activities over time, are unevenly distributed, and are often very large. Thus, since 1968, NYSE retail firms have suffered heavily at various times as volume declined. On the other hand, when stock prices dropped but volume remained high, dealer firms took sharp losses on their trading positions. The occasionally staggering losses of bond houses testify to the cost of misjudging the direction of interest rate movements.

The magnitude of losses incurred by NYSE firms during the 1969–70 downturn is shown in Table 6.

TABLE 6

Data on 1969–70 losses of NYSE firms

	Aggregate losses of deficit firms (*Millions*)	*NYSE trust fund payments*[1]
1969	$131	$7
1970	[2] 103	30
1971	----	32
1972	----	2
Total	234	71

[1] These trust fund payouts are net of repayments to member firms.
[2] Includes an estimated $14 million loss on the part of Goodbody & Co. during the first 3 quarters of the year.

Source: NYSE Income and Expense Reports and Controller's Office.

This enormous $305 million two-year deficit actually understates the real losses.[18] First, because I&E Reports are filed at the end of a calendar year, firms that merge or are liquidated during the year do not submit reports. Thus, a substantial amount of losses in 1969 and 1970 are excluded from these figures. Second, the losses of partnerships do not include imputed salaries for partners.

Concentration of losses is illustrated by the 1969 experience of deficit firms. The firms reporting losses aggregating $131 million accounted for only 25% of the gross revenue of all NYSE firms dealing with the public.

The experience of NYSE firms during the first nine months of 1973 appears to have been even more devastating than that of 1969 or 1970.

Table 7 shows that during January–August 1973, NYSE firms lost $210 million; only in September did they go into the black. However, the break-out of month-to-month aggregate losses may be more relevant for judging the adequacy of a given level of reserves, since, as noted, losses tend to be concentrated. Thus, 30% of all NYSE firms reporting financial results in September 1973 indicated that they suffered net losses during the preceding 12-month period.

[16] Because I&E Reports contain data only on firms that do business with the public, this figure understates somewhat the capital of member firms.
[17] *The Adequacy of Bad Debt Reserves, A Preliminary Study*, pp. 25–26.
[18] NYSE Trust Fund payments are considered a part of the losses, since the alternative would have been for member firms to write off these costs directly.

TABLE 7.—PATTERN OF JANUARY-SEPTEMBER 1973 NYSE FIRM LOSSES

[In millions of dollars]

	Aggregate losses of deficit firms	Aggregate profits and losses
January	($52.0)	($3.1)
February	(58.2)	(41.3)
March	(49.5)	(18.4)
April	(54.0)	(39.7)
May	(56.7)	(39.0)
June	(55.3)	(32.3)
July	(44.2)	(7.6)
August	(47.7)	(28.1)
September	(13.7)	56.1

Source: Joint regulatory reports.

This pattern of losses implies that aggregate NYSE member firm stabilization reserves, when fully funded, should probably be considerably greater than $500 million. At the same time, it must be conceded that no basis for quantifying a higher level has been developed. Moreover, as indicated, the purpose of these reserves is not to insulate broker/dealers from losses but to reduce the instability of the industry.

It would appear reasonable, therefore, to set stabilization reserves for brokerage firms at a level of 5% of the value of a base composed of margin loans and trading and underwriting positions, as outlined earlier. This would mean an aggregate of $502 million in reserve funds, on a total base of $10,031 million for all NYSE member firms in 1972. That reserve fund figure would represent a conservative 13.5% of NYSE member firms' total capital funds of $3,712 million in 1972—well within the 13–14% range commonly viewed as appropriate by the banking industry.

Tax impact of reserves

What would be the tax impact of $502 million in reserves? The answer is complicated by the need to distinguish between the initial build-up phase and the subsequent impact. The latter will depend on the industry's overall cyclical pattern of activity, as well as on the fluctuations in specific types of activities.

The initial tax impact would depend on the profitability of brokerage firms over the build-up period and on the rate at which reserve funds are allowed to accumulate. To control the rate of accumulation, additions to reserve accounts should not exceed either 50% of pretax income or 50% of the permissible amount of reserves as of the close of the taxable year—whichever is lower.

With the additional assumption that 1972 pretax income was distributed among brokerage firms in the same way as the reserve base, it is possible to estimate the tax impact if NYSE firms had been permitted to start accumulating reserves last year. Based on the proposed limitations on additions to reserves and the $877 million earned by NYSE firms in 1972, a total of $251 million would have been placed in reserve accounts. Applying to these reserve placements the 43% aggregate Federal tax rate of corporations reporting financial results in the I&E Reports yields $108 million in tax revenue that the Treasury Department would not have collected.[19] (For purposes of this computation, it was assumed that this tax rate also applied to brokerage firms that are organized as partnerships.)

It should be noted that 1972 was a relatively prosperous year for NYSE firms. Thus, the initial annual tax impact of reserves introduced in the near-term future would not be likely to exceed or even equal the $108 million estimate. Thereafter, as reserves begin to approach maximum permissible levels, their tax effect would depend on the pattern of cyclical fluctuations prevailing within the securities industry. But since brokerage firm losses tend to be highly concentrated and/or associated with specific areas of business, the Treasury's revenue loss

[19] The 43% tax rate was computed from the aggregate tax liability of 178 member-firms that accounted for 59% of the I&E pretax income. It should be noted that the Treasury's tax loss would have been somewhat greater had non-NYSE firms been included.

from stabilization reserves in any given year should be considerably smaller than in any peak year of the initial build-up period.[20]

These modest public costs of reserves must be measured against the public benefits of stronger U.S. capital markets at a time when their need is unprecedented. Realistic incentives to set aside funds in good years, to be drawn upon in poor years, would help stabilize an industry whose financial intermediary services are vital.

THE NEW YORK STOCK EXCHANGE RESEARCH REPORT ON: A CRITICAL ANALYSIS OF ARGUMENTS RAISED IN THE HOUSE OF REPRESENTATIVES AGAINST REPEAL OF THE WITHHOLDING TAX ON FOREIGN PORTFOLIO INVESTMENT INCOME

RESEARCH DEPARTMENT—PREPARED BY: INTERNATIONAL FINANCE SECTION, MARCH 1976

Congressional forces opposing repeal of the withholding tax on interest and dividend income paid to foreign investors have put forward a number of arguments in support of their position.[1] This paper examines their assertions, on a point-by-point basis. Its main conclusions are that arguments against repeal have little merit, and that the benefits from elimination of the tax vastly exceed any costs to the U.S. economy or to the American people.

Assertion #1. Repeal of the withholding tax would discriminate against American investors, and turn the United States into a "tax haven"

It was argued that repeal of the withholding tax would discriminate against American investors because they would continue to be subject to U.S. income taxes while foreigners would pay no tax on their U.S. investments. This was further embroidered to suggest that repeal of withholding would turn the United States into a "tax haven." However, this argument ignores the long accepted principle of international taxation—that individuals should be subject to tax in their own country of residence or nationality. It must be remembered, with respect to dividends, that they are paid out of corporate earnings that have already been fully taxed here. The form and extent of the double taxation that occurs when these dividends are paid out to stockholders is appropriately determined by the income tax procedures of the country in which that stockholder is resident. But the underlying income does not escape corporate tax here. And there is no valid analogy with the "tax haven" in which income is accumulated in a sort of "collection depot" to escape tax altogether.

To be sure, tax treaties already in effect reduce or eliminate U.S. taxes for foreign residents in some countries. Tax treaties with Switzerland, for example, have reduced the levy on dividends to 15 percent and on interest payments to 5 percent, but even then investors are left with the cumbersomeness of detailed reports and submitting claims for credits, which often take years to sort out. For the United Kingdom, and some 11 other countries, treaties have completely eliminated all withholding tax on interest payments. And, of course, the United States does not tax capital gains (nor credit capital losses) accruing to foreigners on stocks or bonds. But all of this represents a patchwork of discriminatory treatment. Elimination of the withholding tax would end the discrimination among foreign investors on the basis of their domicile and the form of their investment.

Assertion #2. Repeal would result in a loss of revenue to the U.S. Treasury

This argument has little merit. Total income from withholding taxes in 1971, the most recent year for which a full set of data is currently available, amounted to just over $211 million, or about 0.1 percent of total federal tax collections in that year. However, to collect this sum, an enormous amount of paperwork had to be generated. According to the Internal Revenue Service, over 636,000 detailed documents were filed with withholding agents in 1971 in order to administer the

[20] A byproduct of reserves would be a reduction in loss carry-overs claimed during profitable years, since losses carried forward would be lowered to the extent brokers draw down reserve accounts in deficit years. Therefore, after the build-up period, the Treasury's revenue loss may be minimal.

[1] A significant debate on the elimination of the withholding tax was held on the floor of the House of Representatives on December 4, 1975. A transcript of this debate is contained in volume 121 of the Congressional Record (1975) beginning on page H11843.

tax—on average, one lengthy form and internal audit for every $330 of tax receipts.

It should be noted that the ultimate tax loss would, in fact, be considerably less than $211 million, as a portion of this total represents inter-corporate dividends paid by subsidiaries to their foreign parent companies. If the tax on this inter-corporate dividend income were retained, the maximum Treasury loss would be considerably less. Unfortunately, no precise estimates of the magnitude of inter-corporate dividend flows are available.

The paperwork involved in collecting this tax also acts as a deterrent to investment in the United States. For the foreign investor, not only must a form be filed in the United States, but notification of taxes paid must also be made to his own government's tax service so that tax payments made to the United States can be credited against domestic taxes, and that often consumes more time and leads to troublesome if not costly delays in final settlement of taxes due and release of funds tied up in overpayments.

Indeed, the overall gain to the economy from repeal of the withholding tax will be significant. As greater income and profits are generated in the U.S. economy from expanded investment in this country, income tax receipts will increase on a direct basis. If a 15 percent pretax rate of return on invested capital is assumed—the median rate of return in the manufacturing sector—then every $1 billion of additional investment capital generated from abroad could eventually produce every year about $150 million in addtional profits, resulting in approximately $75 million in additional tax revenues to the U.S. Treasury. A conservative estimate suggests that the annual gains from aggregate new foreign investment of between $2–$2.5 billion would more than offset any loss in annual tax revenues.

Many indirect benefits would also accrue as a result of the elimination of the tax. The added investment from abroad would have a beneficial impact on the U.S. balance of payments, probably exceeding for many years to come any additional outflows in dividend and interest payments to foreigners. Also of importance would be the improvement of the U.S. position as the premier international financial market, as U.S. securities would become competitive with Eurodollar and Eurobond instruments which are not, of course, subject to withholding tax. Removal of the tax would result in a significant stimulation to investment banking and brokerage firms and commercial banks in New York and, to a lesser extent, elsewhere in the United States. Because of their experience in providing issuing, clearing, market making, trustee, and other services, such firms are uniquely placed to take advantage of an increase in international activity in the U.S. financial markets. The resulting expansion in earnings and employment would also benefit the U.S. economy as well as the balance of payments.

Assertion #3. Repeal of the withholding tax would result in "windfall gains"

Those using this line of argument charge that repeal would provide foreign nationals with substantial tax savings and foreign governments with significant increases in tax revenues as they collected what was preivously withheld here. However, to the extent that any windfall gains would remain with the taxpayer they would not flow to his government, and vice versa. The critics cannot have both points—one excludes the other. To the extent that a foreign government does have an increase in its own revenues, that simply must be accepted as one by-product of getting a better system overall. And the net gain in the United States from greater capital availability here would far exceed any "loss" here through the windfall" route.

Assertion #4. Repeal is not necessary to attract OPEC capital because much of their investments are funneled through government agencies—which pay no withholding taxes

To be sure, the fact that much foreign investment is channeled through government agencies may to some extent limit the impact of repeal—especially as regards the OPEC states—but not appreciably and not for long. Foreign governments are only exempt for investments clearly "related to a governmental purpose." There is no blanket exemption and none that is automatic for a government corporation. Every foreign governmental entity claiming exemption from the withholding tax must prepare its case and apply for an exception from the Internal Revenue Service. Indeed, it was the final clearance of such applications that largely accounts for the 1975 upsurge of about $1 billion in equity investments here by certain OPEC countries.

Assertion #5. Repeal of the withholding tax would be ineffective as a means of attracting foreign investment

This assertion ignores the fact that many countries have found considerable success in attracting foreign capital through reductions in their withholding tax rates. With the exception of Germany, none of the Common Market countries has a withholding tax on interest; and among themselves, withholding on dividends is being eliminated. Japan, in legislation enacted on March 30, 1974, exempted from income taxation interest on foreign currency debt securities issued by Japanese corporations to nonresident investors. The Canadian government has called an exemption from the normal withholding tax on interest paid to nonresidents on Canadian public and private debt securities. In its Budget Report, it was indicated that "The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term debt financing and facilitate access to funds in international capital markets." Many observers believe that enactment of this legislation has played a role in the recent rise of the Canadian dollar.

The German experience with withholding taxes provides confirmation, though in reverse, of the impact that withholding taxes can have on foreign investment flows. In 1969, when the Deutsche Mark was strengthening markedly and investment funds were flowing in, the German government levied a withholding tax on foreign-owned German bonds in order to reduce foreign inflows of capital. And the withholding tax did help to discourage foreign demand for German debt securities. It appears a reasonable deduction that the absence or elimination of such taxes will encourage foreign flows here at home.

To the extent that our tax laws reduce the attractiveness of the U.S. capital markets, moreover, foreign investment will simply be attracted elsewhere. With the partial exception of Germany, every country in the Common Market now has more accommodative tax treatment for foreign investors than is offered here. It is therefore clearly to our advantage to move toward a more receptive posture as concerns the treatment of portfolio investment from overseas.

Assertion #6. Repeal would reduce the bargaining power of the United States in future double taxation treaties

This argument is too simplistic. There are one-hundred-and-one details that provide all the leverage, or self-interest, that either side needs in working toward agreed arrangements of mutual advantage. The withholding tax lever as to dividends or interest is almost a trivial part of this larger set of detailed procedures and tax implications—ranging from customs practices to taxes on extractive industries and much more. Furthermore, the United States already has effective treaties with most of the leading industrialized countries. And, on the other hand, developing countries, with which the United States generally does not have treaties, are reluctant, for internal economic and political reasons, to limit their ability to tax dividends and interest paid to investors abroad. The question of U.S. bargaining leverage does not seem particularly pertinent in the face of such policies.

Assertion #7. If repeal of the withholding tax does, in fact, attract foreign capital, this would place future burdens on the economy in terms of interest and dividend payments that would be due to foreigners

It is certainly true that for every dollar of inflow attracted in one year, we have to pay to the foreigner a continuous stream of interest or dividends over a longer period of years. However, such investment will increase the productive capacity of the economy. The resultant flow of additional income will more than compensate for any future payments to foreigners. In short, inducement of additional foreign investment is a sound national economic policy decision both for today and for the future.

The New York Stock Exchange urges the repeal of the withholding tax on foreign portfolio investment. Elimination of the tax would promote foreign investment—adding to the nation's capital resources and buttressing the country's balance of payments. Furthermore, repeal would ease the way for U.S.-based multinational corporations to raise capital abroad for use here or elsewhere—reducing their demand on domestic sources of funds. Enlarged tax receipts from the additional profits and income generated by expanded foreign investment will more than offset any initial decline in tax proceeds from withholding—especially when the burdensome costs of collection are considered.

Finally, the elimination of the tax should strengthen the U.S. capital markets and increase their importance in the international financial community.

THE NEW YORK STOCK EXCHANGE RESEARCH REPORT ON: AN UPDATE OF THE ESTIMATED IMPACT OF NYSE STABILIZATION RESERVES, BY TYPE OF MEMBER FIRM, 1972–1974

RESEARCH DEPARTMENT—PREPARED BY: SUSANNE SHOA, JUNE 1975

Introduction

The NYSE has developed and circulated a plan providing for the creation of stabilization reserve funds by its member firms. Its basic aim is to provide the securities industry with a cushion against cyclical downturns by strengthening its capital base. The plan is discussed in detail in a study entitled "Stabilization Reserves—A Route to Easting Cyclical Problems in the Securities Industry." (The plan is summarized briefly in the next section.)

This report supplements the earlier study by analyzing the impact of the stabilization reserve plan on the different types of member firms. It shows stabilization reserve levels for each of the years 1972–74, and presents a year-to-year analysis of flows and tax savings over the period. It is desirable that the benefits of the stabilization reserve plan be distributed among the different types of firms in a way that reflects their relative need for improving their capital bases.

The most salient statistics in this study are summarized in the following table.

TAX SAVING AND CONTRIBUTION TO CAPITAL 1972-74

	1972			1973			1974		
	Tax savings			Tax savings			Tax savings		
	Total (millions)	Percent of pretax income	Reserve as percent of capital	Total (millions)	Percent of pretax income	Reserve as percent of capital	Total (millions)	Percent of pretax income	Reserve as percent of capital
Retail	$53	21.4	17.9	$17	20.0	15.3	$12	18.5	12.3
Intermediate	12	17.7	11.0	5	15.2	7.0	5	11.6	6.4
Institutional	18	9.3	8.8	5	12.8	6.4	9	12.2	9.0
Regional	14	8.0	9.2	7	15.9	8.7	4	12.5	8.7
Specialists	3	5.1	5.4	1	3.3	2.6	2	7.1	5.4
Total	100	13.4	12.4	35	15.2	10.2	32	13.2	9.7

Stabilization Reserve Plan in Brief

Under legislation proposed by the NYSE in December 1973, broker-dealers would be entitled to tax treatment similar to that accorded other financial intermediaries. Specifically, the plan calls for the establishment of a stabilization reserve comprised of funds set aside from pre-tax profits, at an ultimate level of about 5 percent of the value of a base composed of margin loans, trading positions in corporate securities, and corporate underwriting positions.

The Exchange's proposal was partially prompted by the fact that brokerage firms are presently taxed at as much as twice the rate of such institutions as banks and savings and loan associations, though they perform similar intermediary functions. But more important is the urgent need to moderate the financial effects of the extreme cyclicality to which the securities industry is exposed. The advent of competitive commission rates on May 1 adds another dimension to the uncertainty under which brokerage firms operate and accentuates the need for stabilization reserves.

Classification of Firms

Based on the 1972 Income and Expense Survey, NYSE member firms were categorized as follows: retail (securities commission income per ticket, $0–65); intermediate (SCI/ticket, $66–130); institutional (SCI/ticket, $131 and over); regional (main office outside New York); and specialists. Except for specialists, firms that do not carry public accounts—representing approximately 5 percent of the value of the reserve base—are not included.[1]

[1] Such firms were excluded because they are not covered by the income and expense survey.

The 1972 analysis reflects all NYSE member firms, whether or not they were profitable. The effort to exclude unprofitable firms was not made, because doing so would have had only a negligible effect on the 1972 results. In fact, only 36 out of 392 firms reported losses on their Income and Expense reports. For 1973 and 1974, years in which member firms reported heavy losses, only profitable firms were included in the analysis.

Profits for 1973 were based on 1973 Income and Expense reports, while 1974 profits were as reported on the Joint Regulatory Reports.[2] The use of the two different sources to determine profitability does not introduce significant distortions.

Reserve Base

A first step for computing stabilization reserves is the determination of a reserve base. (Its composition for each group of firms is shown in Appendix Tables 1A, 2A and 3A.) Table 1 (below) shows the reserve bases and their distribution among the five groups of firms in 1972, 1973 and 1974. Retail firms accounted for 55 percent, 61 percent and 54 percent of the total reserve base in 1972, 1973 and 1974, respectively.

TABLE 1.—NYSE MEMBER FIRMS' RESERVE BASE

[In millions of dollars]

Firm group	1972[1] Amount (1)	1972[1] Percent of total (2)	1973[2] Amount (3)	1973[2] Percent of total (4)	1974[2] Amount (5)	1974[2] Percent of total (6)
Retail	$5,251	55	$2,529	61	$2,222	54
Intermediate	1,159	12	430	11	459	11
Institutional	1,635	17	454	11	854	21
Regional	1,260	13	632	15	434	11
Specialists	271	3	89	2	140	3
Total	9,576	100	4,134	100	4,109	100

[1] All NYSE member firms.
[2] Profitable firms only.

Source: Appendix tables 1A, 2A, and 3A.

The reserve bases in 1973 and 1974 are considerably smaller than in 1972, due to the shrinkage in securities industry profitability. Had unprofitable firms been included, the total industry reserve bases for 1973 and 1974 would have been roughly $8.6 billion and $6.6 billion, respectively; still lower than the $9.6 billion in 1972. Relatively low margin loan activity in 1973 and in 1974 primarily accounts for the decline.

Reserve Levels and Flows

Tables 2, 3 and 4 show the maximum level of reserves for each year and for each group of firms, computed by applying the proposed 5 percent figure to the respective reserve bases.

In 1972, the maximum permissible level of reserves would have been $480 million, while for 1973 and 1974 the maximum reserve levels for profitable firms would have been $207 million and $206 million, respectively.

However, the plan provides for a gradual build-up of reserve accounts by limiting annual additions to the lesser of 50 percent of pre-tax income or 50 percent of the permissible amount of reserves. Under this limitation, the initial reserve build-up in 1972 would have been no more than $233 million. Additions by profitable firms in 1973 and 1974 would have amounted to $84 and $81 million, respectively. Thus, total reserves at the end of 1974 would have been $398 million. This figure, however, does not take into account withdrawals from reserves by firms which suffered losses in 1973 and 1974.

Because the data obtained for this study are aggregates, it is impossible to estimate with any precision the reserve withdrawals that would have taken place. For example, total losses in 1973 by unprofitable firms amounted to $200 million.

[2] Net profit or loss is calculated after voting stockholders' salaries for corporations, and after partners' imputed compensations (using the income and expense reports formula), for partnerships. Noncarrying specialists' pretax income was not adjusted for partners' compensation, as no estimate was available.

But this does not mean that the entire $200 million would have been withdrawn from the estimated $233 in reserves built up in 1972, since some firms that lost money in 1973 had no, or relatively small, reserves to draw on. In addition, not all losses would have been eligible for offsets from reserves. Clearly, a good estimate of reserve depletions requires a detailed firm-by-firm analysis, which is beyond the scope of this paper.

TABLE 2.—SIZE OF RESERVE AND TAX IMPACT 1972

Firm group	Reserve base (1)	Maximum reserve level[1] (2)	Profit before taxes (3)	Initial reserve buildup[2] (4)	Tax impact[3] (5)
Retail	$5,251	$263	$248	−$124	$53
Intermediate	1,159	58	68	29	12
Institutional	1,635	82	194	41	18
Regional	1,260	63	176	32	14
Specialists	271	14	59	7	3
Total	9,576	480	745	233	100

TABLE 3.—SIZE OF RESERVE OF PROFITABLE FIRMS AND TAX IMPACT 1973

Firm group	Reserve base (1)	Maximum reserve level[1] (2)	Profit before taxes (3)	Reserve additions[2] (4)	Tax impact[3] (5)
Retail	$2,529	$126	$85	$43	$17
Intermediate	430	22	33	11	5
Institutional	454	23	39	12	5
Regional	632	32	44	16	7
Specialists	89	4	30	2	1
Total	4,134	207	231	84	35

TABLE 4.—1974

	Reserve base	Maximum reserve level[1]	Profit before taxes	Reserve additions[2]	Tax impact[3]
Retail	$2,222	$111	$65	$32	$12
Intermediate	459	23	43	12	5
Institutional	854	43	74	22	9
Regional	434	22	32	11	4
Specialists	139	7	28	4	2
Total	4,108	206	242	81	32

[1] 5 percent of reserve base.
[2] ½ of the maximum permissible reserve for profitable firms or ½ of profits, whichever is lower.
[3] 1972: 43 percent of col. (4). Tax rate computed from aggregate tax liability of incorporated member firms that accounted for 59 percent of pretax income. 1973: 41 percent of col. (4). Tax rate computed from the aggregate tax liability of incorporated member firms that accounted for 91 percent of total pretax income. 1974: 39 percent of col. (4). Tax rate computed from the aggregate tax liability of incorporated member firms.

Source: Col. (1): table 1. Col. (3): NYSE, "Income & Expense Reports," 1972 and 1973. NYSE, "Joint Regulatory Reports," 1974.

Because this analysis cannot provide accurate estimates of withdrawals, it is not possible to determine when the maximum permissible reserve level would have been reached. For example, Table 3 shows that, for 1973, the maximum reserve level for profitable firms would have been $207 million. Whether the $84 million reserve additions would have brought total reserves to, or even above, the maximum level depends on the amount of actual withdrawals that would have taken place.

Tax impact

The tax savings that would have resulted from the implementation of the stabilization reserve plan are shown in Table 5. In 1972, NYSE member firms would

have saved at most $100 million in taxes. The savings in 1973 and 1974 would have been at most $35 million and $32 million, respectively. It is quite likely, however, that the loss to the U.S. Treasury would have been less than these estimates of maximum tax impact.

TABLE 5.—MAXIMUM TAX IMPACT OF RESERVE BUILD-UP BY NYSE FIRMS

[In millions of dollars]

Firm group	1972 [1]	1973 [2]	1974 [2]
Retail	53	17	12
Intermediate	12	5	5
Institutional	18	5	9
Regional	14	7	4
Specialists	3	1	2
Total	100	35	32

[1] All NYSE firms.
[2] Profitable firms only.

Source: Tables 2, 3, and 4.

In terms of its relationship to profits (Table 6), the industry's 1972 tax savings would have ranged from 21.4 percent for retail firms to 5.1 percent for specialists. The savings for 1973 and 1974 would have ranged from 20.0 percent to 3.3 percent and from 18.5 percent to 7.1 percent, respectively.

TABLE 6.—MAXIMUM TAX IMPACT AS A PERCENT OF PROFIT

In millions]

Firm group	1972 [1]	1973 [2]	1974 [2]
Retail	21.4	20.0	18.5
Intermediate	17.7	15.2	11.6
Institutional	9.3	12.8	12.2
Regional	8.0	15.9	12.5
Specialists	5.1	3.3	7.1
Total	13.4	15.2	13.2

[1] All NYSE firms.
[2] Profitable firms only.

Source: Computed from tables 2, 3, and 4.

Contribution to Capital

Since the basic aim of the proposed stabilization reserve plan is to provide the securities industry with a financial cushion against cyclical downturns, reserves are, in effect, an extension of capital. If the plan's reserve target of 5 percent of the suggested base were reached, reserves would have amounted to $480 million in 1972, $207 million in 1973 and $206 million in 1974. In each of those years, the ratio of the maximum reserve to capital funds would have been 12.4 percent, 10.2 percent and 9.7 percent, respectively. (See Table 8 for a breakdown by type of firm.)

TABLE 8.—MAXIMUM RESERVE LEVEL AS A PERCENT OF CAPITAL FUNDS

Firm group	1972 [1]	1973 [2]	1974 [2]
Retail	17.9	15.3	12.3
Intermediate	11.0	7.0	6.4
Institutional	8.8	6.4	9.0
Regional	9.2	8.7	8.7
Specialists	5.4	2.6	5.4
Total	12.4	10.2	9.7

[1] All NYSE firms.
[2] Profitable firms only.

Source: Computed from appendix table 4A.

These data underscore the potential importance of the proposed reserve plans. The maximum reserve pool would be large enough to forestall ill-advised cuts in industry capacity, especially among retail firms. The latter have traditionally been especially vulnerable during cyclical downturns.

Conclusion

The need for stabilization reserves in the securities industry to cushion the effects of especially sharp and unpredictable cyclical swings is emphasized by actual industry events during the period analyzed. Had the proposed stabilization reserve plan been initiated in 1972, reserve funds would have offset only a small part of the staggering 1973–74 losses. Nevertheless, the data suggest that over the full industry cycle a gradual build-up of reserves would provide a meaningful cushion against undue damage to industry capacity during downturns.

In a period when capital funds are in shortage, maintaining the effectiveness of the role of brokerage firms in the capital raising process should be an important economic objective.

APPENDIX

Composition of the Reserve Base

TABLE 1A.—NYSE MEMBER FIRMS' RESERVE BASE (YEARLY AVERAGES) 1972

[In millions of dollars]

Firm group	Margin loans	Trading position in corporate securities [1] Long	Trading position in corporate securities [1] Short	Corporate underwriting positions	Total reserve base
	(1)	(2)	(3)	(4)	(5)
Retail	4,663	443	109	36	5,251
Intermediate	791	287	58	23	1,159
Institutional	402	933	245	55	1,635
Regional	1,018	185	34	23	1,260
Specialists	74	161	35	1	271
Total	6,948	2,009	481	138	9,576

[1] Long and short positions adjusted to eliminate investment positions.

Source: Col. (1)—NYSE, "Report of Customer Debit and Credit Balances," form R-1, monthly, 1972. Col. (2)-(4)—NYSE, "Joint Regulatory Reports," monthly, 1972.

TABLE 2A.—NYSE PROFITABLE MEMBER FIRMS' RESERVE BASE (YEARLY AVERAGES) 1973

[In millions of dollars]

Firm group	Margin loans	Trading position in corporate securities [1] Long	Trading position in corporate securities [1] Short	Corporate underwriting positions	Total reserve base
	(1)	(2)	(3)	(4)	(5)
Retail	2,324	150	42	13	2,592
Intermediate	268	118	37	7	430
Institutional	157	208	73	16	454
Regional	547	66	12	7	632
Specialists	8	59	22	0	89
Total	3,304	601	186	43	4,134

[1] Long and short positions adjusted to eliminate investment positions.

Source: Col. (1)—NYSE, "Report of Customer Debit and Credit Balances," form R-1, monthly, 1972. Cols. (2)-(4)—NYSE, "Joint Regulatory Reports," monthly, 1973.

TABLE 3A.—NYSE PROFITABLE MEMBER FIRMS' RESERVE BASE (YEARLY AVERAGES) 1974

[In millions of dollars]

Firm group	Margin loans	Trading position in corporate securities[1]		Corporate underwriting positions	Total reserve base
		Long	Short		
	(1)	(2)	(3)	(4)	(5)
Retail	1,996	169	37	20	2,222
Intermediate	274	136	37	12	459
Institutional	92	595	130	37	854
Regional	384	37	7	6	434
Specialists	9	108	22	0	140
Total	2,755	1,045	233	75	4,109

[1] Long and short positions adjusted to eliminate investment positions.

Source: Col. (1)—NYSE, "Report of Customer Debit and Credit Balances," form R-1, monthly, 1974. Col. (2)-(4)—NYSE, "Joint Regulatory Reports," monthly, 1974.

TABLE 4A.—NYSE MAXIMUM RESERVE LEVEL AS A PERCENT OF CAPITAL FUNDS, 1972-74

[Dollar amounts in millions]

Firm group	1972[1]			1973[2]			1974[2]		
	Capital funds	Reserve level	Reserve as percent of capital funds	Capital funds	Reserve level	Reserve as percent of capital funds	Capital funds	Reserve level	Reserve as percent of capital funds
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Retail	$1,467	$263	17.9	$822	$126	15.3	$901	$111	12.3
Intermediate	529	58	11.0	316	22	7.0	360	23	6.4
Institutional	930	82	8.8	362	23	6.4	478	43	9.0
Regional	682	63	9.2	366	32	8.7	252	22	8.7
Specialists	260	14	5.4	157	4	2.6	130	7	5.4
Total	3,868	480	12.4	2,023	207	10.2	2,121	206	9.7

[1] All NYSE firms.
[2] Profitable firms only.

Source: Cols. (1) and (4): NYSE, "Income & Expense Reports," 1972 and 1973. Cols. (2), (5) and (8): tables 2, 3, and 4. Col. (7): NYSE, "Joint Regulatory Reports," 1974.

THE NEW YORK STOCK EXCHANGE RESEARCH REPORT ON: A CRITICAL ANALYSIS OF ARGUMENTS RAISED IN THE HOUSE OF REPRESENTATIVES AGAINST REPEAL OF THE WITHHOLDING TAX ON FOREIGN PORTFOLIO INVESTMENT INCOME

RESEARCH DEPARTMENT—PREPARED BY: INTERNATIONAL FINANCE SECTION, MARCH 1976

Congressional forces opposing repeal of the withholding tax on interest and dividend income paid to foreign investors have put forward a number of arguments in support of their position.[1] This paper examines their assertions, on a point-by-point basis. Its main conclusions are that arguments against repeal have little merit, and that the benefits from elimination of the tax vastly exceed any costs to the U.S. economy or to the American people.

Assertion #1. Repeal of the withholding tax would discriminate against American investors, and turn the United States into a "tax haven"

It was argued that repeal of the withholding tax would discriminate against American investors because they would continue to be subject to U.S. income taxes while foreigners would pay no tax on their U.S. investments. This was further embroidered to suggest that repeal of withholding would turn the United

[1] A significant debate on the elimination of the withholding tax was held on the floor of the House of Representatives on December 4, 1975. A transcript of this debate is contained in volume 121 of the Congressional Record (1975) beginning on page H11848.

States into a "tax haven." However, this argument ignores the long accepted principle of international taxation—that individuals should be subject to tax in their own country of residence or nationality. It must be remembered, with respect to dividends, that they are paid out of corporate earnings that have already been fully taxed here. The form and extent of the double taxation that occurs when these dividends are paid out to stockholders is appropriately determined by the income tax procedures of the country in which that stockholder is resident. But the underlying income does not escape corporate tax here. And there is no valid analogy with the "tax haven" in which income is accumulated in a sort of "collection depot" to escape tax altogether.

To be sure, tax treaties already in effect reduce or eliminate U.S. taxes for foreign residents in some countries. Tax treaties with Switzerland, for example, have reduced the levy on dividends to 15 percent and on interest payments to 5 percent, but even then investors are left with the cumbersomeness of detailed reports and submitting claims for credits, which often take years to sort out. For the United Kingdom, and some 11 other countries, treaties have completely eliminated all withholding tax on interest payments. And, of course, the United States does not tax capital gains (nor credit capital losses) accruing to foreigners on stocks or bonds. But all of this represents a patchwork of discriminatory treatment. Elimination of the withholding tax would end the discrimination among foreign investors on the basis of their domicile and the form of their investment.

Assertion #2. Repeal would result in a loss of revenue to the U.S. Treasury

This argument has little merit. Total income from withholding taxes in 1971, the most recent year for which a full set of data is currently available, amounted to just over $211 million, or about 0.1% of total federal tax collections in that year. However, to collect this sum, an enormous amount of paperwork had to be generated. According to the Internal Revenue Service, over 636,000 detailed documents were filed with withholding agents in 1971 in order to administer the tax—on average, one lengthy form and internal audit for every $330 of tax receipts.

It should be noted that the ultimate tax loss would, in fact, be considerably less than $211 million, as a portion of this total represents inter-corporate dividends paid by subsidiaries to their foreign parent companies. If the tax on this inter-corporate dividend income were retained, the maximum Treasury loss would be considerably less. Unfortunately, no precise estimates of the magnitude of inter-corporate dividend flows are available.

The paperwork involved in collecting this tax also acts as a deterrent to investment in the United States. For the foreign investor, not only must a form be filed in the United States, but notification of taxes paid must also be made to his own government's tax service so that tax payments made to the United States can be credited against domestic taxes, and that often consumes more time and leads to troublesome if not costly delays in final settlement of taxes due and release of funds tied up in overpayments.

Indeed, the overall gain to the economy from repeal of the withholding tax will be significant. As greater income and profits are generated in the U.S. economy from expanded investment in this country, income tax receipts will increase on a direct basis. If a 15 percent pretax rate of return on invested capital is assumed—the median rate of return in the manufacturing sector—then every $1 billion of additional investment capital generated from abroad could eventually produce every year about $150 million in additional profits, resulting in approximately $75 million in additional tax revenues to the U.S. Treasury. A conservative estimate suggests that the annual gains from aggregate new foreign investment of between $2–$2.5 billion would more than offset any loss in annual tax revenues.

Many indirect benefits would also accrue as a result of the elimination of the tax. The added investment from abroad would have a beneficial impact on the U.S. balance of payments, probably exceeding for many years to come any additional outflows in dividend and interest payments to foreigners. Also of importance would be the improvement of the United States' position as the premier international financial market, as U.S. securities would become competitive with Eurodollar and Eurobond instruments which are not, of course, subject to withholding tax. Removal of the tax would result in a significant stimulation to investment banking and brokerage firms and commercial banks in New York and, to a lesser extent, elsewhere in the United States. Because of their experience in

providing issuing, clearing, market making, trustee, and other services, such firms are uniquely placed to take advantage of an increase in international activity in the U.S. financial markets. The resulting expansion in earnings and employment would also benefit the U.S. economy as well as the balance of payments.

Assertion #3. Repeal of the withholding tax would result in "windfall gains"

Those using this line of argument charge that repeal would provide foreign nationals with substantial tax savings and foreign governments with significant increases in tax revenues as they collected what was previously withheld here. However, to the extent that any windfall gains would remain with the taxpayer, they would not flow to his government, and vice versa. The critics cannot have both points—one excludes the other. To the extent that a foreign government does have an increase in its own revenues, that simply must be accepted as one by-product of getting a better system overall. And the net gain in the United States from greater capital availability here would far exceed any "loss" here through the "windfall" route.

Assertion #4. Repeal is not necessary to attract OPEC capital because much of their investments are funneled through government agencies—which pay no withholding taxes

To be sure, the fact that much foreign investment is channeled through government agencies may to some extent limit the impact of repeal—especially as regards the OPEC states—but not appreciably and not for long. Foreign governments are only exempt for investments clearly "related to a governmental purpose." There is no blanket exemption and none that is automatic for a government corporation. Every foreign governmental entity claiming exemption from the withholding tax must prepare its case and apply for an exception from the Internal Revenue Service. Indeed, it was the final clearance of such applications that largely accounts for the 1975 upsurge of about $1 billion in equity investments here by certain OPEC countries.

Assertion #5. Repeal of the withholding tax would result in "windfall gains" attracting foreign investment

This assertion ignores the fact that many countries have found considerable success in attracting foreign capital through reductions in their withholding tax rates. With the exception of Germany, none of the Common Market countries has a withholding tax on interest; and among themselves, withholding on dividends is being eliminated. Japan, in legislation enacted on March 30, 1974, exempted from income taxation interest on foreign currency debt securities issued by Japanese corporations to nonresident investors. The Canadian government has called for an exemption from the normal withholding tax on interest paid to nonresidents on Canadian public and private debt securities. In its Budget Report, it was indicated that "The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term debt financing and facilitate access to funds in international capital markets." Many observers believe that enactment of this legislation has played a role in the recent rise of the Canadian dollar.

The German experience with withholding taxes provides confirmation, though in reverse, of the impact that withholding taxes can have on foreign investment flows. In 1969, when the Deutsche Mark was strengthening markedly and investment funds were flowing in, the German government levied a withholding tax on foreign-owned German bonds in order to reduce foreign inflows of capital. And the withholding tax did help to discourage foreign demand for German debt securities. It appears a reasonable deduction that the absence or elimination of such taxes will ecourage foreign flows here at home.

To the extent that our tax laws reduce the attractiveness of the U.S. capital markets, moreover, foreign investment will simply be attracted elsewhere. With the partial exception of Germany, every country in the Common Market now has more accommodative tax treatment for foreign investors than is offered here. It is therefore clearly to our advantage to move toward a more receptive posture as concerns the treatment of portfolio investment from overseas.

Assertion #6. Repeal would reduce the bargaining power of the U.S. in future double taxation treaties

This argument is too simplistic. There are one-hundred-and-one details that provide all the leverage, or self-interest, that either side needs in working toward

agreed arrangements of mutual advantage. The withholding tax lever as to dividends or interest is almost a trivial part of this larger set of detailed procedures and tax implications—ranging from customs practices to taxes on extractive industries and much more. Furthermore, the United States already has effective treaties with most of the leading industrialized countries. And, on the other hand, developing countries, with which the United States generally does not have treaties, are reluctant. for internal economic and political reasons, to limit their ability to tax dividends and interest paid to investors abroad. The question of U.S. bargaining leverage does not seem particularly pertinent in the face of such policies.

Assertion #7. If repeal of the withholding tax does, in fact, attract foreign capital, this would place future burdens on the economy in terms of interest and dividend payments that would be due to foreigners

It is certainly true for every dollar of inflow attracted in one year, we have to pay to the foreigner a continuous stream of interest or dividends over a longer period of years. However, such investment will increase the productive capacity of the economy. The resultant flow of additional income will more than compensate for any future payments to foreigners. In short, inducement of additional foreign investment is a sound national economic policy decision both for today and for the future.

The New York Stock Exchange urges the repeal of the wtihholding tax on foreign portfolio investment. Elimination of the tax would promote foreign investment—adding to the nation's capital resources and buttressing the country's balance of payments. Furthermore, repeal would ease the way for U.S.-based multinational corporations to raise capital abroad for use here or elsewhere—reducing their demand on domestic sources of funds. Enlarged tax receipts from the additional profits and income generated by expanded foreign investment will more than offset any initial decline in tax proceeds from withholding—especially when the burdensome costs of collection are considered. Finally, the elimination of the tax should strengthen the U.S. capital markets and increase their importance in the international financial community.

Senator MONDALE. Our next witness is Mr. Virgil Sherrill, chairman of the governing council, Securities Industry Association, accompanied by Edward I. O'Brien, president, and James W. Walker, Jr., executive vice president.

STATEMENT OF H. VIRGIL SHERRILL, CHAIRMAN, GOVERNING COUNCIL, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY EDWARD I. O'BRIEN, PRESIDENT, AND JAMES W. WALKER, JR., EXECUTIVE VICE PRESIDENT

Senator MONDALE. As with our previous witnesses, we would hope that opening statements could be limited to 10 minutes.

You may proceed.

Mr. SHERRILL. Mr. Chairman, I am Virgil Sherrill, chairman of the governing council of the Securities Industry Association, a national trade association representing approximately 650 organizations responsible for over 90 percent of the securities brokerage and investment banking business of the Nation.

Accompanying me are Edward I. O'Brien, president of the SIA, and James W., Walker, Jr., executive vice president.

The Securities Industry Association acknowledges and supports the national public policy objectives reflected in several major legislative efforts in recent years.

Those goals include full employment, a clean environment, and energy independence. However, the establishment of these goals without regard for the means to achieve them will not be enough.

The SIA believes that the attainment of public policy objectives will require substantially increased capital investment in the years ahead.

Ironically, our Nation's current economic and tax policies retard investment at a time when an influx of capital is urgently needed.

We were very pleased that Chairman Long and Senator Bentsen, chairman of the Subcommittee on Financial Markets, expressed similar concern when they participated in the National Conference on Capital and Employment, cosponsored by the SIA last year.

In our written statement, we have examined the level of investment necessary for the attainment of national goals and the factors which currently retard investment.

Tax policy can be an important tool to stimulate the investment necessary to achieve national economic and social objectives.

Today, we would like to discuss four improvements in the tax code which would: (1) Improve tax treatment of investment gains; (2) attract the small investor; (3) improve tax treatment of investment income; and (4) eliminate disincentives to investment contained in H.R. 10612.

The capital gains tax, as presently written, is essentially a transfer tax on the sale of capital assets. As such, it locks capital into holdings that investors cannot afford to change for tax reasons even though, on the basis of investment reasons, a change is warranted.

Current capital gains taxes also ignore the impact of inflation and deprive the Government of tax revenues that would be realized if the system encouraged flexibility, diversification, and liquidity.

Moreover, by failing to stimulate the formation of equity capital, the tax code denies businesses the vital requisite for providing rising levels of employment and productivity necessary for a strong, viable U.S. economy.

In order to encourage individual investment, we propose the following changes in the tax treatment of investment income:

1. Adoption of a sliding scale formula that would add to the existing 50-percent deduction an additional 2 percent of the gain for each year a capital asset is held, up to a maximum deduction of 90 percent on capital assets held more than 21 years; and

2. Creation of a 3-year carryback of capital losses against capital gains and a $5,000 capital loss offset against current income.

The sliding scale proposal would free locked-in capital and provide equitable tax relief for investors whose profits on long-held assets are often largely inflationary and encourage investors to make investment decisions based upon economic rather than strictly tax considerations.

Permitting an individual investor to carry back capital losses against capital gains for a 3-year period will, to an extent, parallel the present tax treatment for corporations.

If national capital requirements over the next decade are to be met, particular emphasis must be given to attract the small investor, that is, the investor of modest means.

SIA has previously recommended that a taxpayer be permitted to exclude $1,000 of capital gains per year and a $25,000 lifetime exclusion.

We are very pleased that the chairman and others on the committee as well as the administration have recognized the need to expand equity ownership and have advanced proposals to address that need.

We recommend that the design of any such proposal include the following considerations. The plan should be: (1) Specifically tailored to the needs of small investors; (2) easily understood, nontrusteed, and simple to administer; (3) free from restrictions on the selection among equity securities; and (4) flexible to allow for a shift from one security to another as long as the investment remains committed for a reasonable period of time.

SIA would also like to point out that we are particularly concerned about the departure from the capital markets of the young investor. We are hopeful that any plan to broaden stock ownership be designed to appeal to the young investor.

A simple and effective means toward redressing the adverse impact of double taxation would be to increase the dividend exclusion from gross income of individuals from $100 to $500.

Although this approach would not eliminate the double tax, it would enhance capital formation by improving the risk/reward ratio of equity investment compared with other investments.

A more equitable and comprehensive alternative to eliminating double taxation of corporate income would be through permitting individual shareholders to gross-up dividends received in order to deduct as a credit against their personal income tax a pro rata share of income taxes paid by the issuing corporation.

Under the gross-up procedure, a distributing corporation would notify each shareholder of his pro rata share of the corporate taxes incurred in respect to dividends paid.

The taxpayer would merely be required to reflect these respective amounts as additions to income and as reductions on his income tax liability.

While advantageous to all shareholders of corporations who pay tax and make dividend distributions, this alternative may have particular appeal because it provides proportionately greater benefits to taxpayers in lower income tax brackets.

A seemingly unobtrusive withholding tax on dividends and interest of U.S. securities held by foreign investors is having a negative impact on our capital markets which could not have been foreseen by the drafters of the original legislation.

Once the tax is deducted, the dividend or interest yield on U.S. securities becomes too low to be attractive to foreign investors as compared with investment alternatives in their own country or in the Eurodollar market.

The withholding tax effectively bars from our capital markets an estimated $4 billion to $6 billion which would increase the liquidity of our markets, and aid in providing needed capital to fuel the growth of the American economy.

We support elimination of the current 30-percent withholding tax on portfolio investments in the United States of foreign investors because this tax serves to retard long-term foreign investment.

Now, disincentives to investment contained in H.R. 10612: The legislation passed by the House not only fails to address the factors which currently retard investment, but includes provisions which will further discourage investment and impair the achievement of public policy objectives.

We recommend that this committee eliminate the following proposals in the House bill which constitute disincentives to investment:

1. Redefinition of the distinction between investment and speculation through an extension of the holding period for short-term capital assets from 6 to 12 months;
2. Changes in the minimum income tax which substantially alter the return on equity investment; and
3. Reduction in the limitation on the deduction for nonbusiness interest.

As to the capital gains holding period, H.R. 10612 increases the holding period for short-term capital gains from 6 months to 1 year.

The holding period makes a distinction between the tax treatment for gains on investment assets and the tax treatment on assets held for speculative profit.

We believe that increasing the holding period for short-term capital gains from 6 months to 1 year is inappropriate as it relates to the purchase and sale of securities.

Given the high risks associated with the cyclical and often volatile nature of the stock markets, the holding of a security for 6 months should qualify as an investment transaction.

Extension of the holding period will also be counterproductive. Long holding periods result in shutting off the flow of investment funds.

A 1-year holding period, under present economic conditions, would seriously impair the vitality and liquidity of capital markets. Moreover, rather than increase Federal revenues, we believe a longer holding period will discourage the number of taxpayers who realize capital gains, thereby reducing tax receipts.

The minimum income tax was enacted to assure the payment of at least some tax by wealthy individuals and to prevent excessive sheltering of income.

Taxpayers who realize long-term capital gains do not circumvent regular income taxes. The realization of long-term capital gains on securities neither shelters other income, nor escapes taxation.

In many cases, application of the minimum tax on securities capital gains from the sale of securities causes triple taxation.

The taxpayer-investor pays a minimum tax and a capital gains tax on the appreciation in value. That apprecition is substantially the result of the retained earnings on which the company has been taxed.

It is clear that the imposition of the minimum tax on capital gains is an additional tax, rather than a minimum tax.

As to the limitation on deduction of investment interest, investors who trade on margin are a significant source of equity investment. They not only risk their own capital, but are willing to increase their risk by transforming the debt instruments of others into equity investment.

The House bill would severely affect such investors, including those with moderate investments and incomes. We, therefore, believe the reduction in the limitation in investment interest should not be passed for the following reasons:

1. The combination of the limitation on investment and personal interest of $12,000 is likely to reduce the current limit on investment interest from $25,000 to far below $12,000 and in many instances will serve to completely eliminate any allowance.

2. The reduction in the interest limitation will be particularly burdensome when interest rates are high and equity and other investments depressed.

The proposed legislation is likely to result in forced liquidation of those investments, in turn further depressing such investments and resulting in the taxpayer realizing losses.

The realization of losses under those circumstances in turn can result in reduced revenues to the Treasury at a time when revenue intake is already low.

Mr. Chairman, in the interest of brevity, we have highlighted today only part of the SIA's tax proposals.

Our full statement contains other proposals, including those relating to alternative methods of stimulating individual investment, the investment tax credit, accelerated depreciation and the tax treatment of securities commissions.

We note that the House Ways and Means Committee reported H.R. 12774 last week, creating an option under which State and local governments issuing their bonds on a taxable basis would receive a Federal interest subsidy.

The SIA's Public Finance Division has done extensive research on the taxable bond option. If this committee considers this issue, the association will submit the results of that research.

In conclusion, enactment of changes in the tax code in line with SIA recommendations will greatly strengthen the likelihood that we as a Nation can achieve the desired goals of full employment, environmental restoration and preservation, and greater energy independence.

These goals simply cannot be realized without substantially increasing the amount of private capital available for investment. Thank you, Mr. Chairman.

Senator MONDALE. Mr. Sherrill, disregarding for a moment the argument that tax reductions in this field will stimulate the economy and thus feed back revenues indirectly, what would be the initial cost of your proposals to the Treasury?

Mr. SHERRILL. I don't believe I have available the total amount of the immediate tax loss to the Treasury as to the cumulative effect of all of our proposals. Do you know that, Jim?

Mr. WALKER. No; but we would be glad to submit it.

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

SECURITIES INDUSTRY ASSOCIATION,
Washington, D.C., April 21, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: During the colloquy following testimony by Securities Industry Association (SIA) witnesses before your Committee on April 5th, Senator Mondale asked for an estimate of the "cost" of SIA proposals. As you know, one method used for making "tax expenditure estimates" involves the application of proposed changes to the tax code retroactively. Estimates made in this manner are based on the inaccurate assumption that future years will approximate past years in national income and that individual financial decisions will be unaffected by changes in the tax code. To the contrary, we believe that one basis of tax policy is the conviction that individual financial decisions will change as a result of changes in the tax code.

As examples of such beliefs, we would point to provisions in the tax code which have been effective in carrying out national policy objectives favoring home ownership and encouraging contributions to charitable organizations. Similarly, tax

policy is important in encouraging individuals to save and to make investments which provide the necessary capital for meeting national economic and social objectives including full employment, a clean environment, and energy independence.

Our research department made several attempts to estimate the "cost" of our proposals using econometric models and projections. Our research efforts concluded that none of the available models afford a reliable estimate of revenue impact because objective predictions of human behavior is an important factor and it is difficult if not impossible to produce reliable and precise results with the data available and in the models. Thus, while we feel we must dispute estimates of revenue impact based on the assumption of static taxpayer behavior, we do not have specific alternative data for your consideration. However, we are convinced that the tax changes proposed by SIA will encourage savings and investment. This additional capital will provide a financial base for the creation of jobs which in turn will generate additional tax revenues from both corporate and individual taxpayers. Such revenues should more than offset the projected "costs" associated with the enactment of SIA tax proposals.

Sincerely yours,

JAMES W. WALKER, Jr.,
Executive Vice President.

Senator MONDALE. Senator Ribicoff?

Senator RIBICOFF. No, thank you.

Senator MONDALE. Senator Hansen?

Senator HANSEN. You place great emphasis on encouraging individual investment. Would you elaborate on the reasons for your position?

Mr. SHERRILL. Yes; I would be happy to do that, Senator.

First of all, I have always felt, and certainly this association believes. the individual is really the cornerstone of the investments that go into our equity markets and provides the capital this country needs. The reason we have emphasized this point is that we share Chairman Long's view in that the only thing wrong with capitalism is that there are not enough capitalists. Moreover, which I know you heard from Mr. Needham, due in part to the adverse effects of inflation and recession, the number of shareholders in American enterprise has been greatly reduced by something over 5 million people in the last few years.

We believe that if we are going to raise the capital everyone projects we will need in the next 5 years, ways must be developed to reactivate the savings dollars of individuals for investment. In addition, SIA believes and I personally firmly believe that individual investment improves the mobility of capital, and it slows down the concentration of capital in institutional hands which, as you well know, has prevented the ownership of our corporations being extended to the individual. We as an association have long been mindful of the financial systems in foreign countries, such as Germany, where ownership of large corporations in those countries today rests in the hands of large financial institutions as opposed to resting directly in the hands of individual owners.

Senator HANSEN. The administration testified in favor of the provision in the House bill which would extend the holding period for capital gains to 12 months over a 3-year period.

On what grounds do you reach a different conclusion?

Mr. SHERRILL. Well, we reach that conclusion, the different conclusion on several grounds. I suppose primarily our argument rests on the fact that we believe by extending the period of 6 months to 12 months would prove to be a very drastic disincentive for an individual investor to take the risk of buying an equity security. I can tell you

from my personal experience in the securities industry, which goes back something over 30 years now, that time and time again I have clients and investors to whom I am responsible call me up, and say to me, "Shall I sell this stock? I have a big gain in it."

My first question to them is: How long have you held the stock? They say, "I have held the stock 5 months." I will say, "Don't under any means sell it now because the tax impact will be too great. It's a foolish move."

I think that any time anyone makes the assumption that an investor is just as apt to hold a security for 12 months as he is for 6 months is kidding himself. He is not.

Senator HANSEN. My last question: The House estimated that extending the holding period from 6 months to 1 year for a long-term capital gain would increase tax liability $150 million in 1976; $240 million in 1977; $420 million in 1981.

Would you care to respond to these revenue estimates?

Mr. SHERRILL. Yes; I will respond to them. I cannot respond in a definitive manner but I can say that as a matter of principle, whatever method was used to arrive at these calculations in my opinion are questionable. First, I believe that the assumption must have been made that any individual who would sell his stock long term after 6 months would sell it on that same date even if he were to incur a short-term tax. In other words, an investor who sells after holding a security 7, 8, 9 months would sell it anyway. As I stated before, having had personal experience for about 30 years in this business I can tell you that is a very fallacious reasoning to base any tax assumptions on.

Second, I think the House revenue estimate definitely fails to take into account that the extension of the holding period would serve as a disincentive to investment. I believe that individuals rather than going to the stock market, if that period were extended from 6 to 12 months, would be much more inclined to invest their money through other channels.

Senator HANSEN. Mr. Chairman, I know I have used my time, if I could be permitted just to make one further observation.

Senator MONDALE. Yes, certainly.

Senator HANSEN. Let me say this: I appreciate your response because it seems to me that sometimes taking a simplistic calculation that follows from saying that certain tax treatment brings in so much revenue and to change it would increase or decrease it, may not really provide the answer. I think about some of the changes in the tax laws that affected the oil industry and I mentioned here a couple of days ago that when the depreciation allowance was changed and when some other changes in the accounting procedures were put in that law and took place, we didn't keep the level of activity up where it was before. They started stacking rigs. I know this in my State of Wyoming and we didn't have more money flowing into the Treasury, we had less because a lot of people lost interest in the business at all.

Thank you for your responses.

Mr. SHERRILL. If the holding period instead of lengthened to 12 would be shortened to 3, you would see a greater acceleration of activity and probably the greater tax flow into the Government would be the result.

Senator HANSEN. Thank you, Mr. Chairman.

Senator MONDALE. Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator MONDALE. Thank you very much.

Mr. SHERRILL. Thank you, Mr. Chairman.

[The prepared statement of the Securities Industry Association follows:]

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman, my name is H. Virgil Sherrill, and I am Chairman of the Governing Council of the Securities Industry Association. Accompanying me are Edward I. O'Brien, President of the SIA, and James W. Walker, Jr., Executive Vice President. Our Association is a cross section of the many different facets of the securities business and encompasses members of national securities exchanges and firm which are not member of such exchanges. The business of our members includes retail and institutional brokerage, over-the-counter market making, underwritng and other investment banking activities and various exchange floor functions. Many of our members perform these services in municipal and government, as well as corporate securities. Geographically, the firms which comprise our membership are located all across the nation and provide services to investors of every size and type.

The Securities Industry Association acknowledges and supports the establishment of national public policy objectives indicated by several major legislative efforts in recent years. Those goals include full employment, a clean environment, and energy independence. However, the establishment of these goals without regard for the means to achieve them will not be enough. The need for capital to attain those goals will require increased investment outlays over the next five years. Our nation's current economic and tax policies, however, retard, rather than stimulate, investment. In our statement today, we will examine the level of investment necessary for the attainment of national goals, the factors which retard investment, and discuss the steps this Committee and Congress can take to stimulate the private financing necessary to meet those objectives.

Meeting our national goals through capital investment

In order to meet its long-term economic and social goals, the United States must devote more of its output to investment in plant and equipment. We recognize that it is extremely difficult to forecast the actual capital needs of the U.S. economy. It is possible, however, given specific economic and social goals as well as specific assumptions about the composition of output and capital output ratios. to estimate the levels of investment needed to achieve them. A recent study commissioned by the Council of Economic Advisers (CEA) and carried out by the Bureau of Economic Analysis (BEA) of the Department of Commerce uses this approach. The study estimates that to achieve full employment by 1980, a goal which we strongly support, to satisfy the Clean Air Amendments of 1970 and the Federal Pollution Act Amendments of 1972, as well as to keep the 1980 share of imported crude and refined petroleum products from exceeding its 1973–74 level, we must increase the proportion of output devoted to business fixed investment to 12.4 percent annually over the next five years. (See Table 1)

A number of private economic organizations have also projected substantial capital needs during the next 5–10 years. Failure to take positive action now could lead to a severe capital shortage thereby thwarting public policy goals.

There are at least three reasons why we must increase our investment outlays over the next five years.

1. *Full employment.*—The Bureau of Economic Analysis study estimates that to achieve full employment by 1980 (an unemployment rate of 4.7 percent) output must total $7,068.2 billion in 1972 dollars over the period 1976–80. Such output will require a growth rate of real GNP of 6 percent between 1976 and 1980.

The linkage between the capital stock and the level of output is summarized in the concept of the capital/output ratio. Achievement of a full employment level of real GNP by 1980 will require more capital because it takes more capital to produce more output. However, the capital output ratio does not remain constant. And according to the BEA study, the capital output ratio for the U.S. economy will on average be increasing over the next five years. Consequently, the capital stock necessary to achieve full employment will be even higher than

it would have been if capital output ratios were to remain stable or even decline. To achieve the capital stock that full employment requires means that the proportion of output devoted to investment must be increased substantially.

TABLE 1.—FIXED BUSINESS INVESTMENT AS A PERCENT OF GNP

[Billions of 1972 dollars]

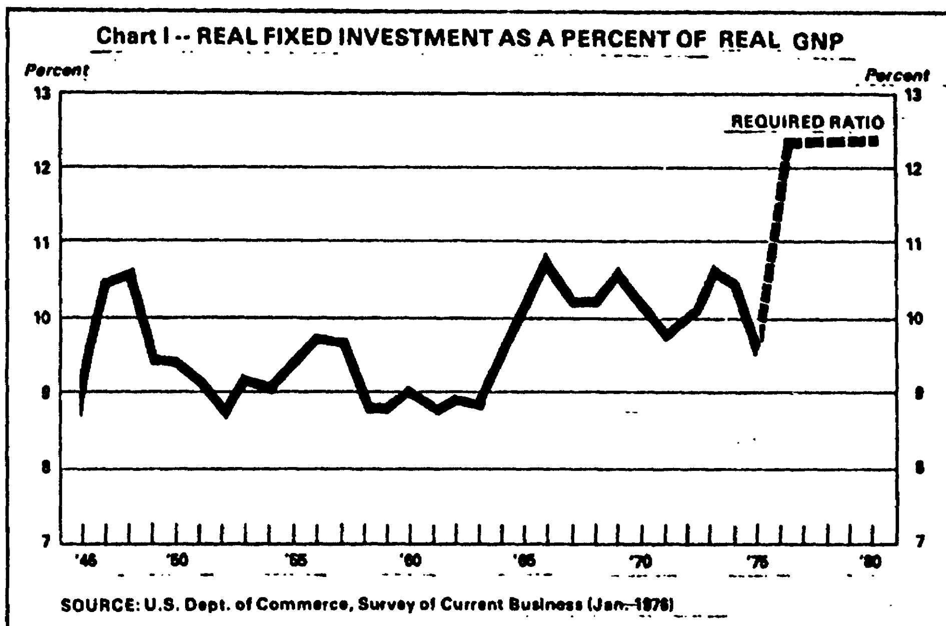
	1965–70	1971–75	1976–80 (projected)
Cumulative GNP	5,999.3	5,909.1	7,068.2
Cumulative fixed business investment	623.4	596.0	[1] 874.2
Cumulative fixed business investment as percent of GNP	10.4	10.1	[1] 12.4

[1] Required amount of investment to meet full employment, energy, and pollution control objectives.

Source: Council of Economic Advisers, "Economic Report of the President."

2. *Environmental Improvements.*—Investment in pollution control equipment as a consequence of legislation relating to clean air and clean water will significantly add to our investment needs over the next five years. According to the BEA study, environmental related investment is estimated to total $48 billion (1972 dollars) between 1971 and 1980. It is estimated that about one-half of this requirement still needs to be satisfied.

3. *Great Energy Independence.*—To meet the goal of greater energy independence, increased investment in petroleum, mining, electric utilities, and other energy-related industries is required. It is estimated such expenditures will add about $58 billion to the 1971–80 investment total. Another $2 billion is required for the induced increase in pollution control expenditures by energy-producing or processing industries.



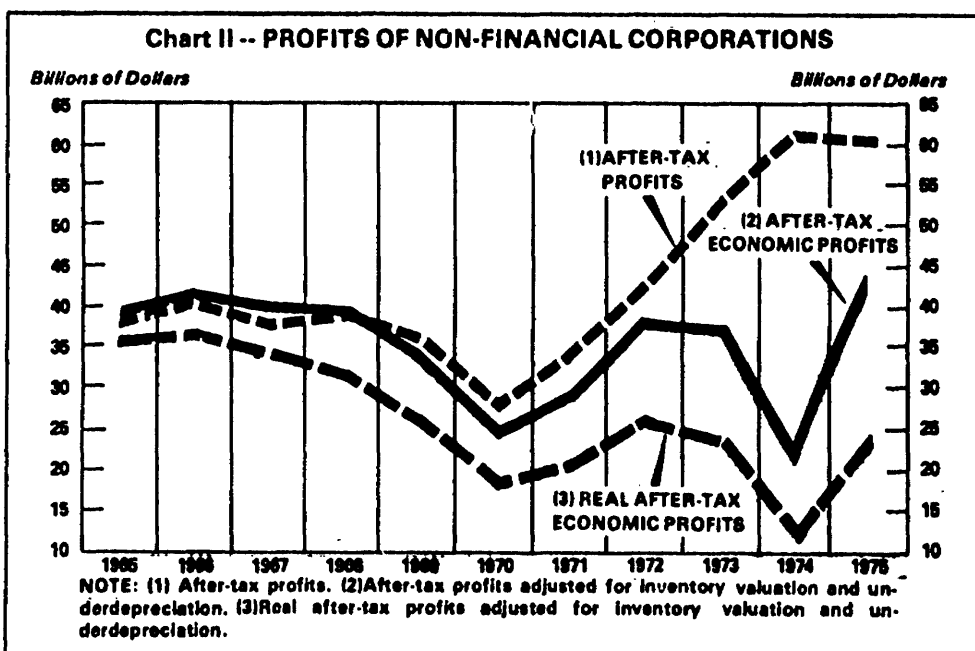
The level of investment required to meet the above goals will not be easy to achieve. Chart I illustrates the ratio of real fixed investment to real GNP for the years 1946–1975 as well as our estimates of the needs between 1976–80. The chart clearly shows that our projected requirements of 12.4 percent over the 1976–80 period are higher than in any previous year. Furthermore, a recently released Government study of capital spending plans indicates that in 1976 businessmen expect to increase their plant and equipment outlays for manufacturing

facilities by 6.5 percent, a rate of investment that will leave little room for expansion of the capital stock in real terms. If we are to achieve our goals—full employment, pollution abatement and greater energy independence—we must, therefore, substantially step up our rate of investment. There are, however, a number of factors that are currently retarding investment growth.

Factors retarding investment

The amount of funds committed to new investment projects by businessmen depends on both the profitability of investment and the cost of capital. In the United States five factors have restricted the rate of investment by either reducing profitability or increasing the cost of capital.

1. *Inflation and Corporate Profits.*—Inflation has raised havoc with profits. For example, non-financial corporations reported before-tax corporate profits of $97.6 billion in 1975, compared with $64.2 billion in 1965, an apparent increase of 52 percent. However, after the effects of inflation (inventory profits and under-depreciation) and taxes are removed, "real" after-tax profits actually fell by 33⅓ percent, from $35.1 billion in 1965 to $23.4 billion in 1975. In short, since 1965 "real" profits have fallen by $11.7 billion (See Chart 2). Because investment in new plant and equipment is a function of the expected return on investment, this sharp drop in profitability has caused U.S. companies to hold back on new investment.



NOTE: (1) After-tax profits. (2) After-tax profits adjusted for inventory valuation and underdepreciation. (3) Real after-tax profits adjusted for inventory valuation and underdepreciation.

Inflation creates two major problems in the arithmetic of profit reporting. One problem stems from the huge gains that companies make on the products and materials that they already have on hand when inflation accelerates. These gains are reported in the profit figures and are taxed. But these funds must go to replace the stock of inventories in an ongoing business and cannot be used in any other way. Thus, they are not available to pay dividends to stockholders, buy new plant and equipment or underwrite the research needed to develop new products.

Depreciation raises an even more obvious problem. As part of the cost of doing business, companies charge off the cost of replacing their equipment so that when it wears out they have funds available to replace it. When prices rise, so does the cost of replacing equipment; and it is a universally accepted fact that inflation renders the deprication charges inadequate to replace the equipment. As a consequence, profits are overstated and, equally detrimental, these overstated profits are taxed. Therefore, with both inventory profits and inadequate depreciation expenses, corporations are paying a tax on what is in essence a cost of doing business rather than true income.

The net effect of inflation is, therefore, to increase the effective tax rate for U.S. corporations. This, in turn, reduces real after-tax profitability which discourages investment.

2. *Reduced Private Savings Rates.*—There are at least three factors that are holding down the individual savings rate.

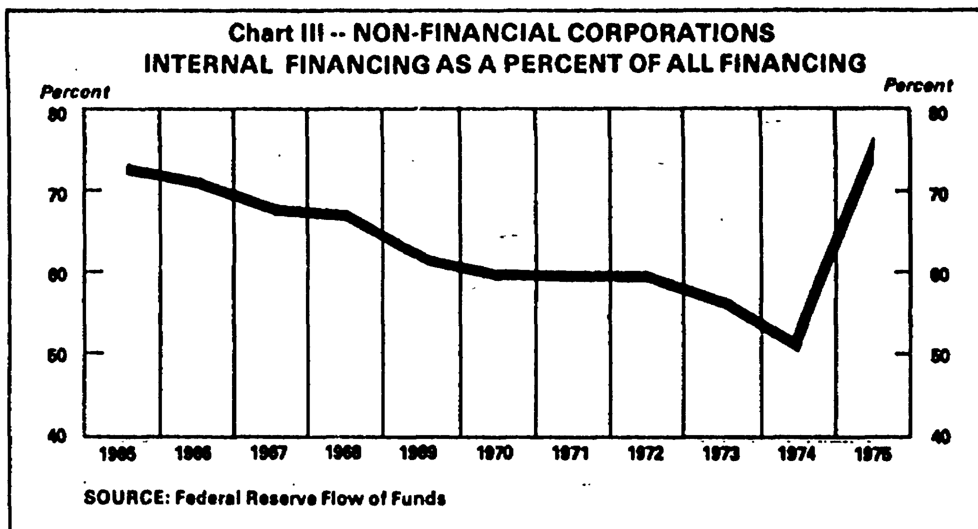
(a) Recent studies have shown that the tax burden on individuals rises faster than the inflation rate. Inflation pushes individuals into higher tax brackets, leaving less funds in the hands of individuals for spending and investment.

(b) The rapid growth of social security benefits, unemployment compensation, and medical insurance has substantially reduced the need for private savings by individuals. Government benefit programs, as opposed to private savings programs, reduce the flow of funds to finance private business investment since in essence the Government programs are simple tax transfer systems with the Government acting as middleman.

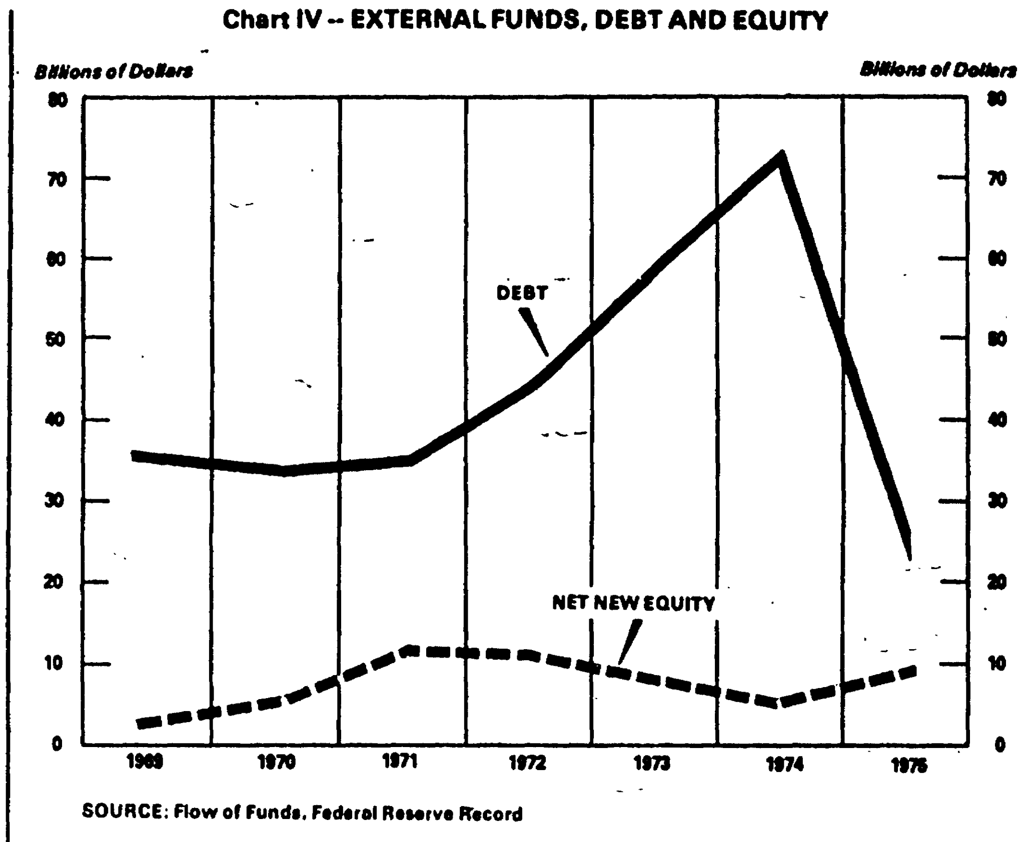
(c) Inflation encourages consumption and discourages private savings. To the extent that inflation reduces "real" interest rates, it lowers the "real" price of current consumption in terms of future consumption. Consequently, individuals will buy now rather than save.

The net effect of these three factors is to reduce the supply of available funds from individuals and, consequently, to increase the cost of capital to coporations.

The business savings rate has also been held down in recent years. Because of the disastrous impact of inflation on corporate profits, businessmen have been unable to rely on a steadily growing source of internal financing. (See Chart 3) As the Chart illustrates, internal financing as a portion of total financings declined sharply between 1965 and 1974. Economic research has shown that there is a strong correlation between cash flow or internal financing and the level of business investment. A big and sustained turn-around in a corporation's ability to finance itself is a necessary ingredient in a generating strong and steady business investment in new plant and equipment.



3. *High Debt-to-Equity Ratios.*—Because of the tax deductibility of interest payments, the after tax cost of debt capital has been substantially lower than equity capital for most corporations. Consequently, when external financing is needed, corporations go further into debt. (See Chart 4) A substantial portion of this debt does not even appear on the balance sheet, taking the form of off-balance sheet leasing financing. Over the past 17 years there has been a steady and significant erosion of the debt-to-equity ratios of U.S. manufacturing corporations. The leveraging of corporate balance sheets has increased the voltility of corporate profits, adding to the cost of both equity and debt capital.



4. *Public Policy Emphasis on Generating Demand by Stimulating Consumption.*—Through the use of tax cuts, more public service jobs, and increased unemployment compensation, the Government has attempted to pull the economy out of a recession. This approach, however, relies almost entirely on stimulating consumption spending to spur the growth in output and employment. Furthermore, the stimulative policies often continue too long. In 1973, for example, when the economy was already approaching its capacity limits, government transfer payments continued to increase rapidly. The next results of this approach is that the economy goes through a series of consumption booms but never reaches the investment boom stage. Consequently, each economic expansion adds little in the way of productive capacity to the economy.

Summary

In general there have been may factors retarding investment in new plant and equipment and few if any encouraging capital outlays. If we are to meet our economic and social objectives over the next five years, a change in public policy must be made. Tax policy can be an important tool in accomplishing this objective. The use of tax policy should recognize the important role that the individual plays in supplying funds to corporations, so that they can in turn invest in new plant and equipment.

The balance of our testimony is devoted to a detailed review of recommendations for encouraging investment which will help our nation achieve public policy objectives.

RECOMMENDATIONS FOR ENCOURAGING INVESTMENT WHICH WILL HELP THE NATION ACHIEVE PUBLIC POLICY OBJECTIVES AND DEAL WITH FACTORS RETARDING INVESTMENT

New legislation is urgently needed to encourage savings and investment—particularly individual investment—to meet the nation's public policy goals. Such

legislation can and should deal effectively with a number of specific factors which presently retard investment.

Legislative action, particularly in the area of tax policy, can change the direction of the U.S. economy. Congress can act to stimulate the private financing for the enormous investment that is necessary for adequate housing, new energy sources, communication and transportation facilities and pollution abatement and control. The following recommendations are respectfully submitted to improve the tax treatment of investment gains, attract the small investor into equity investment, improve the tax treatment on investment income, eliminate impediments to investments, and preserve existing capital. In short, the following recommendations should move more economic decision making into the hands of individual citizens.

Improved Tax Treatment of Investment Gains

The capital gains tax as presently written is essentially a transfer tax on the sale of capital assets. As such, it locks capital into holdings that investors cannot afford to change for tax reasons even though, on the basis of investment reasons, a change is warranted. Current capital gains taxes also ignore that impact of inflation and deprive the government of tax revenues that would be realized if the system encouraged flexibility, diversification, and liquidity. Moreover, by failing to stimulate the formation of equity capital, the tax code denies businesses the vital requisite for providing rising levels of employment and productivity necessary for a strong, viable U.S. economy.

In order to encourage individual investment, we propose the following changes in the tax treatment of investment income:

1. adoption of a sliding scale formula that would add to the existing 50% deduction an additional 2% of the gain for each year a capital asset is held, up to a maximum deduction of 90% on capital assets held more than 21 years;

2. creation of a three-year carryback of capital losses against capital gains and a $5,000 capital loss offset against current income; and

3. providing for the deferral of capital gains tax on sale proceeds reinvested in another capital asset or assets within a thirty-day period.

The sliding scale proposal would free locked-in capital and provide equitable tax relief for investors whose profits on long-held assets are often largely inflationary and encourage investors to make investment decisions based upon economic rather than strictly tax considerations. It would be of special help to the elderly, who, faced with a reduction of their capital should they transfer their assets, are heavily penalized when it becomes necessary or advisable to switch from higher risk, growth-type to lower risk, income-producing investments.

Rather than reduce Treasury revenues, these proposals should have the overall effect of generating additional revenue by substantially increasing the rate of realization of capital gains on appreciated capital assets.

Permitting an individual investor to carryback capital losses against capital gains for a three-year period will to an extent parallel the present tax treatment of corporate investors. Because it frequently results in an immediate refund of a prior year's taxes, in contrast with a carryforward which merely offers the prospect of a lesser tax in the future, a carryback recoups funds on a timely basis relative to the period when the loss occurred. It thus provides both availability of capital for reinvestment and relief for the taxpayer.

It was for this reason that the tax law was amended to permit corporations a three-year carryback of capital losses. There would seem to be no reason why individuals should not be accorded similar treatment.

The proposal to increase the offset for any remaining capital losses against ordinary income from $1,000 to $5,000 in the year of loss should be weighed in light of the "vintage" of the present $1,000 limitation. It was established in 1942 and, over more than three decades, inflation has long since rendered it obsolete. A $5,000 annual limitation recognizes the subsequent impact of inflation, thereby granting relief to investors who enjoy no capital gains against which to apply their losses.

A tax deferred rollover, presently embodied in the tax law with respect to exchanges of property (excluding inventory and stocks and bonds) held for productive use in a trade or business or for investment, should also apply to stocks

and securities. It is proposed that capital gains tax be deferred upon the reinvestment of such proceeds within a thirty-day period into another capital asset. This procedure would encourage investment by providing benefits similar to those now provided for a taxpayer who sells his residence, as well as for an individual who receives a lump-sum distribution from a pension plan and reinvests such funds in an Individual Retirement Account.

The deferred rollover concept recognizes the need to conserve and maintain capital. Without such a provision, present taxation of gain on the sale of a capital asset requires the use of a portion of the sales proceeds to pay the tax, resulting in a reduction of net capital for reinvestment. The mere conversion of one capital asset into another should not automatically reduce capital. It would also encourage investment change and diversification and produce a flow of investment to new enterprise. In so doing this proposal would provide to individuals a benefit currently available to businesses who "trade-in" or exchange certain business assets for other similar business assets.

For elderly investors, the deferred rollover would facilitate a reassembly of assets to best suit changed circumstances such as retirement when investors should be helped to shift from high risk to high income assets without incurring tax liability.

In the event Congress decides not to act favorably on these proposals, we strongly urge at a minimum that the current 25% alternative capital gains tax on the first $50,000 of net long term gains be retained.

Attracting the Small Investor

If national capital requirements over the next decade are to be met, particular emphasis must be given to attract the "small investor", that is, the individual investor of modest means. We favor this special emphasis for the following reasons:

1. Individual investing on a nationwide scale provides broad public support for the system of free enterprise in this country. More, not fewer, Americans should have a direct ownership stake in the success of that economic system. This goal is fully consistent with the economic as well as the democratic political traditions of this nation.

2. Individual investing on a wide scale provides a sound means, perhaps the best means, for improving the mobility of capital. Incentives at the corporate level help existing businesses regardless of their needs whereas providing incentives directly to individuals permits their investment dollars to flow wherever the needs and opportunities are most attractive. It is noteworthy that major industrialized countries enjoy greater growth than the United States all provide more favorable capital gains tax treatment than does this country.

3. Individual ownership, if encouraged, will slow the steady, inexorable trend toward "institutional ownership". If ownership of our corporations continues to concentrate in a relatively small handful of giant institutions, our system will become more like that of Japan or Germany and will have lost one of its unique attributes. Economic concentration of this type will have a further negative impact on the ability of credit-worthy but smaller companies to meet their capital needs. A tax system which imposes a greater burden on individual investors than on institutions exacerbates this problem.

The SIA has previously endorsed two alternative proposals aimed at attracting the investor of modest means. They would

1. permit a taxpayer to exclude $1,000 of caiptal gains per year and a $25,000 lifetime exclusion; and

2. provide a form of tax credit for individuals who invest in equity securities similar to the tax credit provided corporations for investment in equipment and machinery.

We are also very pleased that both the Chairman and the Administration have recognized the need to expand equity ownership and have advanced proposals (Employee Stock Ownership Plan, Broadened Stock Ownership Plan) to address that need.

We recommend that the design of any such proposal include the following considerations. The plan should be:

1. specifically tailored to the needs of small investors;
2. easily understood, non-trusted, and simple to administer;

3. free from restrictions in the selection among equity securities;
4. flexible to allow for a shift from one security to another as long as the investment remains committed for a reasonable period of time.

SIA would also like to point out that we are particularly concerned about the departure from the capital markets of the young investor. A recent survey conducted by the New York Stock Exchange revealed that during 1970 and 1975 the median age of stock holders increased by five years, from 48 to 53. This finding reflects the virtual absence from the capital market of the young investor, and we are particularly hopeful that any plan to broaden stock ownership be designed to appeal to the young investor.

The $1,000 annual capital gain exclusion addresses the need for additional incentives to motivate investors to participate in capital formation on an ongoing and recurring basis. On the other hand, the $25,000 lifetime exemption benefits all owners of capital assets, not only holders of equity investments. In particular,-the lifetime exemption assists individuals such as farmers and small businessmen who experience relatively few capital transactions.

A tax credit to encourage individual investment should rapidly infuse U.S. corporations with new equity capital, improve debt to equity ratios and extend investment rewards to individuals who are unable to invest directly in equities. A qualified equity security investment tax credit would provide an investment tax credit equal to a percentage of the purchase price of a qualifying equity security, up to a maximum credit per taxpayer. Mechanically, the proposal parallels the current business tax credit for investment in qualifying machinery and equipment. More importantly, enactment of such a credit would significantly aid business in raising the capital necssary to finance the plant and equipment modernization toward which the business tax credit is directed.

The credit would permit qualified retirement plans and regulated investment companies to pass investment credits through their employee participants or shareholders. The tax credit also contemplates a ceiling on the amount of credit resulting from the purchase of the securities of any single issuer. Thus, those who invest only through intermediaries, including a major portion of the U.S. work force, would also benefit, while the institutions who service such individuals would be encouraged to further diversify their portfolio investments.

Congress can encourage investment through improved tax treatment of investment income—for all investors.

Elimination of the Double Tax on Dividends

A simple and effective means toward redressing the adverse impact of double taxation would be to increase the dividend exclusion from gross income of individuals from $100 to $500. Although this approach would not eliminate the double tax, it would enhance capital formation by improving the risk/reward ratio of equity investment compared with other investments. Easily implemented and administered, it would also provide recognition of the fact that in our current economic situation, the $100 dividend exclusion, in effect since 1964, no longer adequately serves the purpose for which it was intended. In fact, the current $100 dividend exclusion is no more than token recognition of the inequity of imposing a double tax burden on corporate profits.

A more equitable and comprehensive alternative to eliminating double taxation of corporate income would be through permitting individual shareholders to "gross-up" dividends received in order to deduct as a credit against their personal income tax a pro rata share of income taxes paid by the issuing corporation. Under the "gross-up" procedure, a distributing corporation would notify each shareholder, perhaps on Form 1099 as with regular dividends, of his pro rata share of corporate taxes incurred in respect to dividends paid. The taxpayer would merely be required to reflect these respective amounts as additions to income and as reductions on his income tax liability.

While advantageous to all shareholders of corporations who pay tax and make dividend distributions, this alternative may have particular appeal because it provides proportionately greater benefits to taxpayers in lower income tax brackets. Furthermore, the "gross-up" procedure could be implemented to accommodate shareholders of regulated investment companies, permitting these numerous small investors to participate more favorably in capital and job formation. The attached chart, prepared by the Department of the Treasury, illustrates how the "gross-up" proposal would work.

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

	Case I—Taxpayer in 20 percent marginal tax bracket			Case II—Taxpayer in 50 percent marginal tax bracket		
		Proposed law—			Proposed law—	
	Present Law	With $50 dividend	With maximum dividend	Present Law	With $50 dividend	With maximum dividend
	(1)	(2)	(3)	(4)	(5)	(6)
A. Dividend income received	$50	$50	$66.67	$50	$50	$66.67
B. Gross-up of dividend (50 percent of line A)		25	33.33		25	33.33
C. Dividend income plus gross-up (line A plus line B)		75	100		75	100
D. Tentative tax (tax rate times line C)	10	15	20	25	37.50	50
E. Dividend tax credit (equals line B)		25	33.33		25	33.33
F. Tax liability or refund (−) (line D minus line E)	10	−10	−13.33	25	12.50	16.67
G. Total income after tax (line A minus line F)	40	60	80	25	37.50	50

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

As an alternative, consideration could be given to making dividend distributions deductible for corporate tax purposes. Correcting double taxation from the corporate side recognizes that equity capital, like debt capital, represents a cost of doing business to the corporation and affirms that all costs of capital merit equal tax treatment.

Congress can encourage investment through improved treatment of investment income—to attract foreign investment.

A seemingly unobtrusive withholding tax on dividends and interest of U.S. securities held by foreign investors is having a negative impact on our capital markets which could not have been foreseen by the drafters of the original legislation. In effect, by imposing the tax, we are discouraging foreign investors from buying income securities in the United States. Once the tax is deducted, the dividend or interest yield on U.S. securities becomes too low to be attractive to foreign investors as compared with investment alternatives in their own country or in the Eurodollar market.

The effect, then, of the withholding tax is to bar from our capital markets a large supply of funds that would otherwise help increase the liquidity of our bond and stock markets, and aid in providing needed capital to fuel the growth of the American economy. An estimated return flow of $4 to $6 billion dollars to our capital markets would develop if the withholding tax were eliminated. With a relatively modest reduction in tax revenues, the U.S. might avail itself of new capital for U.S. industry amounting to as much as $6 billion, an undisputable boost to our capital markets and to the financing of American industry.

We support elimination of the current 30 percent withholding tax on portfolio investments in the United States of foreign investors because this tax serves to retard long term foreign investment.

Foreign investors currently favor short-term securities and bank deposits which are exempt from the withholding tax. Eliminating the withholding tax could make longer term investments more attractive and improve our balance-of-payments.

Current withholding taxes on foreign investments are administered in an uneven fashion due to tax treaties between the United States and various other nations. Because of such treaties, the withholding tax applies to foreign investors of some nationalities while others can avoid withholding.

H.R. 10612, as ordered reported by the House Ways and Means Committee, would have repealed the 30 percent withholding tax on dividends and interest received from portfolio investments in the U.S. by foreign persons. An amendment removed this provision from the bill. We urge this Committee to reinstate a provision to eliminate the foreign withholding tax.

Elimination of Disincentives to Investment Contained in H.R. 10612

Earlier in this statement we discussed the capital requirements necessary to meet national goals and achieve public policy objectives and examine factors

which currently retard investment. The legislation passed by the House, H.R. 10612, not only fails to address those factors but includes provisions which will exacerbate the situation by further discouraging investment. We recommend that this committee eliminate the following proposals in the House bill which constitute disincentives to investment:

1. Redefinition of the distinction between investment and speculation through an extension of the holding period for short term capital assets from 6 to 12 months;
2. Changes in the minimum income tax which substantially alters the return on equity investment; and
3. Reduction in the limitation on the deduction for non-business interest.

Capital Gains Holding Period

The Tax Reform Bill of 1975 (H.R. 10612) provides for increasing the holding period for short-term capital gains from six months to one year. During the phase-in period, the holding period will be eight months in 1976, ten months in 1977, and one year in 1978 and future years.

The House Committee has concluded that the present six month holding period is inappropriately short. In its view that special capital gains treatment should be provided for long-term gains in recognition of the fact that a gain realized from the sale of an asset is attributable to appreciation in value of that asset over a specific period of time. Presumed speculative gains generated during a shorter period of time should, in the case of individuals, be taxed at regular rates. In other words, there should be special tax treatment for gains on assets held for investment but not on those held for speculative profit. The House Committee believed that the above reasons for distinguishing between long-term and short-term capital gains suggest that the holding period should be one full year.

SIA disagrees. We believe that increasing the required holding period for investment classification from six months to one year is unwise, particularly as it related to the purchase and sale of securities. Given the high risks associated with the cyclical and often volatile nature of the stock markets, holding a security for six months should qualify as an investment transaction.

Since speculative trading usually involves large volume and rapid turnover of securities based on small price fluctuations, six months is more than sufficient to tax speculative transactions at ordinary tax rates.

In general, long holding periods result in shutting off the flow of investment funds. A one year holding period may effectively freeze capital of risk-takers even after a venture has become sufficiently seasoned to attract the average investor. In this manner, the amount of capital available for new ventures is reduced since the initial risk-taker is locked in for one year.

A one year holding period, under present economic conditions, would seriously impair the vitality and liquidity of the capital market. Current uncertainty in the stability of the market makes it imperative that investors be allowed more flexibility in the handling of their securities.

In fact, a three month holding period might encourage the small investor to enter the market place by enhancing the attractiveness of capital investments. Also, a shorter holding period would strengthen the flexibility, liquidity and willingness of investors to diversity.

At the very least, however, the Senate should reverse the House decision to change the definition of the investment holding period to 12 months.

Proposal to Change the Minimum Income Tax for Individuals

The minimum income tax was enacted in the Tax Reform Act of 1969 to make sure that at least some minimum tax was paid on tax preference items, including capital gains even though, unlike sheltered income, a tax was already applicable. The minimum tax was designed to apply to high-income persons who, it was concluded, were not paying their fair share of income taxes. Because it is believed that the existing minimum income tax did not adequately accomplish this goal, the House bill contains a substantial revision of the minimum tax for individuals which, unfortunately, will further raise the effective tax rate on capital gains. We feel that to increase the rate of minimum tax on capital gains is counterproductive.

The minimum income tax is intended to assure the payment of at least some minimum tax, particularly by wealthy individuals, by not allowing individuals to escape at least some tax on certain portions of the economic income. The minimum tax enacted pursuant to the Tax Reform Act of 1969 was directed toward taxpayers with adjusted gross incomes over $200,000 who paid an average tax on

economic income of 22% basically by sheltering some portions of the income from inclusion in taxable income. Taxpayers who realize long-term capital gains do not circumvent the regular income taxes the system requires them to pay. A taxpayer with substantial long-term capital gains pays income taxes thereon at a basic rate of 25%. In many instances capital gains are in fact already subject to a burdensome double tax. The taxpayer-investor also pays tax on this already taxed income as the result of the capital gains tax on the appreciation—appreciation which is substantially the result of the accumulation of the retained after tax earnings of the company. It is clear that the imposition of the minimum tax on capital gains is an additional tax rather than a minimum tax.

It is, of course, obvious that the realization of long-term capital gains on securities neither shelters other income nor escapes taxation. Moreover, the imposition of the minimum tax on long-term capital gain could adversely affect taxpayers who usually have modest incomes. For example, the withdrawal from an employer retirement plan by an individual may result in a significant long-term capital gain. So may the sale by an individual of his residence, where he chooses not to reinvest the proceeds in another residence. Similarly, a large long-term capital gain may result where a small business, or the stock of a closely-held corporation or a farm is sold. The minimum income tax was not intended to penalize persons in the above circumstances, but it will.

The House bill not only increased the flat rate of the minimum tax but also, due to reductions in the exemption and offset for regular taxes paid, further altered the character of the levy from a minimum to an additive tax. We do not agree with this philosophy. For all of these reasons, we believe this provision should be deleted from the bill.

Interest deduction

We believe both the implementation of a limitation on the deductibility for personal interest and the lowering of the limitation on investment interest to be unwise. We are concerned about the philosophy underlying this section of the Bill, as set forth in the House Ways and Means Committee Report which states as follows:

"Generally, under present law, items of personal expense are not deductible. Thus, where indebtedness is incurred to enable an individual to purchase a home, a car, or appliances, some would argue that the interest on that indebtedness is also personal in nature, and should not be deductible.

"The committee believes, however, that certain economic goals, such as home ownership should be within the reach of as many people as possible and thus the deduction for personal interest should be continued.

"On the other hand, the committee also believes that interest on borrowing should not be deductible where the loan proceeds are spent *for items of a luxury nature. In other words, where the loan is used for personal purposes to provide the taxpayer with a standard of living which is clearly out of the ordinary, a deduction should not be available for interest paid on the loan.*" (emphasis added)

In the 200 years since our Nation was founded, we have become the most successful and the most prosperous nation in history. A Nation for whom the standard of living of the vast majority of its citizens is "clearly out of the ordinary" in comparison to that enjoyed by the people of most every other nation in the world. This achievement has predominately resulted from the earnest efforts of people to continue to improve their own individual standard of living—to seek a standard which in terms of their then standard was, by definition, "clearly out of the ordinary". In so striving those people succeeded in raising the standard of living of all our citizens. What was a "luxury item" 10 or 20 years ago; what was "clearly out of the ordinary" 10 or 20 years ago, has become for many not just an obtainable goal but an accomplished objective. We are disturbed by the very notion of a Congressional determination of what is "clearly out of the ordinary". In addition to our overall concern with the underlying philosophy of this section of the Bill as set forth above, we have the following specific concerns:

1. *Proposed Limitation on Deduction for Personal Interest*

A. The proposed limitation will substantially raise the effective cost of financing future purchases for those currently close to the proposed limit. Moreover, anyone whose interest costs might reasonably be expected to approach the limit must carefully weigh such future commitments against unforeseen medical expenses which must be financed or some other unexpected event could result in future disallowance of interest. Finally, inclusion of the limitation must raise in

the minds of many taxpayers uncertainty as to when the Committee or others will determine to lower the limitation to say $5,000 to conform to their then current perception as to a standard of living that is "clearly out of the ordinary".

The provision also has the potential to both provide self-employed individuals with an unfair advantage over others and to promote business practices detrimental to small businesses. For example, a small businessman may have a business in which working capital needs are substantially financed by equity capital. Given a desire to purchase a new home, the provision may cause him to withdraw capital from the business to reduce the interest otherwise paid on the mortgage and to borrow within the business to meet working capital requirements. This decision, of course, could make the viability of the business somewhat more precarious in times of economic stress.

2. Proposal to Reduce Existing Limitation on Investment Interest

We have previously set forth our views as to the necessity to encourage the formation of equity capital. In this context, it should be noted that investors who trade on margin are a significant source of equity investment. They not only risk their own capital but are willing to increase their risk by transforming the debt instruments of others into equity investment. The House bill would severely affect such investors, including those with moderate investments and incomes. We, therefore, believe the reduction in the limitation on investment interest should not be passed for the following reasons:

A. The combination of the limtation on investment and personal interest of $12,000 is likely to reduce the current limit on investment interest from $25,000 to far below $12,000 and in many instances will serve to completely eliminate any allowance.

B. The reduction in the limitation will be particularly burdensome when interest rates are high and equity and other investments depressed. Such a reduction is likely to result in forced liquidation of those investments, in turn further depressing such investments and resulting in the taxpayer realizing losses. The realization of losses under those circumstances in turn can result in reduced revenues to the Treasury at a time when revenue intake is already low. It will, of course, also result in a deferral and ultimate potential loss by the taxpayer—investor of the deduction for the interest paid.

C. The limitation on investment interest will cause hardship in certain specific cases. For example, potential "employee investors" in small or closely held corporations and partnerships who are required to make substantial contributions to capital for participation incur substantial interest expense. Such interest expense is considered to be investment interest, but results in no offsetting investment income due to the nature of the trade or business underlying the investment.

The limitation on investment interest lacks horizontal equity as illustrated by the following example:

	Taxpayer A	Taxpayer B
Personal interest	$12,000	$12,000
Investment interest	100,000	100,000
Investment income (dividends)	100,000	
Salary		100,000
Disallowed investment interest carried forward and possibly never used	0	100,000

For all of the above reasons, we strongly urge that the provisions respecting personal and investment interest be eliminated from the Bill.

Preserving Existing Capital

In addition to the need to stimulate individual investment, SIA recognizes the need to preserve existing capital. We support the provision in the House bill which extends the corporate investment tax credit to stimulate expansion and to increase productivity, and we urge adoption of accelerated depreciation guidelines to offset the effect of inflation.

1. *Investment Tax Credit.*—The temporary tax credit equal to 10 percent of an investment in qualifying machinery and equipment, which was enacted to stimulate corporate expansion, reduce tax restraints on capital spending, encourage growth and increase productivity. We endorse the House bill to the extent it will further these goals. This panel may wish to consider increasing the rate and/or the duration of the extension.

NOTE: An investment tax credit assumes sufficient corporate capital surplus is available for purchase of machinery and equipment. Therefore, the credit is of little value absent an adequate supply of capital. Accordingly, incentives for savings and investing, which increase the rate of return on investment and encourage participation in corporate ownership, should accompany action on the investment credit.

2. *Liberalization of Depreciation Guidelines.*—Current guidelines enacted by Congress to reflect the cost of depreciation and replacement of machinery and equipment are inadequate to offset the effects of inflation, which overstates real profit and ignores the cost of replacing assets at inflated prices. Accordingly, we believe that guidelines which would permit faster depreciation and a shift from historical to replacement cost in the basis of depreciation accounting should be considered.

Liberalization of accounting for depreciation would encourage investment and expansion, permitting U.S. corporations to increase the rate of recapture of capital expenditures which has been among the slowest of all developed and industrial nations.

We would like to call the Committee's attention to two additional areas of concern to our industry which were not considered by the House during its deliberations on H.R. 10612: 1) the tax treatment of brokerage commissions, and 2) proposed alteration of the market for state and local government bonds.

Investment Expenses

Commissions paid on the purchases and sales of securities are not deductible at present. They are treated either as a part of the cost of securities purchases, or as a deduction from the proceeds received in calculating gains or losses on the sale of securities. Security commissions should be treated as a separate item of deduction, just as other non-trade and non-business expenses such as stock transfer taxes and costs of investment advisory services.

We can find no reason which dictates the existing tax treatment. Actually, logic and consistency would dictate the proposed treatment since all other expenses of investment are treated as a deductible item. We believe that the treatment of commissions as a deductible investment expense is consistent with an overall program of encouraging greater capital investment.

Proposals Relating to the Municipal Bond Market

The House Ways and Means Committee reported last week H.R. 12774, which would create an option under which state and local governments which issue their bonds on a taxable basis would receive a federal interest subsidy. That proposal has evoked mixed reactions from both issuers of state and local government securities and municipal bond underwriters and dealers. SIA's Public Finance Division has done extensive research on the concept of a taxable bond option and has testified before various Congressional committees on the proposal on several occasions (most recently before the Ways and Means Committee on January 21st in testimony delivered by Wallace O. Sellers). Should this Committee decide to examine the taxable bond option or other proposals relating to the municipal bond market, SIA would be eager to provide the Committee with the results of its study and to work with you in drafting legislation in this area.

Conclusion

Enactment of changes in the Tax Code in line with SIA recommendations will greatly strengthen the likelihood that we as a Nation can achieve the desired goals of full employment, environmental restoration and preservation, and greater energy independence. These goals simply cannot be realized without substantially increasing the amount of private capital available for investment. The SIA proposals will significantly shift from the current emphasis in the tax laws which promotes consumption, discourage savings, and inhibit equity investment to an emphasis which will further public policy objectives through increased individual savings and investment.

Senator MONDALE. Our next witness is Mr. Thomas L. Chrystie, senior vice president, Merrill Lynch & Co.

I would remind you of our 10-minute rule. Your full statement will appear in the record.

STATEMENT OF THOMAS L. CHRYSTIE, SENIOR VICE PRESIDENT, MERRILL LYNCH & CO., INC., ACCOMPANIED BY WALTER PERLSTEIN, TAX COUNSEL, AND JOHN C. RICHARDSON, ATTORNEY, WITH BROWN, WOOD, IVEY, MITCHELL & PETTY

Mr. CHRYSTIE. We share the committee's interest in improving our tax structure. The overriding objectives of such tax improvements should no doubt be to promote a better, stronger, more prosperous America and to provide more equitable treatment for all taxpayers. Specifically, in line with these objectives, we see the need for measures to stimulate investment, which in turn creates jobs for our labor force and makes more goods and services available to our consumers. Clearly, one of the most important ways to attract such much-needed investment is to encourage investors to commit more of their available funds. And to accomplish that—in short, to provide the fuel for increased employment and rising living standards—we feel it is urgent to ease some of those tax provisions which serve to greatly discourage investors.

We at Merrill Lynch deal with over a million individual investors and thus are continually conscious of their concerns and aims. A great many of these customers are persons of moderate means. A sample of the accounts we opened last year shows nearly a quarter of these new customers had incomes under $15,000, and the median income was in the $22,000-to-$23,000 range. Most of these persons have only a very limited portion of their hard-earned funds available for investments and are particularly concerned about the tax bite into their laboriously hatched nest egg. Incidentally, our customer survey statistics are before counting the nearly 300,000 workers who regularly buy small amounts of stock under payroll deduction plans through us.

Having spent 17 of my 20 years with the Merrill Lynch in the investment banking area, I am particularly conscious both of the huge needs for new capital facing us in the years ahead and of the incentives required to attract capital at a reasonable cost. It's critical to get these funds to expand and modernize our production facilities because only in that way can we create the needed jobs while keeping inflation under control, enhancing our competitive status in the world, and meeting environmental objectives.

Of special importance is that in stimulating the flow of investment capital we get the benefits of a multiplier effect on the job market. Most directly, the company which is expanding will provide more jobs. But in addition, the expansion creates jobs at the capital goods producer and in the construction industry. And then, as these additional workers spend their income, jobs are added throughout the economy. And aside from the social benefits, the incremental income should increase Treasury revenues far beyond any amount that might be given up to provide the investment incentives.

All the formal and informal surveys we have conducted over the years point to capital gains tax relief as the most effective way to encourage more individual investment. And while I'm certainly aware of the need for large-scale investments by wealthy individuals and major institutions, we also need the cumulative contributions of the

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smaller investor. And it is this smaller investor for whom the capital gains tax has relatively the most severe impact.

The small investors are especially conscious of the fact that the Government is their partner in gains, but not in losses; that many of their long-term gains result from inflation; and above all, that making any change in their investments requires the surrender of part of the total capital built up over the years. This hits hardest those in or near retirement who, as a matter of prudence, should now seek out more conservative, income-type securities but who, to do so, must surrender part of their income-producing assets.

We feel strongly that these investors should be granted relief, both as a matter of equity and as an investment stimulant. We feel that probably the most practical alleviating measure would be a sliding scale for long-term capital gains, with the effective maximum tax rate being reduced by, say, 1 percent a year for each year the security is held up to 20 years. This is similar to the proposal you just heard from the SIA. This method is structurally simple and would help to ease several of the most serious complaints. An important consideration also is that, by "unlocking" many investment portfolios, revenue losses if any, would probably be minor.

In considering tax treatment of capital gains, it is essential to realize that capital gains are by nature completely different from ordinary types of income. In most cases, the funds being invested are already taxed once when the investor originally earned the money he now puts at risk. And the money directly earned by that money—in interest or dividends—is subject to income tax. But when you tax the increased value of the investment itself—a gain which often merely reflects inflation—you take a slice not out of income, but out of the available pool of capital. And you worsen the odds in the risk-to-reward relationship so that the would-be investor will be tempted to divert funds to current pleasures or, at most, to low-risk, straight-income securities. Yet it is risk-taking equity investments we must encourage for America's growth.

And capital gains are threatened with even harsher treatment by H.R. 10612. Some of its provisions turn what was first designed as a true minimum tax to secure a reasonable taxpayment from all taxpayers, into what in effect would be a straight and heavy surtax on many taxpayers. The heaviest impact would probably fall on those reporting capital gains, which in numerous cases would become subject to an effective Federal tax rate of 42 percent, plus, of course, any State or local levies. We are convinced any such measure would be extremely counterproductive and damaging to America's capital-raising efforts.

At the same time I would like to stress the importance, in building up our productive capacity, of encouraging foreign investors to help us to do so. We strongly favor removal of the withholding tax on interest and dividend payments made to foreigners. This would apply only to portfolio investments: in short, to those who recognize that our stock and bond markets offer attractive investment opportunities. The United States should drop this tax barrier so that securities of U.S. corporations can be exported and U.S. dollars held by foreigners can be brought back to the United States. Not only should we be eager to attract these investment funds to strengthen and improve our econ-

omy; we certainly should not follow policies which would cause these funds to be diverted to other countries to build up our competitors.

In summary, we believe that tax policies which will encourage both Americans and foreign investors to put their money to work here will mean a more prosperous America and, incidentally, help build a bigger and more reliable tax base. Thank you.

Senator MONDALE. Thank you very much.

Mr. CHRYSTIE. I have additional comments which I would like to submit for the record.

Senator MONDALE. They will appear in the record.

Senator Ribcoff?

Senator RIBICOFF. I was just curious. You mention that 25 percent of your new customers had incomes under $15,000 and the median income was in the $22,000 to $23,000 range.

What proportion of your business in dollars is based on those customers whose income is under $15,000?

Mr. CHRYSTIE. I can't answer it for individuals under $15,000 at the moment. I will see if we can get you those figures.

Senator RIBICOFF. How about $22,000 to $23,000?

Mr. CHRYSTIE. I don't have the breakdown by classes of individuals. For individuals as a whole it is a substantial portion of our revenue.

Senator RIBICOFF. Not individuals as a whole, you are talking about doing something for the small investor. I was just curious what portion of the investments in the stock market is attributable to the small investors you are talking about.

Mr. CHRYSTIE. I don't have those figures with me, Senator, and I don't know the extent to which they are available. I will try to get some.

[The information referred to is as follows:]

MERRILL LYNCH & CO. INC.,
New York, N.Y., April 20, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate,
Washington, D.C.

DEAR CHAIRMAN LONG: When I had the privilege of testifying before your Committee on April 5, Senator Ribicoff referred to my statement that, according to our sampling, nearly one-quarter of our new customers had incomes under $15,000 and that median income was in the $22-to-$23,000 range. The Senator then asked for certain additional information regarding the importance of such smaller customers to our business and to the financial markets.

As I indicated at the time, I was not certain whether the figures sought by Senator Ribcoff were available. We do not maintain data relating the income of customers to their market activity, etc. However, we feel there is other data available which bears on the points raised by Senator Ribicoff and we submit the attached supplemental information for inclusion in the record.

I would also like to make some additional comments which I believe will help clarify the issues which so properly concerned the Senator.

Even without precise figures, it is undoubtedly true that large-scale customers provide a relatively large proportion of our revenues. However, as we have pointed out, the small investor is entitled to full and fair treatment in his own right and, in the aggregate, small investors provide important support to the financial structure.

This is the point we have tried to stress in our testimony: because of the limited funds which moderate-income Americans can afford to invest, they are the ones who are most discouraged and relatively most severely hurt by taxes that eat into their investment capital. That is why, while we are certainly convinced that improved capital gains treatment is highly desirable for all types of investor, priority attention should be given to the needs of the smaller investors.

Consequently, the recommendations we have made to the Congress in recent years have been intended to give the principal relief to this group. This was done

in two ways: first, proposing alleviating steps in those areas which are of primary interest to small investors; second, by suggesting possible limitations on the relief to be granted.

For illustration, may I refer to my April 5 testimony and specifically to the additional comments I submitted for the record at that time. In Attachment I, page 14, we noted that, "to minimize revenue impact and concentrate the benefits on the group of investors for which it is most needed, [the proposal] could be structured to limit the amount of gains which could be deferred . . . or permit only a certain percentage of the gain to be deferred." While the particular proposal in this instance dealt with tax deferral on portfolio switches, similar limitations could readily be applied to other potential forms of relief. For instance, it would be possible to place a dollar limit on any loss carry-backs that might be authorized. Another application of this principle could be a modest, inflation-correcting adjustment in the current $1,000 annual limitation on writing off losses.

Furthermore, the "sliding scale" proposal on which we concentrated because it seems the simplest way to provide reasonable relief, would, as we noted, be of particular help to the small investor. For the rate reduction to be meaningful, the security must be held for a substantial period of time, a circumstance in which the small investor who makes a few truly long-term investments is most likely to find himself. The large-scale investor is far more likely to make periodic changes in at least a large part of his portfolio and to have offsetting transactions which would dilute the tax impact. Thus, smaller investors are not only in more dire need of relief but would tend, on a proportionate basis, to derive more benefit from the suggested changes.

We at Merrill Lynch have long been known for our willingness to provide service to small investors. They are certainly an important part of our business. We have been instrumental in developing plans which make it easier and more economical to invest modest amounts. And we have just succeeded in forcing an end to the compulsory 12½-cent-a-share odd-lot "differential" fee. In these cases, too, benefits apply to all investors, but they are most meaningful and economically significant to the smaller investors.

To reiterate, moderate-means investors represent a very large number of people, and their contributions are vital to a healthy American economy. And while we sincerely believe all investors merit at least some capital gains tax relief, priority should be (and readily can be) directed toward those of moderate means.

Sincerely yours,

THOMAS L. CHRYSTIE,
Senior Vice President.

Enclosures.

SUPPLEMENTAL INFORMATION SUBMITTED BY THOMAS L. CHRYSTIE, SENIOR VICE PRESIDENT, MERRILL LYNCH & CO., INC.

Merrill Lynch collected the income data cited in our testimony as part of a statistical profile of new customers, and respondents were offered anonymity. Thus we could not track the subsequent degree of market participation of any particular group of these customers. Nor do we have any specific data to correlate customer income with the amount of business done or similar criteria.

However, some other data is available to indicate the sizable number of smaller investors in America and the importance of these investors to the securities markets and to the nation's economy as a whole.

On a broad scale, dealing not just with new customers but with the total direct shareowner population, the New York Stock Exchange's 1975 Shareowner Census shows there are an estimated 23.4 million adult U.S. shareowners (plus another 1.8 million minors). Of the adult shareowners, 8 million people have household incomes under $15,000 and 16.7 million investors have income under $25,000 (see Table I).

A somewhat different approach which also points up the substantial number of stock owners among moderate-income Americans is found in a 1974 Louis Harris & Associates study on Family Financial Planning. It shows the proportion of people in each income bracket who own at least some stocks (Table II). As might be expected, the higher the income, the greater the percentage of people in that bracket who own stocks. But even so, over one out of four families earning between $10,000 and $15,000 hold some stock, and the proportion rises to nearly one out of every two in the $20,000 to $25,000 range.

One other way to gauge the smaller investor's importance is to look at portfolio sizes. According to the New York Stock Exchange 1975 Census, one half of all American shareowners have portfolios valued at less than $10,000 and three-fourths have portfolios under $25,000. As detailed more fully in Table III, the 17.5 million adults whose portfolios are worth less than $25,000 each nonetheless represent an aggregate stock investment value of $150 billion. According to the latest Federal Reserve Board figures, total stock holdings of individuals in the United States amount to $619 billion and bond holdings (including Government and Municipal securities) to $253 billion. That would indicate that more than one out of every six investment dollars in the nation is found in portfolios of under $25,000. Obviously, the massive contribution of the $17.5 million investors in this category is vitally important to the financing of American business and their participation in the investment markets should be encouraged.

TABLE I.—SHAREOWNERS IN VARIOUS INCOME BRACKETS

Income	Millions of shareowners	Percent of total	Cumulative totals: Shareowners (millions)	Cumulative totals: Percent
Under $10,000	3.4	14.6		
$10,000 to $15,000	4.5	19.4	7.9	34.0
$15,000 to $25,000	8.8	37.5	16.7	71.5
$25,000 to $50,000	5.4	23.2	22.2	94.8
Over $50,000	1.2	5.2	23.4	100.0
Total	23.4	100.0		

Note: Only adult shareowners included.

Source: New York Stock Exchange, "1975 Shareowner Census."

TABLE II

Extent of shareownership in different income brackets

Income:	*Percent in group which owns stock*
Under $10,000	12
$10,000 to $15,000	26
$15,000 to $20,000	36
$20,000 to $25,000	48
$25,000 to $35,000	66
$35,000 to $50,000	69
Over $50,000	81

Source: Louis Harris & Associates, Family Financial Planning, 19774.

TABLE III.—INVESTMENT PORTFOLIO VALUES

Portfolio size	Number of shareowners (millions)	Percentage	Approximate total value of portfolio (billions)	Cumulative: Millions of shareowners	Cumulative: Percentage	Cumulative: Billions of portfolio value
Under $1,000	2.2	9.2	$1.1			
$1,000 to $2,500	2.4	10.2	4.2	4.5	19.4	$5.3
$2,500 to $5,000	2.9	12.6	11.1	7.5	32.0	16.3
$5,000 to $10,000	4.2	17.8	31.2	11.6	49.8	47.5
$10,000 to $25,000	5.8	24.9	101.9	17.5	74.7	149.4
Over $25,000	5.9	24.3	(1)	23.4	100.0	(1)
Total	23.4	100.0				

[1] Not estimated.

Source: New York Stock Exchange, "1975 Shareowner Census."

Note: Only adult shareowners included. Portfolio values computations based on midpoint for each size category. No estimate made for "Over $25,000" category.

Mr. CHRYSTIE. We try to look at the small investor in commenting on tax legislation but in the basic conduct of our business we try to treat every investor alike because that money is just as important to the small investor as it is to any other investor.

Senator RIBICOFF. That is why I have asked the question. I would much prefer that the argument be made on its merits, and not try to hide the argument behind what you are doing for the small investor because that isn't the basic argument you are trying to make; are you?

Mr. CHRYSTIE. I agree. I think the point I was trying to make is that the capital gains tax has fully as great if not greater impact on the investor who has one or two investments in the mraket and might for instance have invested in his own company, a growth investment for years, and when he gets—when he retires he has a transaction which may result in a 42-percent tax on that transaction in 1 year.

Senator RIBICOFF. I have no further questions, Mr. Chairman.

Senator MONDALE. Thank you.

Senator Hansen?

Senator HANSEN. No questions, Mr. Chairman.

Senator PACKWOOD. No questions, Mr. Chairman.

Senator MONDALE. You mentioned foreign withholding—withholding with respect to foreign investments in this country. If an American investor invests, say, in a German company, or a French company—buys stock in France or Germany—isn't there a withholding tax on dividends paid to him?

Mr. CHRYSTIE. I have submitted a list of reciprocal treaties. I think it can vary from country to country, but in many cases it is not withheld.

Senator MONDALE. But that is where there is a reciprocal understanding. You are proposing that we remove the withholding requirements, are you not?

Mr. CHRYSTIE. To give you an example, Senator, last year and this year, there are numerous cases of foreign countries and foreign industrial companies raising capital in the U.S. market and bringing that capital to their countries to invest. The U.S. company or Government entities in the United States can't in turn raise capital by selling debt securities in Europe, say, because of this withholding tax imposed by the United States.

Japan is a good example of this where——

Senator MONDALE. What happens if an American wants to buy stock in Japan?

Mr. CHRYSTIE. He doesn't have any tax withheld by Japan.

Senator MONDALE. Is that because of a reciprocal agreement?

Mr. CHRYSTIE. This is because of—Japan has set up no barrier to entities raising money in the United States and bringing it to Japan, while we have set up a barrier in effect to exporting U.S. securities.

Senator MONDALE. If there are no other questions, thank you very much.

[The prepared statement of Mr. Chrystie follows:]

STATEMENT BY THOMAS L. CHRYSTIE, SENIOR VICE PRESIDENT, MERRILL LYNCH & CO., INC.

My name is Thomas L. Chrystie and I am senior vice president of Merrill Lynch & Co.

We share the committee's interest in improving our tax structure. The overriding objectives of such tax improvements should no doubt be to promote a better, stronger, more prosperous America and to provide more equitable treatment for all taxpayers. Specifically, in line with these objectives, we see the need for measures to stimulate investment, which in turn creates jobs for our labor force and makes more goods and services available to our consumers. Clearly, one of the most important ways to attract such much-needed investment is to encourage investors to commit more of their available funds. And to accomplish that—in short, to provide the fuel for increased employment and rising living standards—we feel it is urgent to ease some of those tax provisions which serve to greatly discourage investors.

We at Merrill Lynch deal regularly with over a million individual investors and thus are continually conscious of their concerns and aims. A great many of these customers are persons of moderate means. A sampling of the accounts we opened last year shows nearly a quarter of these new customers had incomes under $15,000 and the median income was in the $22,000 to $23,000 range. Most of these persons have only a very limited portion of their hard-earned funds available for investment and are particularly concerned about the potential tax bite into their laboriously hatched nestegg. Incidentally, our customer survey statistics are before counting the nearly 300,000 workers who regularly buy small amount of stock under payroll deduction plans through us.

Having spent 17 of my 20 years with Merrill Lynch in their investment banking area, I am particularly conscious both of the huge needs for new capital facing us in the years ahead and of the incentives required to attract that capital at a reasonable cost. It's critical to get these funds to expand and modernize our production facilities because only in that way can we create the needed jobs while keeping inflation under control, enhancing our competitive status in the world and meeting environmental objectives.

Of special importance is that in stimulating the flow of investment capital we get the benefits of a multiplier effect on the job market. Most directly, the company which is expanding will provide more jobs. But in addition, the expansion creates jobs at the capital goods producer and in the construction industry. And then, as all these additional workers spend their income, jobs are added throughout the community. And aside from the social benefits, the incremental income should increase Treasury revenues far beyond any amount that might be given up to provide the investment incentives.

All the formal and informal surveys we have conducted over the years point to capital gains tax relief as the most effective way to encourage more individual investment. And while I'm certainly aware of the need for large-scale investments by wealthy individuals and major institutions, we also need the cumulative contributions of the small investor. And it is this smaller investor for whom the capital gains tax has relatively the most severe impact.

The small investors are especially conscious of the fact that the government is their partner in gains, but not in losses; that many of their long-term gains result from inflation; and above all, that making any change in their investments requires surrender of part of the total capital built up over the years. This hits hardest those in or near retirement who, as a matter of prudence, should now seek out more conservative, income-type securities but who, to do so, must surrender part of their income-producing assets.

We feel strongly that these investors should be granted relief, both as a matter of equity and as an investment stimulant. We feel that probably the most practical alleviating measure would be a sliding scale for long-term capital gains, with the effective maximum tax rate being reduced by, say, 1 percent a year for each year the security is held up to 20 years. This method is structurally simple and would help to ease several of the most serious complaints. An important consideration also is that, by "unlocking" many investment portfolios, revenue losses, if any, would probably be minor.

In considering tax treatment of capital gains it is essential to realize that capital gains are by nature completely different from ordinary types of income. In most cases, the funds being invested were already taxed once when the investor originally earned the money he now puts at risk. And the money directly earned by that money—in interest or dividends—is subject to income tax. But when you tax the increased value of the investment itself—a gain which often merely reflects inflation—you take a slice not out of income, but out of the available pool of capital. And you worsen the odds in the risk-to-reward relationship

so that the would-be investor will be tempted to divert funds to current pleasures or, at most, to low-risk, straight-income securities. Yet it is risk-taking equity investments which we must encourage for America's growth.

And capital gains are threatened with even harsher treatment by H.R. 10612. Some of its provisions turn what was first designed as a true "minimum tax" to secure a reasonable tax payment from all taxpayers, into what in effect would be a straight and heavy surtax on many taxpayers. The heaviest impact would probably fall on those reporting capital gains, which in numerous cases would become subject to an effective Federal rate of 42 percent, plus, of course, any state or local levies. We are convinced any such measure would be extremely counterproductive and damaging to America's capital raising efforts.

At the same time I should like to stress the importance, in building up our productive capacity, of encouraging foreign investors to help us do so. We strongly favor removal of the withholding tax on interest and dividend payments made to foreigners. This would apply only to portfolio investments—in short, to those who recognize that our stock and bond markets offer attractive investment opportunities. The United States should drop this tax barrier so that securities of U.S. corporations can be exported and U.S. dollars held by foreigners can be brought back to the United States. Not only should we be eager to attract these investment funds to strengthen and improve our economy; we certainly should not follow policies which would cause these funds to be diverted to other countries to build up our competitors.

In summary, we believe that tax policies which will encourage both Americans and foreign investors to put their money to work here will mean a more prosperous American and, incidentally, help build a bigger and more reliable tax base.

I. CAPITAL GAINS AND RELATED TAX CHANGES

We submit herewith a fuller explanation of Merrill Lynch's recommendations for tax changes and the underlying rationale.

It is almost axiomatic that the welfare and prosperity of America, and indeed of the world, can be enhanced in a real sense only by stimulating the production of goods and services, so there will be more to be shared. To make this growth possible requires large and continuous flows of additional capital, in part raised internally by business, in part contributed to business by outside investors. In both categories, tax policy plays a major role in determining the availability and use of the needed funds.

While this memorandum is intended to deal with the tax impact on various types of investment and capital sources, its major concern is with the tax effects on the individual investor and especially the so-called small investor.

Characteristics of the "small investor"

At Merrill Lynch, we do not normally use the term "small investor," since we feel no investments are small or unimportant to the person who makes them. Therefore, investment of a small amount should be treated with the same respect as someone else's substantial commitments of capital.

However, this may be an appropriate distinction for tax purposes. Compared to large-scale investors, the small investor's investments tend to be relatively much more important to him in terms of total available capital or income; at the same time, his investment actions are likely to be more irregular and be concentrated into fewer occasions. Clearly, he has different investment needs and attitudes, and he feels the tax impact differently. Thus, while many of the comments and suggestions in this memorandum apply to all types and sizes of investors, we have taken special note of tax changes that would be particularly helpful to the small individual investor. At the same time we believe these changes would have a minimal effect on overall tax revenues.

The small investor merits attention and encouragement for a number of potent reasons. First, while each individual's investment may be relatively modest, in the aggregate this group of investors becomes a very substantial contributor to the American capital raising process. Further, as in many other areas of American life, it is socially desirable to have as many people as possible share in the ownership of American enterprise.

Looking at it from the investor's viewpoint, the primary objective of an overwhelming majority of small investors is to build toward personal financial independence—most frequently, for the specific purpose of accumulating a nest-egg which will make it easier to live in retirement years without becoming a

burden to either family or society. This objective obviously deserves a high national priority, and tax policy should seek to aid rather than deter its attainment.

At Merrill Lynch we handle the accounts of over one million individual investors, a great many of them in this modest investor class. In addition there are hundreds of thousands who regularly buy small amounts of stock in the company for which they work through payroll deduction plans. We feel we have our finger on the investor's pulse through continuous contact with this large customer base, supplemented by surveys we have sponsored, and by the flood of mail we receive (including responses prompted by our ad campaign). Our readings strongly indicate that capital gains taxation is one of the biggest extraneous factor in investment decisions—that is a factor apart from straight investment merits or he investor's own objectives and means.

The impact of capital gains

The general response on capital gains we have received from investors, especially those of modest means, breaks down into two complementary parts:

1. They appreciate the present 50 percent long-term gain exemption in the sense that, without it, they feel they would have little hope of attaining their basic financial goal of long-term security, and might stop trying to reach it.

2. But, most of these investors feel the present provisions are inadequate and more extensive relief is needed, not just as a matter of fairness, but to make it more feasible to build for long-term goals—and, incidentally, draw more capital into the investment stream.

The chief complaints about the present capital gains tax system are:

Gains which are taken and taxed in one year are often the cumulative result of many years of capital growth. Moreover, much of the supposed gain merely reflects inflation, and sometimes other extraneous factors as well.

After the investor has risked his capital, the Government claims a partnership share if his risk-taking proves successful, but is willing to accept a share in only a very limited portion of any loss.

Changing investment objectives are penalized because the capital gains tax acts as a transfer tax; in any switch the investor's available capital diminished. This in turn means the investment's current income-producing capacity is reduced, often just at the time when the investor's age and status make it prudent to switch from growth stocks to more income-oriented issues.

Liquidity encourages new investment

Those concerned with practical effects may ask: How will facilitating portfolio switches, that is, re-investment of already committed capital, encourage new investment?

It should first be recognized that increased mobility and liquidity in the securities market—which is what relaxation of transfer taxes would accomplish—are beneficial in themselves. They provide a more efficient market, responsive to changing conditions, with capital tending to be channeled to areas where there is greatest demand.

But the most vital role played by liquidity and mobility is that they provide the underpinning for a market which can attract capital. A prime factor in drawing investment funds into a market is confidence that the investor will be able to find a buyer when and if he decides to sell. In short, facilitating re-investment is an effective way of drawing new investment.

Here again, capital gains treatment can have a much greater impact on the smaller investor. The wealthy individual investor (like the institutions) regularly accumulates funds which he will seek to put to work in some way. On the other hand, he can afford to channel a goodly share of his funds into special projects which may be rather illiquid or have other special characteristics but promise large long-range payoffs. And as a large-scale supplier of capital, he is often able to treat the tax as just a cost of doing business—a cost which, through its influence on yields, may at least partially be shifted to the capital user. Finally, even if he pays the sizable capital gains tax after cashing in on successful projects, he will still have ample funds for further investments.

Contrast this with the small investor. His funds tend to come from a disciplined savings procedure. He often deprives himself of some current pleasures in order

to build for future security. Shatter his faith in that goal, and he will be tempted to spend now and worry about the future "when we get there." But if he thus needs more inducement than his wealthy counterpart to become an investor, once he invests he must concentrate on liquidity since he must be readily able to withdraw his funds in case of unexpected needs. And for him, any capital lost when he pays capital gains tax is apt to represent a permanent and irretrievable shrinkage of his invested capital; at best, he can recoup only gradually from growth of his replacement investment.

To summarize; whereas the wealthy investor is apt to make investments in any case, he is in position to shift his investment strategy to get the most favorable results under whatever tax laws are in effect. The situation is reversed for the investor of modest means whose investment objectives and resources tend to expose him to the full force of taxation—but if he finds this tax impact too severe, he is apt to withdraw from the capital market entirely.

The penalties of a transfer tax

It cannot be emphasized too strongly that capital gains tax is not so much a tax on real income but rather a levy on capital. For the small investor, this is equivalent to a levy on his savings. It is a transfer tax which in effect imposes a penalty fee when the investor changes his mind about an investment, for whatever reason. Put another way, it is an additional capital cost which the investor must bear for changing a previous investment decision in the hope of improving the quality of his portfolio, increasing his income or otherwise adjusting his savings to suit his current requirements. The most upsetting aspect to many a small investor is that his current income from the investment would be reduced because after payment of the capital gains tax he could only invest a smaller amount in the new security of his choice. Consequently he is reluctant to make a switch even if it would be wise from every other investment standpoint.

Here are just three typical situations in which this harsh transfer penalty discourages people from investment steps which the prudent long-term management of their finances would demand:

> An employee acquires a fair-sized amount of stock through payroll-purchase plans or an investor early in his career buys stock in a relatively little-known company. The companies prosper and the value of their stock goes up substantially. The holdings of these investors may be small as far as the companies are concerned, but they represent a very large proportion of the individual's liquid savings. The investors maintain faith in their companies, but, even so, every rule of prudence dictates that they attempt to diversify their holdings to some extent. Yet they feel "locked in", and so take the substantial risk of leaving all their nestegg in one vulnerable basket.
>
> An investor made prudent choices of stock in good-quality companies, and his portfolio has grown nicely. Now, however, he sees changes coming in the investment status of some of the companies. Yet, he feels he can't afford to switch to securities of other companies even though they are now better qualified to meet his investment objective.
>
> The situation most frequently mentioned by our correspondents and surely the most poignant is that of the investor who through the years wisely selected growth stocks. Now, nearing retirement, he wants to switch his emphasis to more conservative, income-producing stocks. But because of the tax bite, switching reduces his amount of invested capital. Thus, he must forego some of the very income he is switching to obtain.

The typical American will accumulate personal savings during his life measured only in thousands of dollars, not in hundreds of thousands or millions. A single capital gain tax of only a few thousand dollars can deprive him of a substantial part of his lifetime capital gains simply because he wanted to improve the quality of is investments. And because of inflation, it could leave him with less "real value" than he started with. American savers and investors should be aided to avoid such burdens.

A practical step: Relating rates to holding period

As perhaps the most practical way to ease some of the problems imposed by the present capital gains tax system, we strongly recommend establishing a tax rate which declines the longer a security is held—the so-called sliding scale system. We have no firm recommendations on just what the scale should be. One suggestion which seems logical is a one point reduction in the effective tax rate

for each year of the holding period, up to a maximum of 20 years. (Presumably this would be accomplished by raising the present long-term exclusion of 50% by two percentage points a year.)

One structural point is very important: whatever the scale used, it should provide for a gradual change in rates at intervals of at least once a year. If, instead, there were to be, say, a 5 percent drop every 5 years, this would induce bunching of sales at the time the holding period changes and, instead of removing an impediment to wise investment action, would actually create a new element of inflexibility.

The sliding scale system is simple in concept and structure and hence should be easy to administer. It also helps to meet at least in part many of the most important inequities and distortions prevailing under the present tax:

(1) It gives recognition to the length of time over which the realized gain was accumulated.

(2) It gives some recognition to the erosion of values by continuous inflation. While there have been suggestions for some type of inflation "indexing," any such system would be complex and cumbersome and raise many questions about what index or indexes would be appropriate. Making some allowance for inflation as part of a flat annual decrease in the tax rate is certainly simpler and probably at least as equitable as any effort at more precise adjustment.

(3) While investment portfolio changes would still be penalized, the severity of the "penalty" would usually be reduced. This would be particularly true for the modest-means, long-range investor since if he had a sizable gain in a stock which now no longer met his investment objective, it would most often be a stock in which the gain was built up over a period of years.

(4) When a high tax rate lessens the attractiveness of capital gains relative to the risks involved, investors are motivted more towards low-risk fixed-income securities where capital gains are normally not a major factor. Yet it is widely agreed that what most corporations need is more equity capital. By promising the long-term holder a lower rate on any capital gain he may attain and thus providing a more favorable risk/reward ratio, the sliding scale system should also be helpful in attracting more investments to common stocks.

(5) Since capital gains taxes become collectable only when an investor voluntarily undertakes a taxable act, the revenue effect of any changes cannot be predicted. But by "unblocking" many portfolios which investors are reluctant to sell at present tax rates, lowering the rates for these very-long-time holdings will probably not result in any major revenue losses to the Treasury. It may actually bring enough "frozen" securities into the market to increase the total tax receipts.

We are under no illusions about the sliding scale being a panacea which would solve all or most of the problems associated with the present capital gains structure. It has certain unfavorable features of its own, such as continued restriction on investment mobility, and it provides only limited alleviation of other tax-created obstacles to smooth investment flow. However, we feel the practical improvements provided by the sliding scale plan decidedly outweigh the drawbacks and therefore urge that it be adopted as promptly as possible. This does not obviate the need to seek further improvements, including those in areas where the sliding scale plan will bring partial relief.

Deferral on portfolio switches

It has been brought out above that one of the greatest areas of hardship, especially for the investor of modest means, is the tax imposed when it becomes desirable to make changes in an investment portfolio. No actual cash is realized, since the funds (or that portion of the funds which remains available after the tax is paid) is reinvested.

From the standpoint of investment logic, it should be possible to make such re-investments on a tax-deferred "rollover" basis, much as it is possible to defer the gain realized on the sale of a residence when the proceeds are reinvested in a new residence. Even closer to the securities investment field, we now have the examples of Keogh Plans and Individual Retirement Accounts. Under both these plans, invested funds remain tax-free until they are disinvested.

Again as noted earlier, a rollover or deferral privilege for ordinary investment accounts would be particularly important to the small investor. From his viewpoint, the shifting of his savings from one stock to another is a change of form rather than substance—his savings are still invested in the "market." His purpose and situation is as unchanged as when he moves his residence or, when he exchanges one life insurance, endowment or annuity contract for another.

Consequently, we feel serious study should be undertaken of such a tax plan. To minimize revenue impact and concentrate the benefits on the group of investors for which it is most needed, it could be structured to limit the amount of gains which could be deferred (either on a per annum or lifetime basis) or permit only a certain percentage of the gain to be deferred.

Treatment of capital losses

A major source of individual investor complaint is the treatment of capital losses which seems discriminatory not only compared with the way the individual's gains are taxed but also compared to the loss carrybacks available to corporations. Since the investor is granted only the limited $1,000 offset against current income, if he suffers any major loss, he must (unless he is fortunate enough to realize an equivalent capital gain) wait patiently for many years as he gradually writes off the loss at the $1,000-a-year rate.

It would seem simple justice to grant this investor the three-year carryback privilege accorded to corporations. Such a provision would help ease the natural human reluctance to realize capital losses and thus would contribute to improved market liquidity and efficiency. It would also neutralize the influence of tax law as a factor which could otherwise induce the investor to risk further losses rather than to realize those already accrued.

This would seem to be a simple action, worthwhile both from a standpoint of fairness and economic benefits.

In addition, it might be well to study the possibility of offsetting capital losses against interest and dividend income, since these are all aspects of income (or loss) from invested savings.

New disincentive to capital investment

While, as outlined above, we are convinced that meeting of American investment needs requires more constructive capital gains treatment, H.R. 10612, as passed by the House, contains provisions which instead would seriously undermine the incentive to invest. It threatens to impose a sharply higher capital gains tax on many investors, not by directly raising the rate but through the back door by a drastic alteration of the so-called minimum tax concept.

The minimum tax was instituted because it was found that a number of Americans paid no or only a minimal income tax for certain years in which they had relatively high adjusted gross income. While this was accomplished in full compliance with then existing tax laws, it was felt that these high-income recipients should share at least some of the general tax burden in the future. That was the basis for a true "minimum tax" requirement. The House bill, however, by eliminating offsets and exemptions now in force, would turn this tax from a "minimum" levy into a straight surtax on "preference income." And for most affected taxpayers, the principal preference to be taxed would probably be the 50 percent portion of long-term gains now excluded from regular taxes. Under the proposed setup, applying the levy to capital gains seems particularly inappropriate since, whereas most "preference" items involve income which would be exempt from tax except for the "minimum," in capital gains a portion of the income is already subject to taxation. Put another way, where other "preference" would be subjected to a 14 percent tax, existing law already taxes these capital gains at a far higher 25-to-35 percent, making an additional "minimum" a contradiction in terms.

What the House bill would do is eliminate the offset of "minimum" liability against regular tax paid, thus abrogating the whole "minimum" principle and subjecting taxpayers who have paid substantial regular taxes to an additional but clearly misnamed "minimum" impost. Further, the $30,000 exemption on preference income would be completely phased out for anyone whose income reached $40,000. This would expose many taxpayers to a capital gains tax of 42 percent (the present 35 percent maximum plus the 14 percent "minimum" surcharge on the half of the gain that's considered "preference" income), plus possible state and local levies. To make matters worse, another provision of the bill would remove part of the "preference" taxpayer's regular earned income from the 50 percent tax ceiling. Thus, if a taxpayer should chose to realize a sizable capital gain in one year he could expose himself to a higher rate than if he had no "preference" income at all. In short, "preference" income would be turned into "penalty" income.

Any such measure would be frighteningly damaging to our capital markets and severely hamper efforts to raise new capital. It would go directly counter

to the clear need for tax treatment that fosters capital formation so that we can effectively provide job opportunities, combat inflation and pave the way for the future growth of the economy. In sum, we share Chairman Long's view that these and certain other provisions now in the House bill, by discouraging investment, would actually cost jobs and result in a net loss of revenues to the Treasury.

Consequently, we strongly recommend that the Committee, rather than accepting a counterproductive surtax on capital gains, consider a true alternative tax which would insure that every American pays a fair and reasonable amount of tax on his income, including tax preference. We believe that this approach can satisfy the requirements of tax equity without creating serious damage to the capital markets and the economic needs of the nation.

The problems with interest deduction limitations

These comments on the need for a viable alternative which safeguards the basic requirements of the economy apply also to another potentially highly counterproductive provision included in the House version of H.R. 10612: namely, a $12,000 a year ceiling on the amount an individual taxpayer may deduct for personal interest as well as for investment interest in excess of investment income. The $12,000 limitation is not only arbitrary but will have a detrimental effect upon the capital markets. This limitation can have the effect of permanently disallowing deductions for the acquisition of capital assets with borrowed funds. Among other areas which could be substantially affected by this provision would be margin account activity on the major stock and commodity exchanges, with resultant deterioration in the liquidity and economic viability of these markets.

We recognize that the Congress may want to address itself to the problem presented by those taxpayers who use the interest deduction to unreasonably reduce their overall tax liability. But rather than use such an overkill approach, it would seem that these problems could be adequately handled by such measures as, for example, classifying interest deductions in excess of 70 percent of adjusted gross income as a tax preference item.

In short, we recognize the desirability of dealing with certain specific problems or potential abuses, and are confident that, if carefully approached, this purpose can be accomplished without erecting new obstacles to capital formation. At the same time, we urge the necessity of tax revisions which would increase the incentives for investment which is so essential to our country's welfare.

Treatment of dividends and the supply of equity capital

A dangerously large part of the growth of American manufacturing corporations since the start of the Sixties has been financed by "deterioration of the balance sheet," mostly by increases in both bank borrowings and bonded debt in relation to equity. To correct this imbalance of the balance sheet and put corporations in better shape for sound, job-building growth, it is important to build up the stock side of their capital structure.

This is difficult enough from the strictly financial investment standpoint. The long bear market in which the typical stock lost 75 percent of its value between 1968 and 1974 took its toll. By the second half of 1974 there were virtually no corporations other than a few utilities ready to sell common.

With the stock market improvement, there has come an upsurge in common stock financing, especially as many companies whose financing efforts had been sidelined by poor market conditions have shown an eagerness to take advantage of the more favorable climate. But even with this catch-up factor thrown in, equity financing is still below earlier peak levels. And since, unlike the Dow-Jones, the typical stock has recovered only about one-third of its steep 1968–74 drop, many managements still find they have to pay a relatively high cost for stock financing in terms of earnings dilution and divided yields. And for its part, much of the investing public is still quite selective about the offerings to which it will entrust its funds and decidedly hesitant about participating in venture capital enterprises.

But in addition to these financial considerations, the tax angle remains strongly leveraged toward debt rather than equity financing. The reason, of course, is that interest is a deductible expense to the corporation whereas dividends must be paid out of after-tax income and so are twice as costly to the corporation. In addition, dividends are taxed a second time when they become income to the stockholder.

This distinction has a sound historical background. It is obvious that interest must be treated as a full-fledged business expense. It is a valid legal obligation that must be met regularly if the company is to remain solvent. Default, and there won't be any income for either the tax collector or the stockholders.

The status of dividends is quite different. By law, they can only be paid out of funds the company has earned, which means taxes have already been paid on them. All that has seemed very logical. Not so logical, and certainly not fair, is the fact that these dividends are then taxed a second time when they become income to the stockholder.

While the double taxation raises the issue of fairness, the corporate tax status of dividends raises the question of practical effect—on a lower level philosophically but high in impact on economic health. It is generally agreed that too much debt, because of the very fact that it entails fixed obligations, is unsound, and yet the tax laws tilt the financing options in that direction.

A logical solution would be to accord dividend payments the same pre-tax status as interest. The results would free up more corporate cash (because of the pre-tax distribution) which the company might well use in part for larger dividend payout and in part to finance growth internally. The higher dividends would make it easier to seel new stock, and since the stockholders would have higher dividend income, the Treasury would recover a portion of the taxes lost from the corporate acount.

Such a system would promote both equity investing and equity in dividend distribution.

Investment credit and depreciation

All suggestions so far cover incentives for investors to contribute capital. Another major source for corporate funding is of course within the corporation itself. We consider it highly worthwhile in the interest of a healthily growing economy (and thus, in the long run, of increased tax revenues) to assist corporations in generating funds for increased capital spending. A proven effective method is the investment tax credit, which we feel should be extended permanently at a suggested rate of 12 percent.

At the same time, we must recognize that the costs of replacing plants, machinery and other capital assets are continually rising, and in a highly competitive world technical obsolescence is steadily speeding up. Thus, old fashioned accounting principles for depreciation and amortization, based on long equipment life and reasonable replacement costs, simply cannot meet the requirements of today, and even less so, those of tomorrow. It is important to recognize the fact and liberalize depreciation and amortization allowances.

II. ELIMINATION OF U.S. WITHHOLDING TAX ON INTEREST AND DIVIDENDS PAID TO FOREIGNERS ON THEIR PORTFOLIO INVESTMENTS

The interests of the United States are best served by encouraging portfolio investments by foreigners in the securities of American corporations. Our total needs for capital are immense, and it is only sensible to tap all appropriate sources. Accordingly, the withholding taxes imposed by the United States on interest and dividends paid to foreigners are counterproductive. They are an obstacle to the free flow of foreign portfolio investment to the United States, because they limit the cash return which foreigners can obtain on fixed-income and yield-oriented U.S. securities. The taxes range up to a maximum of 30 percent depending on the foreigner's country of residence.

It should be noted that H.R. 10612, as reported by the Ways and Means Committee last year, repealed the withholding tax on portfolio dividends and interest. However, that provision was struck on the House floor. We regret that action and hope that, in the interests of the American economy, the provision will be restored by your committee. The House seemed to be focusing on the direct revenue loss and to be ignoring the large potential benefits from the proposal. Even from a strictly tax receipt viewpoint, it is most likely that increased foreign investment resulting from the repeal will produce increased domestic revenues which would offset any lost withholding tax revenue. Moreover, repeal of the withholding tax is consistent with the desire to simplify the tax laws; by now, the withholding provision has become a complex patchwork of legislative and treaty provisions and is subject to numerous exceptions and qualifications.

Anticipated benefits

Elimination of these taxes should stimulate significantly increased flows of foreign long-term capital to the United States. It would:

Help to bring home substantial amounts of the over $100 billion held in private hands abroad;

Significantly benefit the U.S. balance of payments;

Facilitate direct borrowings by U.S. companies in the international markets to finance their activities both at home and abroad;

Increase the flow of foreign funds in the U.S. real estate and building industries by making such fixed income securities as mortgages and real estate-oriented equities attractive to foreigners;

Increase foreign investments in U.S. corporate bonds and yield-oriented common and preferred stocks such as those issued by U.S. utility companies;

Tend to reduce interest rates in the United States;

Help to reestablish the United States as an international financial center by making U.S. investments competitive with the Eurodollar and Eurobond markets which are not subject to withholding taxes.

It is important to note that the witholding tax discourages exactly the type of investment which we want to attract—the portfolio investor primarily interested in income. As for the takeover operator, not only can the proposed relief be written so as not to apply to him, the withholding tax is in any case largely irrelevant to his game plan. The reason is he expects his benefits to flow not from investment income but from a capital gains build-up and/or integration of a U.S. enterprise into his total scheme of operations.

Placing ourselves at a competitive disadvantage

A useful analogy may be found domestically, in the income taxes imposed by various states. While states routinely tax non-residents on wages earned or income produced from a business carried on within its borders, they carefully steer away from taxing investment income. For instance, those who work in New York but live in New Jersey or Connecticut are fully taxed in New York earnings. But interest on New York savings accounts are untouched—not because New York wants to be generous, or doubts its legal prerogative, but because it knows non-residents would just remove the deposits to a friendlier jurisdiction. The same, of course, is true of interest and dividends from New York-based companies. And, in fact, we have just seen how onerous securities transfer taxes led some brokerage firms to abandon New York and led to legislative amelioration to forestall wholesale flight.

The lesson is clear, whether locally or internationally: when investments of non-residents are taxed, investments within that taxing entity are placed at a competitive disadvantage. It is a disadvantage American enterprises seeking capital should not be asked to bear. In fact, going a step further, it is a disadvantage American consumers and workers (to whom the burden must inevitably be passed on through higher costs and fewer job opportunities) should not be asked to bear.

Indeed, the need to remove this competitive disadvantage has been recognized in the short-term area. Therefore, for the time being at least, the withholding tax has been removed from foreigners' interest-bearing bank deposits (including Certificates of Deposit) or such other short-term investments as commercial paper and U.S. Treasury bills. Not only does this discriminate in favor of one category of American capital seekers at the expense of the others, it favors quickly-shifting short-term investments by foreigners at the expense of more stable, and therefore more desirable, long-term debt and equity investments.

The taxes

Since the 1930's, the United States has imposed taxes withheld at the source at a flat 30 percent rate on gross interest and dividend payments to foreigners. However, the 30 percent rate has been reduced or eliminated for residents of a number of countries, including many major industrial nations, with which the United States has double taxation treaties. Attached is a list showing applicable rates for some of the countries with which the United States has treaties. The average U.S. withholding tax for residents of these countries is around 15 percent.

However, the United States lacks such treaties with the majority of countries around the world. Among these are some very substantial sources of funds for investment in the United States: for example, Hong Kong, most countries of

Latin America and the Middle East. In view of the history of unsuccessful attempts to negotiate treaties with many of these countries, it is doubtful that any significant number would be interested in concluding such agreements in the foreseeable future.

An important point is that while the Swiss tax treaty reduces the rate to 15 percent on dividends and 5 percent on interest, these rates apply only to Swiss residents. However, when a non-Swiss resident invests in the United States through his Swiss account, Switzerland, under the treaty, withholds additional amounts and remits them to the United States in order to bring the tax paid by such investors to the 30 percent rate. And significantly, the vast majority of funds available in Switzerland for investment in the United States is for the account of non-Swiss residents.

In many countries, any withholding taxes paid to the United States can be credited by the foreign nationals against their own domestic tax bills. However, even in these cases the procedures involved are often cumbersome and therefore do not facilitate the free flow of funds to the United States. This is particularly true in the case of individual foreign investors.

The effect of elimination

While it is not possible to project an exact dollar figure for the increase in portfolio investment in the United States which would result from removal of the taxes, it could well be several billions of dollars over a period of time. Foreigners already have a strong appetite for U.S. equities. Their net purchases of U.S. common stocks were $697 million in 1970, $836 million in 1971, $2,268 billion in 1972, $2.790 billion in 1973. Like many U.S. investors, they tended to sit on their hands in 1974 and bought only $540 million net in that year. Then with the market upswing in 1975, they too returned with a rush and their net investments for the first eleven months are estimated at $3.8 billion.

This shows that we have already had considerable success in attracting foreign portfolio investments for some categories of U.S. securities. What is significant is that, in general, these are stocks which have been bought for their growth potential. The U.S. capital gains tax does not apply to foreigners. If the withholding tax on dividends is removed, it will open the way to greatly increased flows into another class of U.S. equities—those which appeal to the substantial numbers of foreigners who are yield oriented. In particular, it would direct the attention of foreign purchasers at such securities as utility common and preferred stocks and real estate equities. This could aid industries which are in dire need of new sources of funds, if their ever increasing capital expenditures are to be financed at resonable costs.

Investments by foreigners in interest-bearing debt securities have been minimal. While accurate statistics which would measure these flows are not available, the closest approximation indicates that net foreign purchases of U.S. bonds were $347 million in 1970 and $233 million in 1971. In 1972, net sales of $81 million were made and in 1973 they were $17 million. Like everyone else, foreigners were more attracted to high-yielding bonds than depressed stocks in 1974, so there was a spurt to $481 million in their bond investments in that year. But then they again got busy switching out of bonds with net sales in that category amounting to $83 million in the first half of 1975.[1]

The generally low level of bond purchases stems to a considerable degree from the U.S. withholding tax, since foreigners interested in fixed income dollar investments can buy Eurodollar bonds which carry no withholding tax. Dollar-denominated Eurobond sales in the past five years have averaged $2.3 billion. Removal of the tax on interest would for the first time permit substantial purchases of U.S. debt securities including corporate straight and convertible bonds as well as mortgages and government bonds. This will occur even if interest rates in the United States are somewhat lower than abroad because there is a shortage of first-class, liquid investments outside the United States.

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[1] These figures are from U.S. balance of payments articles in the Survey of Current Business (U.S. Department of Commerce), June 1973 and September 1975, Table 6, Lines 67 and 66 respectively. Both the Treasury and Federal Reserve Monthly Bulletins give statistics which seem to show substantially higher foreign bond purchases. However, these statistics include purchases of Eurobonds issued by U.S. companies and U.S. bonds acquired by international organisations. Since neither of these are subject to U.S. withholding tax, they are not pertinent to this study.

Implications for U.S. tax policy

The effect on U.S. Treasury revenues of the removal of the taxes would be slight. Total income from these taxes was about $200 million in 1973 (the latest available year). Of this amount less than $20 million was attributable to the tax on interest payments, an indicator of the small size of foreign investment in interest bearing U.S. securities. It is believed that a substantial part of the remainder stems from inter-corporate payments by subsidiaries to their foreign parent companies; a tax on these would be retained if the proposed relief is limited to portfolio investments. In a larger sense, of course, it is expected that the added funds which can be drawn to the United States by withholding tax relief would be put to work so as to generate American wages and American business income—and within a reasonable period of time, the taxes on this newly generated domestic income could well exceed the revenues which would have been realized from the withholdings.

Some have argued that removal of these taxes would discriminate against American citizens who would, of course, continue to be subject to U.S. income tax on their debt and equity investments. However, it is a principle of international taxation that individuals should be subject to tax in their country of residence and/or nationality. After all, it is we, not the foreigner's own country, who are asking him to put his money to work here. And in our turn, we see nothing wrong in requiring a U.S. resident who owns some foreign stocks to pay U.S. income tax on dividends he receives. And, as noted earlier, the various states of the Union apply the same principle in regard to investment by citizens of sister states.

Weighing the benefits

In any event, the benefits to be derived for the United States in this time of monetary upheavals and historically high interest rates far outweigh the cost of this tax relief. Moreover, our tax treaties already waive or reduce the withholding tax for foreign residents in several countries. Thus, in a sense, this move would simply eliminate existing discrimination among foreigners from different countries. In addition, it bears repeating that all foreigners are exempt from the U.S. capital gains tax. Finally, the United States would join a significant group of industrialized countries such as Austria, the Netherlands and the Scandinavian countries, with which we must compete for funds and which do not tax interest paid to non-residents. In addition, Australia, Canada, and Japan have recently enacted laws exempting interest on long-term international bonds sold by local companies.

Others have argued that removal of the withholding tax would tend to stimulate tax evasion by Americans who would send their money abroad to be invested back in the United States. It is highly doubtful that a 15 to 30 percent withholding tax can be much of an obstacle to tax evasion when compared with U.S. income tax rates ranging as high as 70 percent. Moreover, the real incentive already exists in that there is no capital gains tax on foreign investment in the United States. The way to prevent tax evasion, of course, is through continued and enhanced enforcement of the law in the United States, improved reporting requirements by U.S. citizens and through the exchange of information with tax authorities of other countries which is built into U.S. tax treaties. In addition, it should be possible to draft the withholding tax elimination legislation so that the Secretary of the Treasury would have discretion, after a reasonable period, to reapply the taxes in respect to those countries which are unwilling to exchange tax information with the United States.

It is also argued that the United States would reduce its ability to negotiate future double taxation treaties because unilateral relinquishment of the right to withhold these taxes would reduce its leverage to exact similar concessions from the other countries. However, the United States already has treaties with most industrialized countries who are interested in such mutual arrangements. Others, especially developing countries, with whom the United States generally does not have treaties, are unwilling for economic and political reasons to diminish their ability to tax dividends and interest paid to investors abroad; they feel this would lead to additional profits remitted abroad. Thus the United States would seem to have little leverage in negotiating this issue in any case.

In summary, this simply is not a question of trying to accommodate or grant favors to other countries and their citizens. The foreign money is wanted for the benefit of the American economy. In real terms, the tax we impose on the

imported money is not borne by the foreign investor but is simply turned into an added cost of capital raising for American business. And if this added cost makes us less competitive in seeking international funds, it does not just mean there is less capital which can be used to build up the American economy. It means that the funds scared off from U.S. shores will be invested instead to build up our foreign competitors. How much better to make the foreign funds welcome here.

SELECTED TAX TREATIES IN EFFECT BETWEEN THE UNITED STATES AND FOREIGN COUNTRIES AS OF APRIL 1975

[In percent]

Country	General rate of U.S. tax withholding at source	
	Dividends	Interest
Australia	15	30
Austria (except mortgage interest)	15	0
Barbados	15	30
Belgium	15	15
Canada	15	15
Congo, Republic of	15	15
Denmark	15	0
Finland	15	0
France	15	10
Germany, Federal Republic of	15	0
Greece	30	0
Ireland	15	0
Italy	15	30
Jamaica	15	30
Japan	15	10
Luxembourg	15	0
Malawi	15	0
Netherlands	15	0
Netherlands Antilles	15	0
New Zealand	15	30
Nigeria	15	30
Norway	15	0
Rwanda	15	15
Sierra Leone	15	30
Sweden	15	0
Switzerland	15	5
Trinidad and Tobago	15	30
Zambia	15	0
United Kingdom	15	0
South Rhodesia (as United Kingdon colony)	15	0
Other United Kingdom colonies	15	30

Aden, Antigua, British Honduras, Dominica, Falkland Islands, Gambia, Grenada, Montserrat, (St. Christopher, Nevis and Anguilla Federation), St. Lucia, St. Vincent, Seychelles, United Kingdon Virgin Islands.

III. ECONOMIC BENEFITS OF TAX REFORM LEGISLATION

At a time when the total unemployment rate is still in excess of 7½ percent, and the Bureau of Labor Statistics reports total unemployment of more than 7.5 million people, it is tempting to seek tax changes directed toward stimulating incomes and spending. The idea is that as demand for goods and services expand, new jobs would be created. In our opinion, however, such an effort to solve the job problem through spending stimulation would be a short-sighted approach which before long would prove self-defeating.

By virtually everyone's calculations, in 1973 U.S. industry was fully utilizing its physical plant and machinery facilities. Yet, nearly five million people were still classified in government statistics as unemployed and the total unemployment rate was only slightly below 5 percent throughout the year. Thus it appears that the U.S. economy reached its physical productive limits before its human resources were fully utilized. The ramifications in terms of shortages, retarded growth, and double-digit inflation are well known. Our estimates suggest that we could again reach capacity limits within the next couple of years. To prevent this, proper steps should be taken so that businesses have the incentive to expand their physical facilities and also have access to capital markets for the necessary funds.

Not only would such an approach create jobs of a more permanent nature, but it would also help the nation to avoid future inflationary pressures.

Growth in employment multiplied

First, stepped-up spending for capital goods means stepped-up employment. The effects on employment are far reaching. They entail a phenomenon basic to economic growth, the multiplier. The initial step in the multiplier mechanism consists of fostering hitherto nonexistent final demand for the products of any particular sector. The increase in that sector's employment and income will, in turn, expand demand and employment throughout other sectors, and this continues in chain reaction fashion.

In the context of the latest recession a subtle yet not unimportant point is worth noting. Under one set of policies, increases in final demand could be generated by increased income support payments. This would lead to a multiplier effect with increased employment and income in consumer-goods sectors. On the other hand, increased demand could also be induced by increasing industry's incentives to invest through liberalized tax policies. In this last case the "first order" effects would be felt in investment goods sectors. The multiplier effect would then proceed to expand income and employment in other sectors of the economy—both consumer goods and investment goods.

These two prescriptions for expanding aggregate demand, however, have quite different implications. In the first case (i.e. final *consumer* demand being increased) the increases in, say, welfare payments will likely be regarded as temporary. Producers of consumer goods would therefore expand employment and production to meet the added near-term demand but may hesitate to expand their productive capacity to any great extent. In time, capacity limits could be reached. In the second case (i.e. final investment demand being increased through incentives to investment) all the beneficial effects on employment still take place. Indeed, it could cogently be argued that employment in investment-related industries will reflect increase in demand *more dramatically*. The reason is that consumer goods industries are much less cyclical and therefore have suffered less unemployment problems than, say, the particularly unfortunate construction industry where unemployment stood at 15.4% in January 1976.

Not only would investment incentives lead to both a multiplier effect through increased final demand *and* an attack on the unemployment problem on those fronts where it has claimed the highest casualties, but—and this is at least as important—it would lay the grounds for increased production and real income later on.

Productivity increased by investment

Furthermore, investment spending increases worker productivity and therefore the living standards of everyone. Although an increase in productivity is often associated with forcing people to work harder, history documents that this country has achieved annual increases in productivity for many years while the average work week was declining. This was achieved largely through capital formation and increased investment in the tools of production.

Each worker today has a much greater amount of capital equipment to augment his labors. The increase in the stock of equipment on hand, of course, came about through the efforts of business management and investors and through business cash flow. However, after adjusting for the effect of inflation and making allowances for mandatory pollution abatement expenditures, the capital spending figures reveal a serious long-term decline in real new investment in productive facilities, especially in manufacturing areas. Declines in such real spending can be accomplished by a deterioration in the quality of the equipment on hand to do the job.

Although tax changes do not necessarily show up in spending immediately (business plans are usually laid well ahead of time), they actively influence business strategy. The evidence, as we see it, makes a very clear case for a tax policy that encourages investment.

Financing requires capital availability

Once businesses have the incentive to expand their stock of plant and equipment, they must of course be assured of reasonable access to financial markets so they can fund the needed expenditures.

There have been several recent studies projecting future capital shortages. A typical approach of these studies has been to make various assumptions about demand patterns in future years, calculate the capital stock necessary to satisfy that demand, and then throw up one's hands in despair because of the sizable

number of dollars needed. While some valuable insights may come from that type of analysis, we believe it hides the real capital adequacy problem—that of the priority mix in the use of savings.

Consumers and businesses are savers as well as users of those savings. For the past fifteen years, however, the government sector has run sizable deficits and as a result has been a major borrower of privately generated savings. In every year from 1960 to 1974 no less than 5 percent of the funds raised in credit markets went to various governmental units, and that percentage has more often been above 15 percent. This is not what John Maynard Keynes had in mind when he advocated government activity in order to assure that the flow of savings was always returned to the spending stream. In only one of those years did the unemployment rate average over 6 percent and in seven of them it was below 5 percent. And that is hardly enough of an unemployment problem to justify the massive incursion that government has made into the nation's credit markets.

The concern that was expressed so often in early 1975 over "crowding out" by Federal borrowing was valid as an expression of a serious potential threat, but the timing factor may not have been properly apprehended. Federal Government borrowing (including agencies) totaled more than 52 percent of all funds raised in 1975, but even so, short-term interest rates generally declined throughout the year. Therefore, little argument can be made that crowding out occurred during that depressed period.

However, some crowding out appears to have taken place in the expansion years of the past decade or so. Heeding the lessons of the past and the studies of future requirements we must guard against governmental pre-emption of an excessive share of available investment funds if a capital shortage is to be avoided over the coming years.

A second problem, and one that is a little more difficult to clearly identify, is related to the higher taxes that follow excessive government spending. While no one really knows precisely what level of taxation seriously reduces the motivation to seek higher incomes, it is obvious that such effects are growing and spreading.

As these higher taxes reduce incentives to work for higher incomes and profits, they particularly start to reduce that part of the income stream which is the major source of new savings. In the long run, these reduced income streams would reduce the need for capital expansion because of a long-term slowdown in total demand. But in the short run, the effect would be to reduce the supply of savings, thereby contributing to the capital shortage problem.

The third, and perhaps most important problem, arising from rapidly growing government expenditures, is upward pressure on prices. As the growth in tax collections lags behind the growth in spending—the usual political tendency—the Federal Reserve is often forced to finance part of the resulting deficit through excessive monetary creation. And rapid growth in the money supply is generally related to higher rates of inflation.

Between 1950 and 1965, annual changes in government spending stayed in the 6 to 8 percent range, money supply changes were only 2 to 3 percent per year and inflation rates averaged 2 percent or less each year. However, in the next ten years government spending changes jumped to 10 to 12 percent per year and the money supply and prices grew at rates that were double and triple those of earlier years.

Higher inflation rates foster capital shortages in several ways. First, because of the higher inflationary premium, interest rates rise to higher levels. And the resulting inflationary psychology can lead to anticipatory borrowing before interest rates rise even further, and anticipatory buying before prices jump still higher. Thus, the savings flow is lowered while the demand for borrowed funds is raised, creating an artificial capital shortage in the financial markets.

Second, inflation can also distort the apparent size of savings flows. For example, with higher inflation rates, corporate cash flow is larger in dollar terms; however, this higher cash flow is swallowed up by inventory needs. Furthermore, depreciation charges do not cover replacement costs of plant and equipment in a period of rising prices. Thus, real needs are greater than they appear while the supply of funds is smaller.

Third, the use of the available stock of financial capital is also changed during inflationary times. Investors are reluctant to channel funds to the equity or long-term bond markets, preferring instead to purchase short-term debt instruments in order to avoid loss of principal due to rising interest rates. As a

consequence, the sources of permanent capital needed by businesses are unavailable as funds move to the short-term markets—where most goverument borrowing is done.

Fourth, some major users of capital are industries that are regulated by the government. In an inflationary environment, typical regulatory lag often results in a below-market return on investment while the borrowers must acquire their funds in a market where interest rates are determined in an atmosphere of relatively free enterprise. This makes for a fundamental contradiction between a suppressed return on capital and the presumed requirement of raising their capital in free markets.

In short, while unchecked growth in government spending may manifest itself in a capital shortage, the biggest problem is a constant erosion of purchasing power and the continuing encroachment of government on private-sector resources.

Equity capital necessary to long-term growth

Finally, steps must be taken to help U.S. businesses improve the condition of their balance sheets. One of the more important changes would remove the existing bias in favor of debt rather than equity financing.

During the past ten years, U.S. nonfinancial corporations have gone heavily into debt. Of the total funds raised in the last decade, debt accounted for 87 percent with bonds alone representing 35 percent. Equities contributed only 13 percent to business external financing. Reasons for this reliance on debt include: (1) the fact that interest payments are deductible from income taxes while dividends are not, and (2) the difficulty in raising funds in equity markets.

The following table spells out the historical funding:

FUNDS RAISED, PRIVATE DOMESTIC NONFINANCIAL CORPORATIONS

[In billions of dollars]

	Total raised	Equities	Debt	
			Total	Bonds
1965	20.4	....	20.4	5.4
1966	25.3	1.3	24.0	10.2
1967	29.6	2.4	27.2	14.7
1968	31.5	−.2	31.7	12.9
1969	38.9	3.4	35.5	12.0
1970	39.5	5.7	33.8	19.8
1971	46.8	11.4	35.4	18.8
1972	55.3	10.9	44.4	12.2
1973	67.1	7.4	59.7	9.2
1974	77.1	4.1	73.0	19.7
1975	34.2	9.5	24.6	27.0

Source: Federal Reserve Board flow of funds.

One result of this heavy indebtedness has been a sharp long-term decline in corporate liquidity as shown in the following table. This situation is restricting new investment in productive facilities.

CORPORATE BUSINESS SELECTED LIQUIDITY RATIOS

[In percent]

End of period	Quick ratio [1]	Current ratio [2]
1965	35.0	120.7
1970	21.7	103.3
1971	23.4	106.2
1972	21.7	105.7
1973	18.7	101.6
1974: quarter:		
1	18.0	107.8
2	18.1	102.7
3	17.6	100.5
4	19.0	96.9
1975: Quarter:		
1	18.9	99.8
2	20.7	104.0
3	20.6	103.8
4	22.7	103.4

[1] Cash assets/current liabilities.

[2] Current assets (excluding inventories)/current liabilities.

Source: Federal Reserve Board flow of funds.

The erosion of corporate liquidity in the post-World War II period, especially during the past decade, can be attributed in part to the tax provisions that make interest an expensable item, while dividends cannot be expensed. This quirk in tax treatment has resulted in corporate treasurers increasingly using debt financing instead of equity. Unless the bias against equity financing is overcome, corporate liquidity could be stretched beyond the point of repair, thus jeopardizing the viability of all capital markets. The expensing of dividends out of pre-tax earnings is long overdue and is necessary if equities are to be on equal footing with debt instruments in financing future capital expenditures. Just as interest is viewed as a necessary business expense to pay for corporate debt, dividends should be viewed as a necessary expense in attracting equity participation on the part of investors. A related result of heavy indebtedness is increased financial instability and uncertainty during recession. Debt for leveraging purposes is helpful in accelerating economic growth. However, in times of recession, debt-ridden companies find themselves with heavy interest and principal payments in the face of declining income. This problem does not occur with equity financing.

The use of debt financing has also been caused by relatively low values of equity securities and the narrowing of the investor base in those markets. The following table illustrates the pullback of individual investors from equity purchases:

INDIVIDUALS' HOLDINGS OF EQUITY SECURITIES

[In billions of dollars]

	Net purchases		Total holdings (market value)			
			Corporate shares		Mutual fund shares	
	Corporate shares	Mutual fund shares	Amount	Year-to-year change	Amount	Year-to-year change
1960	−1.9	−1.4	379.0	−7.9	17.0	1.2
1961	−1.8	2.1	278.9	99.9	22.9	5.8
1962	−3.8	1.7	416.6	−62.3	21.3	−1.6
1963	−4.3	1.4	489.3	72.7	25.2	3.9
1964	−2.2	2.0	536.9	47.6	29.1	3.9
1965	−5.4	3.2	602.2	65.3	35.2	6.1
1966	−4.6	3.7	542.1	−60.2	34.8	−.4
1967	−7.3	3.0	689.0	146.9	44.7	9.9
1968	−12.3	5.8	812.4	123.4	52.7	8.0
1969	−8.6	4.8	701.7	−110.7	48.3	−4.4
1970	−4.4	2.6	685.9	−15.7	47.6	−.7
1971	−6.5	1.1	777.0	91.1	56.7	9.1
1972	−4.7	−.7	899.3	122.2	59.8	3.1
1973	−6.5	−1.6	697.9	−201.4	46.5	−13.3
1974	−2.0	1.0	487.4	−210.5	35.8	−10.7
1975	−2.5	1.5	[1]	[1]	[1]	[1]

[1] Not available.

Source: Federal Reserve Board, flow of funds.

Although individuals' total holdings of equity have risen over the years with stock market values, these investors have been net sellers of stock since the late 1950s. This is all the more significant because this investor category contains trust accounts, foundations, and other nonprofit organizations. Some of the slack has of course been picked up by pension funds and other institutional investors, but liberalization of tax laws, especially concerning capital gains, could help bring individuals back to the stock market. Raising equity capital would be greatly facilitated in such an environment.

In summary, the existing tax structure has contributed to overreliance of business on debt capital. This decreases corporate liquidity and flexibility and leaves business more vulnerable in times of recession. The economy as a whole would benefit from a healthier atmosphere for raising equity capital. This would be enhanced by removing the double taxation of dividends and liberalizing capital gains taxes.

Senator MONDALE. Our next witness is John H. Filer, chairman of Aetna Life & Casualty Co.

STATEMENT OF JOHN H. FILER, CHAIRMAN, AETNA LIFE & CASUALTY CO., ACCOMPANIED BY JOHN J. CREEDON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL OF THE METROPOLITAN LIFE INSURANCE CO.; AND MORTIMER CAPLIN OF THE FIRM, CAPLIN & DRYSDALE

Mr. FILER. Mr. Chairman, I am John Filer, and I am chairman of the Aetna Life & Casualty Co. of Hartford, Conn.

I am speaking today on behalf of the Aetna and 11 other life insurance companies, large and small, stock and mutual, which with their affiliates also write a variety of other kinds of insurance.

With me today is John Creedon, senior vice president and general counsel of the Metropolitan Life Insurance Co., and on my left, Mortimer Caplin of the firm Caplin & Drysdale, a Washington law firm.

I will summarize our position very briefly and ask that our written statement be made a part of the record.

Senator MONDALE. Very well.

Mr. FILER. We are supporting an amendment to the Code to repeal the present rule which prevents life insurance companies from joining in consolidated tax returns with their property-casualty insurance affiliates or other corporate affiliates.

We believe this amendment, which is reflected in S. 2985 and H.R. 12126, is necessary for two reasons, (a) because it is sound tax policy which will correct the discrimination that has existed for 18 years after the historical reasons for it have disappeared, and (b), because it is sound public policy, which will help to mitigate the serious social and economic problems which now plague the insurance industry as well as the public.

First with respect to the tax policy issues: Permitting corporations with common ownership to file consolidated returns is the general rule in our tax system. Thus, this legislation would not give any special treatment to life insurance companies. It would give them the same treatment which is available to virtually every other corporation in the country. Furthermore, consolidation recognizes business realities. As stated by this committee as long ago as 1918, and I quote: "The principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both for the taxpayer and to the Government."

Prior to 1958, life insurance companies were taxed solely on investment income, excluding capital gains, and this precluded consolidation of life companies with nonlife companies since the latter were generally taxed on a total income basis.

The 1959 Life Insurance Company Taxation Act adopted a total-income approach for life company taxation and, therefore, it is now feasible to consolidate life and nonlife companies, but it is not permitted under specific provisions of the present Internal Revenue Code.

The principal advantage of consolidation, of course, is that it allows current losses of one affiliate to be offset against profits of another. This offset is now permitted for a broad variety of corporations which, like life insurers, are subject to specialized tax provisions. Thus, other

types of corporations can consolidate with their property-casualty affiliate and it makes no sense to preclude a life insurance company from doing so as well.

State statutes normally require separate corporations for life and property-casualty operations. So, although forced to incorporate separately, these companies actually function as a single business unit being under common ownership and control. They are separate corporately to protect the policyholders from risks of different types of business. But in many instances they report their financial results as a single consolidated unit, are served by many of the same agents, and use the same actuarial, accounting and claims support. Investment management and overall executive direction are also centralized. So it is clear that an integrated group such as this is a single business unit and should be permitted to be taxed under the normal consolidated return rules.

Turning from tax policy to public policy, it seems to us that the public has a clear stake in this measure.

The insurance industry today is facing a very real capacity shortage in the property-casualty area. Rising claim costs, largely the product of inflationary pressures and increased claims-consciousness, have created severe problems. For the past 2 years most property casualty companies have incurred substantial losses with resulting reductions of surplus. In fact, the prospect of insolvency exists for some companies. In any event, the industry as a whole is in a weakened capital position compared to just a few years ago.

More and more the public has come to believe that insurance is one of its basic rights and indeed insurance is often a necessity. Our ability to serve these insurance needs is the greatest single problem facing the casualty-property insurance business today. The capacity of a company to write insurance depends directly on its surplus. As claims costs have risen faster than premium income increases, surpluses have diminished and therefore so has capacity.

Because of this capacity crisis, insurers are not now fully able to serve the needs of the country for insurance coverage. They must control their premium volume, they must be more stringent in their underwriting, they must insist on higher deductibles and they must write shorter term policies, and this is in fact what they are doing.

Permitting consolidated returns by the companies will not in and of itself solve the capacity problem but it will help substantially. The tax savings resulting from any loss would accrue directly to the property-casualty companies with a favorable impact on their capacity.

It seems to us there are other public benefits as well. First of all in the area of innovation and competition. our changing economy is generating new demands for insurance coverage. Fairly recent examples are fiduciary liability coverage under the requirements of ERISA, municipal bond guarantee insurance, some forms of crop insurance and others. It is crucial that our private system respond to needs such as these. By assuring that the losses from the introduction of new insurance products will be promptly recognized like those of any other new business venture, consolidation will help make possible the capacity and creativity we need from the industry.

Finally, there is the area of investment stability; the property-casualty insurance business is a cyclical one alternating between profits

and losses. The fact that consolidation is barred in the industry today leads to undesirable short-term swings in investment policy. One example is the switch from stocks to taxable bonds. Also State and municipal bonds become less attractive, which operates to the detriment of Government entities in need of financing. The amendment would make possible a more consistent investment policy and help maintain more stable capital markets, a goal desired by both private and governmental borrowers.

While the impact of the bar to consolidation on the casualty industry is the problem that we face today, the issue is a general and continuing one. In other conceivable circumstances, such as a significant unfavorable shift in mortality, due for example to a serious epidemic or disaster, it would well be the life insurance companies, not the casualty companies that are hampered by the ban on consolidation. We are not looking for short-term tax advantage but a long-term solution to problems.

In summary, it seems to us the bill corrects a tax inequity; simultaneously it helps to alleviate a serious social and economic problem. Such a combination is rare. We deeply hope for your favorable action this year.

Senator MONDALE. Thank you very much.

Senator Ribicoff?

Senator RIBICOFF. Mr. Chairman, first I would like to point out that not only is Mr. Filer an outstanding insurance executive, but without question one of the most public-spirited men in the State of Connecticut, and I am delighted to see you here with your colleagues, Mr. Filer.

I am just curious, what other business corporations with common ownership in the United States are prevented from filing consolidated tax returns? I don't recall any——

Mr. CAPLIN. Senator, I am Mortimer Caplin, representing with our firm, Mr. Filer, and the ad hoc group of insurance companies.

Consolidation is the norm. Only a handful of corporations are not permitted to consolidate. They are essentially tax-exempt organizations. For example, tax-exempt organizations, per se, are not permitted to consolidate; a foreign corporation which is generally not subject to U.S. tax is not permitted to consolidate; nor are real estate investment trusts which are essentially nontaxable.

And DISC corporations, because again they are essentially nontaxable, cannot consolidate with the rest.

But aside from them, you have very disparate companies which are permitted to consolidate. For example, a cooperative could consolidate. A Western Hemisphere trading corporation, which is not categorized as a foreign corporation, could consolidate.

A bank could consolidate. Natural resources companies could consolidate; personal holding companies, too. So really what the insurance industry is asking is that it be given equal treatment and not be artificially carved out.

Senator RIBICOFF. For the record Mr. Caplin, I would appreciate it if you would file for the record those corporations with common ownership which are prevented from filing consolidated returns outside the insurance industry, with a short explanation of why or the philosophy of why they are prevented from filing.

Mr. CAPLIN. We will be very happy to do that.
[The information referred to follows:]

CORPORATIONS EXCLUDED FROM FILING CONSOLIDATED RETURNS

Corporations excluded from filing consolidated returns, other than insurance companies, are either (1) completely exempt from U.S. tax, (2) foreign or possession corporations which are taxed only on income effectively connected with the U.S. or U.S. source income; or (3) not subject to tax because they are in substance treated as "conduits" for their shareholders (that is, if certain distributions or other rules are met their income is not taxed at the corporate level). Specifically, the kinds of corporations, other than life insurance companies and mutual property-liability insurance companies, presently barred by section 1504 (b) from joining in groups filing consolidated returns and the reason for their exclusion are as follows:

Excluded corporations	*Rationale for exclusion*
(1) Corporations exempt from taxation under § 501 (charities, unions, social clubs, etc.).	Tax exempt.
(2) Foreign corporations	Tax exempt, except for income effectively connected with the U.S.[1]
(3) So-called "possessions" corporations, as described in § 931.	Tax exempt, except for U.S. source income.
(4) China Trade Corporations[2]	Conduit.
(5) Regulated investment companies (i.e., mutual funds).	Do.
(6) Real estate investment trusts (i.e., "REITS").	Do.
(7) Domestic international sales corporations (i.e., "DISCs").	Do.

Not a single one of the above 7 corporations is taxed on their total income, which is the case for insurance companies since their tax treatment was extensively revised in 1959 (for life companies) and 1962 (for mutual property-liability companies).

[1] A foreign corporation also acts as a conduit for its U.S. shareholders for subpart F income and foreign personnel holding company income.
[2] H.R. 10612 would repeal the tax benefits of such entities; if repealed, such corporations would become includable corporations.

Senator RIBICOFF. Of course, one of the problems we have, Mr. Filer, is that there are many worthwhile requests for different tax treatment, and everybody is going to ask the question, "What is the revenue impact of this bill?" I think in all fairness I should ask that question. Have you any idea what the revenue impact of this bill would be?

Mr. CAPLIN. Again, Senator, I would be glad to answer.

The Treasury and the Joint Committee staff are working together and looking at that, and we are cooperating with them. We have made an attempt to make our best possible estimate through circularizing a number of insurance companies. We believe that for 1976 this bill—if it were made effective as drafted, January 1, 1976—would result in an immediate loss. I underscore "immediate" because I am going to qualify that. In 1976, an immediate loss of $90 million. In 1977, it would be $41 million. In 1978, it would be $44 million.

Now, the reason why I underscore "immediate" is because everyone is agreed—including the Treasury and the Joint Committee estimator—that this is virtually all a matter of timing and that the overwhelming portion of these figures, the so-called revenue loss figures, will be used up as an offset against future income. In brief, over 90

percent of these losses will in effect be recaptured by the companies over a period of time.

Today, they do this by generating taxable income as they see that they have some revenue losses on the books: among other things, they might acquire profitable businesses or shift their investment portfolio. Mr. Filer could elaborate on how that is done, to generate income to be used as an offset against the revenue loss.

This may not be good economics, but it is good tax planning that they are forced into.

Secondly, so far as this revenue loss is concerned, Senator Mondale has been doing some very important work in his Budget Committee in connection with tax expenditures. Now, consolidation is not regarded as a tax expenditure. It is a norm. It is a part of taxable income as considered normative. In contrast tax expenditures are deviations from the norm—preferences or special treatment. So again, it is difficult to regard the proposed legislation as creating any sort of real revenue loss.

Finally, as Mr. Filer pointed out, the industry is looking for a permanent solution to put it on a parity with all other corporations. We are not looking for any special benefits. We want to be able to function on a day-to-day basis without having to make artificial investment decisions or distorted ones. They are also prepared to have transition rules that would not result in heavy immediate revenue losses—provisions for phasing into the legislation, perhaps not 100-percent benefit under the first year, perhaps some fraction of that benefit, so that this industry could have a long-range permanent solution. We would be very happy to work on easing any initial impact on the budgetary process.

Senator RIBICOFF. I'll have some more questions when my turn comes again.

Senator HANSEN. I have none, so proceed.

Senator MONDALE. Why don't you proceed?

Senator RIBICOFF. I am trying to follow this. Now, maybe Mr. Filer or you could respond.

Mr. CAPLIN. Right.

Senator RIBICOFF. But taking the first 3 years and looking to a period we hope that the casualty companies won't always be a loss-producing part of the insurance industry. The time could come that a consolidation would bring in more money to the Treasury than less money. Isn't that true?

Mr. CREEDON. May I respond to that, Senator?

I think you are exactly right. Just to take an illustration. If a company had a $1 million tax loss which it could offset against income on its life side, it would offset it and pay no income tax on the $1 million income on the life side. But if it had a $2 million profit the next year, it would pay income tax on the $2 million profit. Now, if you did not consolidate, it would have a $1 million tax loss this year which it would offset against the $2 million profit next and pay income tax only on $1 million next year. So I think what we are talking about here is simply a deferral rather than a permanent loss. This is the point Mr. Caplin made and I think it is a deferral with respect to 90 percent of the figures that he mentioned.

Senator RIBICOFF. I have been reading in the press, it is the national press, not just the Washington press, of GEICO, which must cover many, many people in this area, and the troubles that casualty companies are suffering.

I think there isn't a Senator who isn't getting letters from his consituents talking about the cancellation of his automobile liability policies.

And, of course, it is generally known that casualty companies are having problems. I won't say "are in trouble," but they have all got problems.

What are the causes of these problems?

Mr. FILER. Two causes, principally. It is terribly difficult in an inherently inflationary economy under the system of insurance that we have had to avoid a substantial time lag in the achievement of adequacy of rates through the regulatory processes of rate filings. You use historical data, and by the time you have the rate increase approved and put it into effect as policies renew, it takes 6 months, or 1 year for the premiums to increase and so there is an inherent lag. That is one problem.

We have had a change in claims consciousness in this country, the medical malpractice problems and automobile coverage problems are clear. The potential of product liability problems, unavailability of coverage, are clear. The public believes it has a "right to reimbursement" and the system is quite costly. And you have had a very substantial increase in claim costs.

The automobile insurance business had a particularly difficult time because when wage-price controls came off the small businessman was relieved first. The body repairman raised his prices. When the prices for automobile crash parts were increased, they were increased very substantially. Medical care costs came out from under controls and a very substantial escalation of inflation developed. This system is just not able to accommodate to it and, therefore, 1975 really was the worst year in the history of the insurance industry.

Senator RIBICOFF. Well, we have a very substantial public interest here, that if you have a consolidated return some of the more prosperous sides of the insurance business would be able to prop up the weak portions of the business, which are the casualty and automobile insurance segments of the industry.

Mr. FILER. I think it is in the public interest for the market, in the private sector, for people who need all lines of property-casualty coverage to get it. This is one way to help build and maintain the capacity of the property-casualty companies. In our company we don't lose tax-loss carryforwards, we use them up in a shift in investment policy. If we were able to consolidate, under statutory accounting, which is the accounting that determines how much surplus we have to support our business, we would immediately get an increase in surplus in our casualty-property companies through using the tax consolidation mechanism rather than waiting and using it through the loss carryover provisions through investment income.

So it would be a very clear direct increase in our surplus and permit us, frankly, to take more risk than would otherwise be the case.

Senator RIBICOFF. Let me ask you: In the past I understand that there was some concern expressed by some of the small casualty companies—that if this were done they would be in a bad competitive position. Does that pertain? Is there an answer to that?

Mr. FILER. Perhaps I might comment this way, Senator:

Since the bill was first drafted there have been a number of discussions and a number of changes and a great number of discussions within the industry. Some opposition that existed has disappeared. Some of the companies that didn't see any particular benefit and had some question as to the appropriateness of this bill have decided on a position of neutrality. They are no longer involved. I think it is fair to say there is much clearer understanding today of the need for this bill and how the provisions would operate. You can always make the theoretical argument that this could produce increasing competition and, therefore, be difficult for some companies. I happen to believe, however, that something that does open competition and does increase competition is in the public interest rather than the contrary. But I think to the extent that this makes each company in the situation where you have a life and nonlife affiliate better able to compete, I think that is in the public interest.

Senator RIBICOFF. My feeling is that there is not much problem here when it comes to the element of fairness to allow this industry to file a consolidated return the same way that every industry can file a consolidated return.

I was interested in your suggestion, Mr. Caplin, about the recognition of the revenue loss, which we are all going to struggle with in marking up the tax bill, one way or another, that there might be a way of phasing this in over a few years. I wonder if I could suggest—and I make this open suggestion—that the Treasury and the Joint Committee on Taxation and yourself might meet to see if you could work out a formula that would be acceptable to the Treasury, the Joint Committee on Taxation, and your industry?

I think this is a sound suggestion and since you have made it I would ask you that you try to work this out.

Mr. CAPLIN. I think there are some representatives here from the Joint Committee staff and we would be very happy to work with them and Treasury, too, on some transition rules.

Senator RIBICOFF. I think that the insurance industry in the casualty field has become so important when we consider, as I understand, the many casualty companies that are in such serious trouble, and I imagine one of the factors of having some life companies take over some casualty companies will depend on whether they can file a consolidated return or not?

Mr. CAPLIN. Yes, and there is this to be recognized: Today two life companies can file a consolidated return, and the Internal Revenue Service and Treasury are working on regulations to implement that.

But a life and a casualty company cannot file.

Senator RIBICOFF. Even though they have the same ownership?

Mr. CAPLIN. Yes. Furthermore, an industrial corporation that controls a casualty company—there are many of them—can file a consolidated return.

Senator RIBICOFF. I did not know that. In other words——

Mr. CAPLIN. For example, Sears, Roebuck, which owns All State, can file a consolidated return.

Senator RIBICOFF. Then I think it is very important for the record to have a list of industrial companies that own a casualty company that can file a consolidated return. This is the first I have known that they can file a consolidated return, but a life company cannot.

Mr. CAPLIN. We will be happy to do that.

Senator MONDALE. Very well, that will appear in the record.

Thank you very much.

[The material referred to and the prepared statement of Mr. Filer follows:]

STATEMENT OF JOHN H. FILER, CHAIRMAN, AETNA LIFE & CASUALTY

SUMMARY OF PRINCIPAL POINTS

1. Elimination of the bar to life insurance companies filing consolidated income tax returns with property-casualty and other non-life affiliates is both sound tax policy and sound public policy.

2. *Tax policy:*

A. Life companies and their affiliates, though often forced to incorporate separately by state law, operate as fully integrated economic units. The consolidation privilege should be available to reflect this business reality. The privilege is already available to virtually every other type of corporation, including many with tax rules as specialized and complex as those for life companies.

B. Since 1958, life insurance companies have been taxed on their total income, so they are fully compatible members of a consolidated group, and the historical basis for the exclusion no longer exists.

C. Consolidation of life and non-life companies is fully feasible under general consolidation principles, which treat each member as a distinct entity, whose separate taxable income is calculated in accordance with its own method of accounting, subject to adjustment of certain specified items on consolidation.

3. *Public policy:*

A. The industry faces a severe capacity crisis in the property-casualty field, aggravated by the inability of a life-company's casualty affiliate to use losses currently for tax purposes.

B. Consolidation would ease this capacity problem because the tax saving to the group would be allocated to the property-casualty company experiencing the loss, reducing the impact of the loss on its surplus, and thereby increasing its insuring capacity.

C. Permitting consolidation would also promote innovation in the industry by assuring prompt recognition of losses on new types of insurance risks.

D. Investment stability would be promoted.

4. In summary, the measure corrects an unjustifiable tax inequity and simultaneously eases a serious economic and social problem. Such a combination is rare, and repeal of the ban on consolidation should be included in any tax measure reported by this Committee this year.

STATEMENT

My name is John H. Filer. I am Chairman of the Aetna Life & Casualty. I am speaking on behalf of an ad hoc group of twelve life insurance companies—large and small, stock and mutual—that are supporting an amendment to the Code to repeal the present rule which prevents such companies from joining in consolidated tax returns with their property-casualty insurance affiliates or other corporate affiliates.[1]

[1] A list of the life insurance companies most active to date in supporting the bill is attached. The bill would also repeal a similar ban on consolidated filing by mutual casualty insurance companies taxed under section 821. Stock casualty insurance companies taxed under section 831 have been permitted to file consolidated returns with other corporations [other than life or mutual casualty] since 1941.

This amendment, reflected in S. 2985 and H.R. 12126, is necessary—

Because it is sound tax policy, correcting a discrimination that has existed for 18 years after the historical reasons for it have disappeared, and

Because it is sound public policy, mitigating a serious social and economic problem now plaguing both the insurance industry and the public.

I. SOUND TAX POLICY

Permitting corporations with common ownership to file consolidated tax returns is the general rule in our tax system. Thus, this legislation would not give any special treatment to life insurance companies. It would do no more than extend to them a privilege which is available to virtually every other corporation in the country.

Prior to 1958, the Federal income taxation of life insurance companies was based solely on investment income, and even then excluding certain forms of investment income, such as capital gains. As a result of the 1959 Life Insurance Company Taxation Act, which rewrote the law for the taxation of life companies, the Congress subjected all elements of a life company's income to tax under a formula designed to measure its total income on an annual basis. Thus, consolidation of life and nonlife companies is now entirely feasible under the normal consolidated return rules. Such rules treat each member as a separate and distinct entity which computes its own separate taxable income in accordance with its own method of accounting subject to adjustment of certain specified items upon consolidation.[2]

Under current law, consolidation is permitted for a broad variety of kinds of corporations. Like Life Insurance companies, many of them are subject to highly specialized tax provisions, for example, natural resource corporations, banks, Western Hemisphere Trade corporations, cooperatives, and stock property-casualty companies. This means that any corporation other than a life (or mutual property casualty) insurance corporation can acquire or establish a property-casualty business and can consolidate—the principal advantage being the ability to offset current profits against current losses. It simply makes no sense to encourage this sort of diversification, while setting up an artificial barrier to the more natural affiliation of life insurance and property-casualty insurance corporations.

Even apart from the issue of discrimination, permitting consolidation by life companies and their affiliates is good tax policy because it corresponds to economic and business reality. The policy underlying consolidated returns was stated by this Committee as long ago as 1918:[3] "The principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both for the taxpayer and to the government."

From a business viewpoint, it is certainly the case that a life insurance company and its affiliates are a single "business unit." They report their financial results to shareholders as a single consolidated unit. The life insurance and the casualty and other insurance elements of our companies are served by the same network of agents. They receive actuarial, accounting, and claims support from the same staffs, and investment management and overall executive direction are centralized. It is clear that an integrated group such as this should be taxed as a single business unit under the normal consolidated return rules.

Because of state regulatory requirements, life insurance operations and property-casualty operations normally must be conducted through separate corporations rather than as divisions of a single corporation. In short, though forced to incorporate separately, we function as a business unit, and we think the case for applying the normal consolidated tax rules is compelling.

II. SOUND PUBLIC POLICY

There is an urgent public interest in this measure. As this Committee is aware, these are difficult times for our economy, times which raise real questions about the ability of our institutions to respond to the challenges we face from inflation, recession, technology and rising social needs. This challenge confronts us in the insurance industry as well, and this legislation will help us meet the challenge.

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[2] The many technical and policy reasons supporting the suggested Code amendment are discussed in detail in a series of memoranda previously submitted to the Joint Committee Staff and the Treasury Department by our attorneys, Caplin & Drysdale. With the Committee's permission our attorneys will submit for the record a single memorandum consolidating the various legal discussions.

[3] S. Rep. No. 617, 65th Cong., 3d sess. 9 (1918).

The capacity shortage

The insurance industry today faces a crisis in the property-casualty area. Rising claims costs, largely the product of inflationary pressures and the increased scale and frequency of claims, have created severe problems for the industry. Many property-casualty companies have incurred substantial losses, and the prospect of near insolvency exists for certain companies.

The shortage of capacity to satisfy the insurance needs of the public is perhaps the greatest single problem facing the property-casualty insurance business. The capacity of a company to write insurance depends on its ability to cover the risk shifted from the policyholder to the insurance company; this, in turn, depends ultimately on its surplus. As claims cost rise faster than premium income increases, underwriting losses develop, surplus is diminished, and so is capacity. The efforts to maintain or increase capacity can take numerous forms, such as larger deductibles, more reinsurance abroad with unfavorable balance of payments effects, cutting back on new customers, cancellation of old customers, shorter term policies and renewals, and even refusal to write important classes of insurance coverage, such as professional malpractice insurance. In short, the capacity crisis means that insurers are not fully able to serve the needs of the country for insurance coverage.

Obviously the bar to consolidation is not the source of the capacity problems, and permitting consolidated returns by the companies would not solve it entirely. But it is indisputable that the present bar to consolidate return filing by life insurance companies contributes to the industry's capacity difficulties.

There is an urgent public interest in this measure. As this Committee is aware, these are difficult times for our economy, times which raise real questions about the ability of our institutions to respond to the challenges we face from inflation, recession, technology and rising social needs. This challenge confronts us in the insurance industry as well, and this legislation will help us meet the challenge.

Our amendment would mitigate the problem because the tax saving resulting from the loss offset privilege permitted by consolidation would accrue directly to the property-casualty company experiencing the loss, since state regulatory authorities require that tax benefits be allocated to the particular corporation within a group whose loss was responsible for the saving. Thus, permitting consolidation with a profitable life insurance company would result in immediate reflection of the tax benefit in the loss casualty company's surplus, with a concommitant favorable effect on its capacity.

Other public benefits

The general public benefits of the change are not limited to capacity, but include relief of other current industry problems:

1. *Innovation and Competition.*—Our changing economy is generating new demands for insurance coverage. For example, articles have recently appeared in the Wall Street Journal concerning the potential of "all risk" crop insurance and product liability protection. It is crucial that our private economic system respond to these needs. By relieving the pressure on capacity and by enhancing competition (by assuring that the losses of a new subsidiary can be promptly recognized like any other new business venture) consolidation will help make possible the capacity and creativity we need from the industry.

2. *Investment Stability.*—The property-casualty insurance business is a cyclical one alternating between profit and loss periods. In order to assure utilization of the losses within existing carryover periods where consolidation is barred, sufficient taxable income must be generated during the applicable loss carryover periods. This leads to short term swings in investment policy. An example is a change from stocks to taxable bonds. Also state and municipal bonds become less attractive. The amendment would regularize investment policy and help maintain more stable capital markets.

III. OUR GOAL—LONG-TERM INSURANCE

We see the elimination of the current discrimination against insurance companies as an important long range improvement of our tax law. The impact of the bar to consolidation on the casualty element of the industry is the problem today, but the issue is a general and continuing one. Another round of inflataion could intensify the problem for the casualty insurance business.

In other conceivable circumstances, e.g., a significant unfavorable shift in mortality rates, due for example to another influenza epidemic, it could well be the life insurance companies, not the casualties, that are hampered by the consolidation bar. This bill will provide some insurance against such results.

In any circumstances, it is clear that harmful and artificial effects will result from a tax rule which prevents current recognition of the losses of part of an integrated business unit.

* * * * * * *

In sum, the bill corrects a tax inequity and simultaneously mitigates a serious social and economic problem. Such a combination is rate, and we strongly urge that the proposed measure be included in any tax bill the Committee reports this year.

AD HOC GROUP SUPPORTING S. 2985

Aetna Life & Casualty, 151 Farmington Avenue, Hartford, Conn. 06115.
CNA Financial Corp., CNA Plaza, Chicago, Ill. 60685.
Connecticut General Life Insurance Co., Hartford, Conn. 06115.
The Equitable Life Assurnace Society of the United States, 1285 Avenue of the Americas, New York, N.Y. 10019.
Fidelity Mutual Life Insurance Co., P.O. Box 7318, Philadelphia, Pa. 19101.
IDS Life Insurance Co., IDS Tower, Minneapolis, Minn. 55402.
Metropolitan Life Insurance Co., 1 Madison Avenue, New York, N.Y. 10010.
Penn Mutual Life Insurance Co., Independence Square, Philadelphia, Pa. 19105.
Prudential Insurance Co. of America, Prudential Plaza, Newark, N.J. 07101.
Reserve Life Insurance Co., 403 South Akard Street, Dallas, Tex. 75203.
State Mutual Life Assurance Co. of America, 440 Lincoln Street, Worcester, Mass. 01605.
The Travelers Insurance Co., 1 Tower Square, Hartford, Conn. 06115.

PARTIAL LIST OF INDUSTRIAL CORPORATIONS WITH PROPERTY/LIABILITY AFFILIATES POTENTIALLY ABLE TO FILE CONSOLIDATED INCOME TAX RETURNS

1. Agway, Inc.:
   Agway Insurance Co.
2. Ahmanson, H. F., & Co.:
   Mohawk Insurance Co.
   Stuyvesant Insurance Co.
   National American Insurance Co.
   Trans-oceanic Insurance Co.
   National American Insurance Co. of California.
3. American Express Co.:
   American Automobile Insurance Co.
   American Insurance Co.
   Associated Indemnity Corp.
   Fireman's Fund Insurance Co.
   National Surety Corp.
   Fireman's Fund Insurance Co. of Texas.
   National Surety Corp. of California.
4. American Financial Corp.:
   American Empire Insurance Co.
   American National Fire Insurance Co.
   Agricultural Insurance Co.
   Constellation Reinsurance Co.
   Great American Insurance Co.
   American Continental Insurance Co.
   Republic Indemnity Co. of America.
5. Anderson Clayton and Co.:
   Ranger Insurance Co.
   Pan American Fire & Casualty Co.
   Pan American Insurance Co.
   Pan American Thrift Insurance.
   Ranger-Allied Underwriters.

Ranger County Mutual Insurance Co.
Ranger Insurance Co.
Ranger Lloyds.

6. Armco Steel Corp.:
   Belefonte Insurance Co.
   Compass Insurance.
   General Fire & Casualty Co.
7. Avco Corp.;
   Balboa Insurance Co.
   Meritplan Insurance Co.
   Newport Insurance.
8. Baldwin & Lyons, Inc.:
   Protective Insurance Co.
9. Bausch and Lomb, Inc.:
   Soflens Insurance Co.
10. Beneficial Corp.:
    American Centennial Insurance Co.
11. Berkshire-Hathaway, Inc.:
    Cornhusker Casualty Co.
    Home & Automobile Insurance Co.
    Insurance Company of Iowa.
    Lakeland Fire & Casualty.
    National Fire & Marine Insurance Co.
    National Indemnity Co.
    Texas United Insurance Co.
12. Budget Industries:
    Transnational Insurance.
    Transitional Casualty Insurance.
13. CIT Financial Corp.:
    North American Accident Insurance Co.
    North American Co. for Property and Casualty Insurance.
14. City Investing Co.:
    City Insurance Co.
    Home Insurance Co.
    Seaboard Surety Co.
    Home Indemnity Co.
15. Continental Corp.:
    Boston Old Colony Insurance Co.
    Buckeye Union Insurance Co.
    Commercial Insurance Co. of Newark.
    Continental Insurance Co.
    Fidelity and Casualty Co. of New York.
    Firemen's Insurance Co. of Newark.
    Glens Falls Insurance Co.
    Kansas City Fire and Marine Insurance Co.
    London Guarantee and Accident Co. of New York.
    National-Ben Franklin Insurance Co. of Illinois.
    National Reinsurance Corp.
    Niagara Fire Insurance Co,
    Pacific Insurance Co.
    Phoenix Assurance Co. of New York.
    Seaboard Fire and Marine Insurance Co.
    First Insurance Co. of Hawaii, Ltd.
    Equitable Fire Insurance Co.
    Tokyo Marine and Fire Insurance Co., Ltd.
16. Control Data Corp.:
    American Credit Indemnity Co.
    Calvert Fire Insurance Co.
    Cavalier Insurance Corp.
17. Deere and Co.:
    John Deere Insurance Co.
18. Exxon Corp.:
    Petroleum Casualty Co.
19. Ford Motor Co.:
    American Road Insurance Co.

20. General Electric Co.:
    Manhattan Fire and Marine Insurance Co.
21. General Motors Corp.:
    CIM Insurance Corp.
    Motors Insurance Corp.
22. Gulf and Western Industries, Inc.:
    Emmco Insurance Co.
    Excell Insurance Co.
    Providence Washington Insurance Co.
    Motor Vehicle Casualty Co.
    Providence Lloyds.
    Providence Washington Insurance Co.
    Providence Washington Insurance Co. of Alaska.
    Western Alliance Insurance Co.
    York Insurance Co.
23. Halliburton Co.:
    Highlands Insurance Co.
    Highlands Underwriters Insurance Co.
24. International Bank:
    Northeastern Insurance Co. of Hartford.
    United Security Insurance Co.
25. International Harvester Co.:
    Harco National Insurance Corp.
26. International Telephone and Telegraph Corp.
    Hartford Casualty Insurance Co.
    Hartford Accident and Indemnity Co.
    Hartford Fire Insurance Co.
    New England Reinsurance Corp.
    New York Underwriters Insurance Co.
    Twin City Fire Insurance Co.
    First State Insurance Co.
    Pacific Insurance Co.
    Sentinel Insurance Co.
27. Katy Industries, Inc.:
    Midland Insurance Co.
28. CNA Financial:
    American Casualty Co. of Reading.
    Continental Casualty Co.
    National Fire Insurance Co. of Hartford.
    Valley Forge Insurance Co.
    Transportation Insurance Co.
    Transcontinental Insurance Co.
    CNA Casualty of California.
    CNA Casualty of Puerto Rico.
    Columbia Casualty Co.
    Mid-States Insurance Co.
29. Mobil Oil Corp.:
    Forum Insurance Co.
30. National Distillers & Chemical Corp.:
    Elkhorn Insurance Co.
31. Penney, J. C. Co., Inc.:
    Educator & Executive Insurers, Inc.
32. Reliance Group, Inc.:
    Reliance Insurance Co.
    Commonwealth Land Title Insurance Co. of New York.
33. Sears, Roebuck and Co.:
    Allstate Fire Insurance Co.
    Allstate Insurance Co.
34. Standard Oil Co. (Indiana):
    Imperial Casualty & Indemnity Co.
35. Teledyne, Inc.:
    Argonaut Insurance Co.
    Argonaut Midwest Insurance Co.
    Argonaut Northwest Insurance Co.
    Security National Insurance Co.
    Trinity Universal Insurance Co.

Argonaut Southwest Insurance Co.
Financial Indemnity Co.
Georgia Insurance Co.
Great Central Insurance Co.
Trinity Universal Insurance Co. of Kansas.

36. Textron, Inc.:
Metropolitan Fire Assurance Corp.
Connecticut Indemnity Co.
Security Insurance Co. of Hartford.
Admiral Insurance.
Fire & Casualty Co. of Connecticut.

37. Ticor:
Pioneer National Title Insurance Co.
Title Guarantee Co.
Ticor Mortgage Insurance Co.

38. Transamerica Corp.:
Transamerica Insurance Co.
Premier Insurance Co. of New York.
Automotive Insurance Co.
Countrywide Insurance Co.
Marathon Insurance Co.
Mount Beacon Insurance Co.
Olympia Insurance Co.
Premier Insurance Co.
Riverside Insurance Co.
Transamerica Insurance Co.
Wolverine Insurance Co.

39. Wachovia Corp.:
South State Insurance Co.
Southeastern Fire Insurance Co.

40. Wyly Corp.:
Gulf Insurance Co.

Senator MONDALE. Our final witness today is Mr. LeRoy Johnson, tax manager, Northrup, King & Co.

STATEMENT OF LeROY JOHNSON, CORPORATE TAX COUNSEL, NORTHRUP, KING & CO., ACCOMPANIED BY WAYNE UNDERWOOD, INTERNATIONAL MARKETING DIRECTOR OF ASTA

Mr. JOHNSON. Thank you, Mr. Chairman.

Senator MONDALE. We are very pleased to have you with us to talk about a matter that affects the seed industry and because of that the State of Minnesota.

Mr. JOHNSON. Thank you very much.

Senator MONDALE. You might introduce your colleague.

Mr. JOHNSON. Mr. Chairman, we appreciate this opportunity to make a statement——

Senator MONDALE. Just a moment. Let's have it quiet; a Minnesotan is talking. [Laughter.]

Mr. JOHNSON [continuing]. We appreciate this opportunity to appear before the committee.

My name, as you mentioned, is LeRoy Johnson, corporate tax counsel of Northrup, King & Co., which has its corporate headquarters in Minneapolis. I am appearing here today in behalf of Northrup, King & Co. and the American Seed Trade Associations (ASTA) which is an association of over 500 firms engaged in the processing and distribution of all kinds of seeds for planting.

Appearing here with me today is Mr. Wayne Underwood, international marketing director of ASTA, who is prepared to assist me in

responding to any questions you may have upon the conclusion of oral testimony. I have supplied you with a written statement for the record. In the interest of time, I will attempt to summarize the more important points discussed in the written statement.

It is the position of Northrup, King & Co. and the other members of the American Seed Trade Association that:

1. Agriculture, and the seed industry in particular, needs the tax benefits now provided by the DISC provisions of the Internal Revenue Code if seed exported from the United States is to compete effectively in foreign markets.

2. The incremental approach to limiting DISC benefits is not workable for exporters of seed and many other agricultural products.

3. If agricultural exports become ineligible for DISC benefits, additional qualified investments must be allowed to avoid the taxation of the accumulated profits of DISC's which have been involved in the exportation of agricultural products.

4. If any modifications are to be made to the present DISC provisions of the Internal Revenue Code, they should serve to expand the benefits received from DISC instead of restricting them.

THE EXPORT SEED INDUSTRY

During 1975, approximately $113 million of seed was exported from the United States. Many of the firms involved in exporting seed do so through DISC corporations.

Senator MONDALE. What is the total dollar volume of the seed industry in the United States?

Mr. JOHNSON. Perhaps you could answer that better.

Mr. UNDERWOOD. Mr. Chairman, these are hard figures to come up with.

Senator MONDALE. Just give me an approximation.

Mr. UNDERWOOD. When you talk about the private sector combined, it is difficult, but we think the export volume is something in the range of 10-or-less percent of the total, so we are talking about $1.5 billion, approximately.

Senator MONDALE. I see.

Mr. UNDERWOOD. To $2 billion.

Senator MONDALE. What has been the trend in seed exportation? Is it going up or down?

Mr. UNDERWOOD. It is going up; it has been going up in dollar volume for the last 5 years.

Senator MONDALE. Yes.

Mr. UNDERWOOD. The poundage has been going down the past couple years.

Senator MONDALE. Even with DISC coverage.

Mr. UNDERWOOD. Yes.

Senator MONDALE. OK.

Mr. JOHNSON. Although some firms in the seed trade produce their own seed, most companies enter into contracts for seed production with independent farmers throughout the United States. The total seed production contracted by each such company is based on its estimate of its share of the domestic and foreign market for seed 1 or more

years in the future. Such seed production contracts allow farmers to diversify their production and to produce special-purpose corps destined for domestic and foreign markets.

Once the seed is produced by the farmer, it is cleaned, tested, treated, graded, bagged, and sold by companies in the seed trade. In order to perform these functions, seed companies invest a significant amount of capital into specialized equipment and processing facilities. Such plants are usually located in rural areas where the seed is being produced. The construction and staffing of these plants means additional employment opportunities for those living in rural areas near such facilities. The vast distribution network necessary to move substantial volumes of seed to many markets in time for planting creates numerous additional jobs in the transportation and storage industries.

As the world population increases, so does the need for food. Foreign countries are attempting to meet this need by placing more land into agricultural production. They are also attempting to improve yields from land now in production through the use of modern technology and improved seed varieties. This developing market presents the seed industry with exciting growth potential. Because the climate in the United States is so diverse, seed adaptable to virtually every foreign market can be produced here. If the economic climate of the United States allows the seed industry to remain competitive with foreign seed producers, the U.S. seed trade will make significant contributions to the future U.S. balance of trade and will create many additional export-related jobs.

Although the seed industry anticipates an expanding foreign demand for seed, it is not as certain that seed produced in the United States will retain its competitive position within the market. This skepticism is due to the increased competition the U.S. seed trade is experiencing from foreign-produced seed. Seed produced in or near the market for which it is intended enjoys the obvious competitive advantages of (1) reduced freight cost and delivery time, (2) possible elimination of import and export permits, tariffs and phytosanitary restrictions, and (3) lower cost of production due to lower wage levels.

Significant amounts of Government aid and protection to seed producers in foreign countries pose a substantial additional threat to the ability of seed produced in the United States to remain competitive with foreign-produced seed. For instance, the European Economic Community (EEC) fosters and protects their seed industry by the following means:

(*a*) Direct subsidies to seed producers. A recent study indicated that subsidies paid to grass seed producers within the EEC countries were in the range of 50 percent of the price paid to growers of silimar seed in the State of Oregon. This means that the seed producer in an EEC country can sell his seed for one-half the price of the Oregon farmer and enjoy the same gross revenue. This artificially low priced seed is then allowed to compete advantageously in foreign markets against seed produced in the United States.

(*b*) Restrictive variety lists—the EEC has official variety lists and only seed varieties on the list are approved for marketing within the EEC. Becoming an approved variety is a long, complex, and expensive procedure definitely favoring EEC-bred varieties.

Senator MONDALE. Now, there are a lot of these techniques and policies of the Common Market for disadvantaging foreign competition in seeds within the Common Market. Do we have any similar barriers against European seed manufacturers exporting to the United States?

Mr. UNDERWOOD. No, sir; we don't. We possibly are the easiest trading country in the world in terms of seeds and our industry wants it this way. We encourage free trade in and free trade out. We are the largest exporters of seeds, but we are also the largest importers of seeds.

Senator MONDALE. Do we have a fairly large importation of foreign seed?

Mr. UNDERWOOD. We import about one-fourth the volume that we export.

Senator MONDALE. You are talking about our Nation's importing now about a quarter of what we export?

Mr. UNDERWOOD. Of what we export.

Senator MONDALE. Do American seed companies import seeds for sale here, or is most of our seed produced within the United States?

Mr. UNDERWOOD. Most of our seed for domestic use are produced within the United States. The importation of seed sometimes is the opposite side of the export. We will import—or a foreign country will extend, in other words, Holland will send a certain seed to the United States to be multiplied. It is multiplied here, so coming in it is an import to us. After multiplication it is a much larger volume, and goes back, which is an export. So many of our imports are the mother seed coming in which go back out as exports to a foreign market.

Senator MONDALE. Has your industry sought to complain about Common Market policies?

Mr. UNDERWOOD. Yes, sir; we are into this in the GATT negotiations and we are feeding information into the Technical Advisory Committee for GATT related to these matters.

Of course, we are hopeful that something can be done. Some of our problem here is that the United States in terms of agriculture only has very little to give away. In other words, we have so few restrictions, we have little to give away on our restrictions to get another restriction on.

Senator MONDALE. In other words, there is no trading stock within this industry.

Mr. UNDERWOOD. That is the reason that agriculture does not necessarily want to be separated from industry in the GATT negotiations.

Senator MONDALE. Yes, OK. Now, I have wondered, if we are going to have DISC, why agriculture would be expanded. I am still not persuaded that this is the right step if we are going to have DISC's.

But the two arguments used in the House for the agricultural exclusion in their present bill were: (1) that high foreign demand for agricultural products makes export incentives unnecessary; and (2), that domestic companies cannot relocate agricultural operations overseas, so there is no need to provide incentives to keep firms in the United States.

To what extent are these reasons applicable to the seed companies?

Mr. JOHNSON. These reasons are not applicable to the seed industry. Northrup, King & Co., has historically maintained the posture of

domestic investment of plant facilities and has always wanted to place its stock in the American farmer as opposed to foreign farmers. We are really very concerned as to our ability to maintain this posture in light of what is going on in the world now.

DISC is one of the things that we can look to which provides us with benefits we would not receive if we transferred our production to a foreign country. We have in DISC, a means by which to obtain pre-tax funds to finance our inventory. Financing is a significant problem due to the seasonality of our business.

Historically, Northrup, King has not taken the posture of being active and participating in legislative matters other than those directly affecting the seed industry. Our presence here today, I think, indicates the seriousness with which we view this legislation. Frankly, we see in the House bill several problems that we are not going to be able to live with. I think if the House bill is adopted, we are very likely going to have to start putting emphasis into production and processing facilities outside the United States in many competitive foreign markets.

We can invest 3 million or 6 million into a plant in France or Germany or wherever we feel the market can best be served. We obviously need land. However, there is land available in foreign countries and many foreign countries are more than happy to see our technology and knowledge come in to help them develop their own production capabilities.

Where the seed is produced is where the investment is going to be, it is as simple as that. When we ship a seed out of the United States, it is a finished product. All the labor, cost that makes the seed a usable commodity have been placed in that seed within the United States. We feel it is essential that we are given the same opportunity to make a reasonable profit on it and to be competitive in foreign markets as that given to manufacturers.

Senator MONDALE. Did you or your industry participate at all before the House Ways and Means Committee in their hearings?

Mr. JOHNSON. Our industry did not participate actively in the House hearings.

Senator MONDALE. I am not persuaded the arguments for excluding agriculture are that strong. In other words, if you are going to have DISC's, I don't know why agriculture shouldn't be in it as well as sewing machines, et cetera. But, to the extent the arguments for excluding agriculture are valid, it seems to me that the seed industry—which is really a processing-research area of agriculture—would in theory fit more appropriately in the area that was not excluded from DISC's. You can move; you can relocate elsewhere in another country. As you have just testified, you may have to relocate if DISC is not continued for the seed industry.

Mr. JOHNSON. One of the DISC provisions of the Internal Revenue Code allow the DISC benefits to be applicable where at least 50 percent of the value of the finished product results from manufacturing or processing. Specifically excluded from manufacturing or processing are things like bagging, wrapping, and virtually everything the seed industry does to the seed. Because our industry is based on taking a unit of grain and then making it something that can be planted the major cost is the original grain. Therefore, we can't qualify for this special provision which would allow us to be eligible for DISC benefits.

Senator MONDALE. Yes.

Mr. UNDERWOOD. I would like to make a comment that I think gets us trapped so many times in several phases of agriculture, that is that agriculture is painted with a big brush. I think you are looking at an instance right now when you use the big brush and it doesn't work. The big brush is that agriculture can't move. The land in Iowa will always stay in Iowa. Well, that's true; but the utilization of that land can be changed in all kinds of ways.

In other words, once Northrup, King & Co. or another of our members develops specific agricultural products such as varieties, they then can take those to other parts of the world and use their land.

Senator MONDALE. That is right.

Mr. UNDERWOOD. And the thing that strikes me about this is that most of our companies are not located in the large metropolitan areas, they are out in the country in the medium-sized or smaller cities, they are keeping people employed out of the slums and the ghettos of the city. We are trying to keep these people employed out in the country. So that every one of our companies that closes processing and warehousing facilities to move abroad, will result in these people having to seek other employment. We think this will end up being even urban Congressmen's and Senators' problems and we would rather not see this. We would rather produce at home, if possible.

Senator MONDALE. Senator Hansen?

Senator HANSEN. Mr. Chairman, I am pleased to have heard the testimony of Mr. Johnson, the tax counsel for Northrup, King & Co. That is a name not unfamiliar to Wyoming people, as you gentlemen know.

I think that the points that have been made in support of continuation of DISC for agriculture ought to be persuasive. I would just say that with your home offices in the State of Minnesota, you are fortunate to have the persuasive and articulate chairman as a member of this committee.

Mr. JOHNSON. We are aware of that, Senator.

Senator MONDALE. You have never been more eloquent [laughter].

Senator HANSEN. Thank you, sir.

Senator MONDALE. That wasn't a question: we won't go into that.

Mr. JOHNSON. Mr. Chairman, we would like to emphasize another point and it has to do with the incremental method.

Senator MONDALE. Right, your whole statement will be in the record. Go ahead.

Mr. JOHNSON. Agriculture has a problem relative to methods proposed to limit the benefits of DISC. One of them is the incremental approach suggested by the House, which limits DISC benefits on the basis of the increase in sales volume.

The seed trade is subject to significant fluctuations in value in seed. For instance, the dollar revenue of exported seed has gone up in the past couple of years by 10 percent but our pounds of seed sold was down 24 percent. That is indicative of how significant price changes are. There is no reason to believe that it won't turn around next year and the pounds of seed will go up but our revenues will stay the same or go down. Therefore, if revenues are the only factor considered when imposing limitation of DISC benefits, we are concerned that our benefits will be limited by factors beyond our control.

Senator MONDALE. So, in addition to proposing that you be included back in the DISC provisions, you want to address the incremental problem which deals somewhat differently with your industry than others.

Mr. JOHNSON. That is right. I realize that complicates things. Northrup, King & Co., and I don't have any reason to believe they are unique in the industry, could have very serious problems with DISC continuing to be an incentive to continue exporting seeds from the United States, if the incremental approach is maintained and applied to the seed industry. Manufacturing firms have the advantage over us in that they can predict their cost. They know that if they are going to get a 5, 10 percent increase in labor costs and metals and so on, they have some degree of control over their destiny. Moreover, it is more of a scheduled increase as opposed to one that may be very high 1 year and very low the next.

Mr. UNDERWOOD. The incremental approach is in the House version. This is what will make it very difficult for us in the seed industry. What we really would like to see is some DISC law similar to what is presently in the law which our firms have, although it is not perfect, learned to live with.

Most assuredly, we feel it is not in any one's best interest to isolate agriculture or the seed industry out and treat it separately from other industries.

Senator MONDALE. Thank you very much.

Mr. JOHNSON. Thank you very much.

[The prepared statement of Mr. Johnson follows:]

STATEMENT ON THE CONTINUATION OF D.I.S.C. BY LEROY J. JOHNSON, CORPORATE TAX COUNSEL, NORTHRUP, KING & CO.

My name is LeRoy Johnson. I am the Corporate Tax Counsel of Northrup, King & Co. which has its corporate headquarters in Minneapolis, Minn. I am appearing here today in behalf of Northrup, King & Co. and the American Seed Trade Association (ASTA) which is an association of over 500 firms engaged in the processing and distribution of all kinds of seeds for planting. Appearing here with me today is Mr. Wayne Underwood, international marketing director of A.S.T.A., who is prepared to assist me in responding to any questions you may have upon the conclusion of oral testimony. I have supplied you with a written statement for the record. In the interest of time, I will attempt to summarize the more important points discussed in the written statement.

POSITION ON D.I.S.C.

It is the position of Northrup, King & Co. and the other members of A.S.T.A. that:

1. Agriculture, and the seed industry in particular, needs the tax benefits now provided by the D.I.S.C. provisions of the Internal Revenue Code if seed exported from the United States is to compete effectively in foreign markets.

2. The incremental approach to limiting D.I.S.C. benefits is not workable for exporters of seed and many other agricultural products.

3. If agricultural exports become ineligible for D.I.S.C. benefits, additional qualified investments must be allowed to avoid the taxation of the accumulated profits of D.I.S.C.'s which have been involved in the exportation of agricultural products.

4. If any modifications are to be made to the present D.I.S.C. provisions of the Internal Revenue Code, they should serve to expand the benefits received from D.I.S.C. instead of restricting them.

THE EXPORT SEED INDUSTRY

During 1975 approximately $113 million of seed was exported from the United States. Many of the firms involved in exporting seed do so through D.I.S.C. corporations.

Although some firms in the seed trade produce their own seed, most companies enter into contracts for seed production with independent farmers throughout the United States. The total seed production contracted by each such company is based on its estimate of its share of the domestic and foreign market for seed one or more years in the future. Such seed production contracts allow farmers to diversify their production and to produce special purpose crops destined for domestic and foreign markets.

Once the seed is produced by the farmer, it is cleaned, tested, treated, graded, bagged and sold by companies in the seed trade. In order to perform these functions, seed companies invest a significant amount of capital into specialized equipment and processing facilities. Such plants are usually located in rural areas where the seed is being produced. The construction and staffing of these plants means additional employment opportunities for those living in rural areas near such facilities. The vast distribution network necessary to move substantial volumes of seed to many markets in time for planting creates numerous additional jobs in the transportation and storage industries.

As the world population increases, so does the need for food. Foreign countries are attempting to meet this need by placing more land into agricultural production. They are also attempting to improve the yields from land now in production through the use of modern technology and improved seed varieties. This developing market present the seed industry with exciting growth potential. Because the climate in the United States is so diverse, seed adaptable to virtually every foreign market can be produced here. If the economic climate of the United States allows the seed industry to remain competitive with foreign seed producers, the United States seed trade will make significant contributions to the future United States balance of trade and will create many additional export related jobs.

Although the seed industry anticipates an expanding foreign demand for seed, it is not as certain that seed produced in the United States will retain its competitive position in the market. This skepticism is due to the increased competition the United States seed trade is experiencing from foreign produced seed. Seed produced in or near the market for which it is intended enjoys the obvious competitive advantages of (1) reduced freight cost and delivery time, (2) possible elimination of import and export permits, tariffs and phytosanitary restrictions (3) and lower cost of production due to lower wage levels.

Significant amounts of government aid and protection to seed producers in foreign countries pose a substantial additional threat to the ability of seed produced in the United States to remain competitive wih foreign produced seed. For instance, the European Economic Community (E.E.C.) fosters and protects their seed industry by the following means:

(1) Direct subsidies to seed producers—A recent study indicated that subsidies paid to grass seed producers with the E.E.C. countries were in the range of 50% of the price paid to growers of similar seed in the State of Oregon. This means the seed producer in an E.E.C. country can sell his seed for one-half the price of the Oregon farmer and enjoy the same gross revenue. This artificially low priced seed is then allowed to compete advantageously in non-E.E.C. foreign markets against seed produced in the United States.

(2) E.E.C. Reference Prices—The E.E.C. establishes a minimum price at which certain seed may be sold in E.E.C. countries. This protects its seed producers from competition from imported seed.

(3) E.E.C. Compulsory Certification—The E.E.C. requires most varieties of seed be produced under certification programs before they are eligible to be imported into E.E.C. countries. When the variety is not normally produced under such certification programs in the United States, this additional requirement increases the cost of producing the seed and results in it being less competitive with seeds produced in the foreign countries.

(4) Restrictive Variety Lists—The E.E.C. has "official variety lists" and only seed varieties on the list are approved for marketing within the E.E.C. Becoming an approved variety is a long, complex and expensive procedure definitely favoring E.E.C. bred varieties.

The presence of such extensive government assistance and competitive advantages provide significant incentives to companies to transfer the production of seed destined to foreign markets from the United States to foreign countries. Some members of ASTA have already been forced, by competition from foreign produced seed, to commence producing and processing seed in foreign countries. As a result, capital investment, employment opportunities, and export profits which otherwise would have benefited the economy of the United States were not realized.

DISC AND THE SEED INDUSTRY

Although there exist many competitive advantages to foreign seed production, ASTA believes most of its members would prefer to produce the seed needed for foreign markets within the United States if it remains economically feasible to do so. The D.I.S.C. provisions of the Internal Revenue Code are regarded by many members of ASTA as an important consideration in evaluating their relative competitive position in the foreign marketplace. The source of financing provided by D.I.S.C. during periods of high interest rates and tight money is an important benefit to companies and is not regarded lightly by those involved in the seed trade who must, due to the highly seasonal nature of our business, finance large volumes of inventory for extended periods during the year.

EFFECT OF H.R. 10612

It is, therefore, with understandable alarm that companies in the seed trade view the provisions of H.R. 10612. If this bill is allowed to become law in its present form, it would exclude seeds and other agricultural products from the benefits of the D.I.S.C. provisions of the Internal Revenue Code. Even if agricultural products were not specifically excluded by the bill, the incremental approach to limiting D.I.S.C. benefits would have the effect of excluding many agricultural products from D.I.S.C. benefits. The reason for this is that prices of seed and other agricultural exports fluctuate significantly from year to year depending on the yields attained by the farmers. As a result, a company could achieve a substantial increase in the physical volume of seed exported in a given year and yet enjoy no tax deferral under D.I.S.C. due to lower selling prices which resulted in little or no increase in total dollars of export sales. Incentives based on a system which grants benefits on the basis of circumstances beyond the control of the companies involved in export cannot be effective.

If H.R. 10612 is allowed to become law, it will require many companies who have been exporting agricultural products through a D.I.S.C. to subject all of their deferred profits to taxation due to their inability to invest in "qualified export assets." The drafters of the House bill attempted to prevent this from occurring by allowing companies to invest these funds in "producer loans." However, the significant fluctuation in inventory values will make it impossible for many firms to qualify for producer loans due to their inability to satisfy the limitation on such loans provided in Section 993(d)(3) of the Internal Revenue Code.

Although the resulting tax may be paid over a period of years, certified public accounting firms will require many smaller, less diversified companies to recognize the tax expense on their entire deferred D.I.S.C. income in one year causing serious financial reporting problems to those corporations who have exported through D.I.S.C.'s in years past. This is tantamount to punishing those firms who have relied on and responded to the incentive provided in the Internal Revenue Code to increase exports. If this problem is to be avoided, existing D.I.S.C.'s must be allowed to invest their accumulated profits in any asset which would have been a qualified export asset had agricultural products remained eligible for D.I.S.C. benefits.

RECOMMENDATIONS

Northrup, King & Co. and other members of ASTA strongly urge you to refuse to adopt the language of H.R. 10612 which would serve to discriminate against the seed and other agricultural industries by excluding them from the benefits of D.I.S.C. We would also like to reiterate our position that the incremental approach to limiting D.I.S.C. benefits would not be effective for agricultural products due to the significant price fluctuations experienced from year to year. We, therefore, would urge you to preserve the present D.I.S.C. provisions of the Internal Revenue Code, and, if possible, to make it even more effective by (1) increasing the percentage of export profits eligible for tax deferral, and (2) by increasing the authorized uses of accumulated D.I.S.C. profts to permit the financing of any domestic investment in production facilities or other business assets.

Senator MONDALE. We stand adjourned.

[Whereupon, at 12:02 p.m., the committee adjourned to reconvene at 10 a.m., Tuesday, April 6, 1976.]

TAX REFORM ACT OF 1975

TUESDAY, APRIL 6, 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, Hartke, Byrd, Jr., of Virginia, Bentsen, Curtis, Hansen, Packwood, and Roth.

The CHAIRMAN. This hearing will come to order. I will call as first witness a panel consisting of Peter Griskivich, director, Motor Vehicle Manufacturers Association, Berkley C. Sweet, president, Truck, Body & Equipment Association, accompanied by James A. Hackney III, chairman, Tax Committee, Hackney & Son.

F. Murray Callahan, vice president, Heavy Duty Truck Manufacturers Association, accompanied by Garner Davis, and Charles J. Calvin, president, Truck Trailer Manufacturers Association.

This group has been asked to limit themselves to 15 minutes overall.

Mr. Griskivich, can you take charge of this presentation and hold your group to 15 minutes?

PANEL CONSISTING OF PETER GRISKIVICH, DIRECTOR, MOTOR VEHICLE MANUFACTURERS ASSOCIATION; BERKLEY C. SWEET, PRESIDENT, TRUCK BODY & EQUIPMENT ASSOCIATION, ACCOMPANIED BY JAMES A. HACKNEY III, CHAIRMAN, TAX COMMITTEE, HACKNEY & SON; F. MURRAY CALLAHAN, VICE PRESIDENT, HEAVY DUTY TRUCK MANUFACTURERS ASSOCIATION, ACCOMPANIED BY GARNER DAVIS, VICE PRESIDENT, MACK TRUCK, INC.; CHARLES J. CALVIN, PRESIDENT, TRUCK TRAILER MANUFACTURERS ASSOCIATION

Mr. GRISKIVICH. Yes, sir, Mr. Chairman.

Mr. Chairman and Senator Packwood, I am Peter Griskivich, director of the Motor Truck Manufacturers Division of the Motor Vehicle Manufacturers Association of the United States, Inc. (MVMA).

I urge the committee to reaffirm its previous support for the repeal of the 10-percent Federal excise tax on medium and heavy duty trucks, truck trailers, intercity buses, and the 8-percent tax on truck and bus parts and accessories.

MVMA's support for excise tax repeal is documented in the full statement, which I trust will be incorporated in the hearing record.

The CHAIRMAN. It will be.

Mr. GRISKIVICH. Briefly, repeal is based on the following considerations: the need for greater tax equity; and repeal of these taxes will remove a longstanding tax inequity. These taxes represent some of the last vestiges of a form of taxation which has its origins in either temporary or emergency measures, adopted during wartime or the Depression.

Most items subject to these taxes have since been exempted—automobiles, parts, radios, TV's, furs, luggage, jewelry, refrigerators, and so forth.

No similar taxes are levied on the manufacture of competing forms of surface transportation—trains, river barges, sea freighters, or pipelines.

Declining sales: Sales of retail trucks subject to Federal excise taxes—I refer to trucks weighing over 10,000 pounds—dropped 40 percent in the past 2 calendar years, 495,768 in 1973 versus 298,105 in 1975. The sales slump has continued into 1976.

The major reverses experienced in the past 2 years in commercial vehicle markets has caused one manufacturer to permanently close one of its plants; another has decided to withdraw from the heavy truck market; still another has gone into bankruptcy; another has been forced to seek a merger partner in order to overcome its financial difficulties.

Another consideration is declining tax revenues. These trends underscore the fact that when there are fewer sales, there are fewer tax revenues collected.

The Federal budget forecasts truck, bus, and trailer excise tax collections at $375 million in fiscal year 1976—a drop of almost 40 percent from $601 million in fiscal year 1975.

Another consideration is increased manufacturing costs. The sales decline of taxable commercial vehicles has been compounded by sharply increased costs. A tandem-axle road tractor which sold for $22,000 in 1971, rose in cost to over $33,000 in 1975—a 50-percent increase.

Another consideration is the effects on consumer prices. Any increase in the manufacturer's price of new trucks and any increase in costs to the trucker will be reflected in the price the consuming public must pay for the goods it purchases. Therefore, the repeal of these excise taxes will help ease the inflationary burdens imposed on consumers by serving to lower or at least stabilize transportation costs.

Another consideration—truck excise tax is not a user charge. The excise tax, because it is not a user charge, tends to discriminate against a specialized segment of our transportation system.

In conclusion, Mr. Chairman, we urge the repeal of these vehicle excises. This would serve to stimulate truck manufacturing and its related industries, encourage employment, provide relief to the consumer, and end a discriminatory, burdensome tax.

Mr. Chairman, the second two members of the panel will also confine their remarks to 4 minutes, and Mr. Calvin will confine his to 3 minutes.

Mr. HACKNEY. Mr. Chairman, and members of the committee, my name is James Hackney, and I am chairman of the Taxation Committee of the Truck Body and Equipment Association, a nationwide organization of manufacturers and distributors of truck bodies, parts, and accessories. These items are presently subject to the Federal manufacturers excise tax.

Our members urge the repeal of the tax for two reasons: first, because the economic state of the industry demands it. Other witnesses have already told you of the 40-percent decline in heavy truck sales in the past 2 years. Our association members have experienced similar declines, coupled with inflated costs and increased Government requirements. The repeal of the excise tax would provide a much needed shot in the arm.

Second, the tax is both cumbersome to administer and causes competitive discrimination against many members of our industry. Its complexity imposes on manufacturers and the Government alike costs far out of proportion to the revenue which it produces. Unlike true user fees and sales taxes, such as taxes on gasoline and diesel fuel, the manufacturers tax is not a simple one to assess and collect. The amount of tax to be collected on a single taxable item may vary, depending on who purchases it and to what use it will be put. The person liable for reporting and remitting the tax to the Government may also vary.

One of the problems is that the pattern of distribution in the truck body industry is different from that envisioned by the Congress when the present revision of the statute was passed in 1954. The statute imposed a tax on the price at which a manufacturer sold his product to a wholesale distributor. The wholesale distributor would normally sell to a retailer without further excise tax being added, and the retailer would then sell to the ultimate consumer, or user. This was the prevailing distribution pattern for most items originally covered by the statute. However, in the truck body industry there are few, if any, manufacturers who sell through wholesale distributors. Most sell through retailers or direct to users. Hence there has been an administrative nightmare for the Internal Revenue Service, and consequently for the industry, in attempting to apply a statute designed for one distribution pattern to an industry which generally did not and does not follow that pattern.

The overwhelming complexity of administration which resulted has had many side effects, all of which are detrimental to our industry and to the interest of the general public. First, as with any complex subject, thousands of valuable man-hours are expended annually by our business executives, their attorneys and accountants, and by personnel of the Internal Revenue Service, in trying to fairly interpret and apply the statute to the wide variety of products produced in our industry, sold in a variety of ways to a variety of users. Simple differences in interpretation have large economic impact on companies in terms of tax liability, and some firms have been severely hurt and even bankrupted by excise tax liabilities resulting from errors caused by the complexity of the situation.

Second, the application of the tax causes a competitive disadvantage to different companies within our industry, depending on to whom they sell. A manufacturer who sells his truck body to a retailer must

normally collect more excise tax than an identical manufacturer who sells the identical item for an identical price to a fleet user. This is clearly in violation of the fundamental principal of taxation, which is equal treatment under this law. Third, the concept of further manufacturing increases still more the complexity. The ultimate user of a truck body or chassis may find himself classed as a manufacturer and be liable for payment of additional excise tax if he makes minor changes in the product which are construed to be further manufacturing. The small tax normally due from further manufacturing seldom justifies either the administrative expense to the taxpayer company or the audit expense to the Internal Revenue Service in collecting it.

Fourth, the unique nature of the problems I have outlined have resulted in a pyramiding of the tax as the item passes from manufacturer to ultimate user.

In closing, I say again that the solution to the economic and administrative burdens of the tax is to repeal it. Repeal would strengthen the industry, reduce unemployment and help to minimize inflation, all at an acceptable cost in loss of revenue. It would remove a source of competitive discrimination and free IRS personnel to deal with more productive taxes. The tax was enacted as a wartime measure and has outlived the need for which it was adopted. The Congress removed the tax on automobiles in 1971, and is actively considering removing those on intercity buses and radial tires in this session.

We feel the time is at hand, in fact, long since past, when Congress should give the same consideration to trucks and truck bodies.

Mr. CALLAHAN. I am F. Murray Callahan, general counsel of the Heavy-Duty Truck Manufacturers' Association. Our association, founded over 6 years ago, represents exclusively heavy-duty truck manufacturers and component producers thereof. We are headquartered in Washington, D.C. and our members have facilities in all 50 States. In the past 2 years, this industry was harder hit than most and at one time or another in 1974 every heavy-duty manufacturer shut down their lines for varying periods. One of our members—a venerable name in trucks—Diamond Reo—was forced out of business.

This morning I am pleased to have with me Garner L. Davis, vice president sales, Mack Trucks, Inc., Allentown, Pa. We thought it would be helpful to the committee to hear directly from a manufacturer.

Mr. DAVIS. In the early 1970's, Federal regulations were first introduced governing the manufacture of heavy-duty trucks. These regulations covering such items as noise, emission, et cetera, while creating vehicles that were more socially acceptable, also had the end result of increasing the prices of trucks. At the same time, the American economy was expanded at an unprecedented rate and the demand for heavy-duty trucks needed to move the resulting freight showed no signs of abating.

With the onset of inflation, prices of trucks increased rapidly, along with all other products. At the same time, demand for heavy-duty trucks decreased. Because of the fuel shortage, the Federal Government has imposed a maximum speed limit of 55 miles an hour for all highways. For the trucking industry, a slower speed is a longer time

period for a given haul, and this has increased the cost of driver wages by some 9 percent for a given load.

In addition to the extra labor costs, the actual cost of diesel fuel has risen an average of 84 percent in the past 4 years.

In 1974, the final decision was made by the Department of Transportation to enforce MBSS 121 requiring the installation of anti-wheel-lock devices on all airbrake trucks, and this encompasses all heavy-duty trucks. The result was not only a heavier chassis necessitated by the general strengthening of brakes, axles and wheels to withstand the stress created by short stops, which meant lighter, less economical payloads, but an increase of up to 1,200 for the average truck, plus a substantial increase in the price of the trailer.

Because of increased costs brought about partially by federally mandated expenses, the prices of heavy-duty trucks both as an initial investment and as an operating expense has risen to the point where it has become uneconomical for users to purchase new equipment. This is equally true of the owner-operator of single vehicles to the largest fleets operating coast to coast. The cost of buying and operating heavy-duty diesel trucks is growing at a rate far greater than the revenues available to potential customers. If this economic impasse continues, the result will be totally inadequate transportation systems which can only work to the detriment of the national economy.

This occurred at the same time as the recession's full effects were felt. The results have been catastrophic for the heavy-duty truck industry, both manufacturers and users. In the course of providing vehicles that were safer than ever before with emissions cleaner than any other form of transportation, the industry has been forced into an untenable position, and the final results are a near collapse of the industry—a decline of 54 percent in industry sales from 1974 to 1975, and a decline of 46 percent in my truck sales.

All indications are that 1976 will show a substantial economic recovery for the entire United States. However, because of the factors outlined before, the consensus of truck manufacturers is that heavy-duty diesel truck markets will not share in this general recovery.

It is anticipated that sales will increase only about 20 percent from the low 62,841 trucks in 1975 to approximately 75,000 trucks. This figure is still some 45 percent below 1974 sales, and indicates the condition of our industry.

Not only has the collapse of the heavy-duty truck industry resulted in tremendous loss in sales, but the unemployment rate experienced in our industry has been at an extremely high level. As an example, Mack Truck, Inc.'s employment has fallen from a high of 14,136 in 1974 to the present level of 12,057. It should be borne in mind that Mack Truck has been extremely fortunate in its participation in the export market which has helped alleviate the high unemployment rates suffered by other heavy-duty truck manufacturers.

One large item included in the price delivery of all heavy-duty diesel trucks is the Federal excise tax, an impost previously removed from other forms of transportation. We feel that elimination of this tax will make it feasible for truck manufacturers to reduce the price of their vehicles to a level where users could economically reenter the

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market and to enable the transportation industry to experience the revival necessary for the health not only of the truck manufacturing industry but the whole economy.

One last point. I assure you that should the 10-percent Federal excise tax be repealed, all the savings will positively be passed on to the customer. Thank you.

Mr. GRISKIVICH. Mr. Charlie Calvin will summarize his statement in about 1½ minutes.

Mr. CALVIN. Mr. Chairman and members of the committee, I am Charles Calvin, president of the Truck Trailer Manufacturers Association. Our members build more than 90 percent of the truck trailers produced annually in the United States.

Gentlemen, to the best of our knowledge no other industry suffered a greater decline in 1975 than the truck trailer manufacturing industry. While Government economic indicators showed other industries down 10 to 50 percent, our industry was operating at a 75.4-percent decrease. In no single month during 1975 did we operate at more than 25 percent of capacity. In some months our production was down almost 80 percent. We might say that business is now improving, but the fact is that January 1976 production remains down 66.6 percent and Ferbuary down 61 percent.

My purpose in appearing before this committee is to urge the repeal of the 10-percent Federal excise tax on truck trailers, truck bodies, and trucks, and the 8-percent Federal excise tax on related parts and accessories.

In an effort to assist manufacturers, TTMA published a "Federal Excise Tax Guide." Even though this guidebook has 740 pages and weighs almost 8 pounds, it still cannot be considered the ultimate panacea to interpreters of this difficult excise tax regulation.

Let us say Congress does repeal the automotive excise taxes. Highway experts point out that a 1-cent increase in the fuel tax would result in an increase of $1 billion annually in receipts to the highway trust fund. Imagine, a realtively simple collection task replacing a very complicated excise tax and resulting in higher receipts. It is $1 billion compared to $500 to $700 million.

There is one more very important matter to be considered. Outright repeal is the only sensible solution to this troublesome tax problem. A reduction would, of course, help the purchaser; however, every single administrative problem created by the 10-percent and 8-percent taxes would remain intact even if they were reduced to 1 percent or less. In fact, any reduction would only serve to greatly intensify the collection burden which, in the truck trailer manufacturing industry, is believed to already exceed the value of the revenue collected. In other words, we believe it costs industry and Government $1 to collect $1. If the tax were reduced, we might find ourselves spending $1 to collect 10 cents.

It is our sincere belief that the production decreases, plant closings, and the unemployment that has so devastated the truck trailer manufacturing industry in 1975 and continuing in 1976 can be reversed in the near future by repeal of the taxes. We are not requesting billions of dollars in Federal funds in order to "reorganize." Our plea is for an opportunity to put our people back to work and help stimulate the recovery of the national economy. Thank you.

The CHAIRMAN. Before we interrogate these witnesses, we are going to suggest two things. First, because we have a lot of witnesses today, and we have had very challenging thoughts suggested to us, I am going to suggest that insofar as possible we submit written questions. I have written out one question, and I hope you can give us an answer to it for the record before you leave town today.

Second, since Senator Griffin has arrived, and since he is interested in the same thing you gentlemen are interested in, I am going to call on Senator Griffin to make a statement.

STATEMENT OF HON. ROBERT P. GRIFFIN, A SENATOR FROM THE STATE OF MICHIGAN, ACCOMPANIED BY HON. MARVIN L. ESCH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Senator GRIFFIN. Thank you. Congressman Esch from Michigan is here and would like to add some additional comments.

The CHAIRMAN. We are glad to welcome you back on this committee, Senator. I do not know why you wanted to depart. [Laughter.]

Senator GRIFFIN. I will not read my entire statement but will summarize by saying that we are here because of the serious unemployment situation that still exists in our State of Michigan, 13 percent. Although the sales of automobiles have improved considerably, and although we see some improvement in the economic picture, it is a fact that unemployment in this segment of the motor vehicle industry—namely, the truck and bus manufacturers and sales segment—is showing little improvement. In fact, sales actually dropped last year and the unemployment picture deteriorated, which is rather out of keeping with the rest of the automotive industry.

Last year the committee did approve, in concept, the repeal of this last vestige of the excise taxes—a holdover from World War II.

I think repeal is still justified, and I might just add that such action will not benefit the State of Michigan alone. There are actually more workers in this industry in California, Illinois, Indiana, Missouri, North Carolina, Ohio, Pennsylvania, and Texas than in Michigan.

So, from the standpoint of the unemployment picture, the committee could certainly help these States, our State, and the Nation were it to see fit to include repeal of these excise taxes in its legislation.

Now, perhaps Congressman Esch would like to say a word.

Mr. ESCH. I appreciate, Mr. Chairman, the opportunity to join my colleague from Michigan and to emphasize the importance of this issue. I am well aware that the committee has already taken action, but I think it is important to recognize the relationship between unemployment and excise taxes. As Senator Griffin has correctly pointed out, this is true not only in Michigan, but throughout the country.

Comments were made to this committee last year when we worked on the Tax Reduction Act; you, Mr. Chairman, emphasized that, as regards the 10-percent investment tax credit. In addition to providing shortrun stimulus to the economy, it would increase the amount of desirable investment for other reasons. Investment not only creates jobs directly and through the multiplier effect, but also increases productivity. Unless our capital stock is significantly increased in the future, there will be serious problems providing enough jobs for those entering the labor force.

Yet, in this one industry, and in this one industry alone, the capital made available by the investment tax credit is offset by other taxes; namely, the 10-percent excise tax. I would hope that the committee would want to act aggressively to reduce this inequity.

We all are aware of the number of individuals who are employed in the industry, but I would like to point out that equipment distributors and their sales outlets alone employ 500,000 to 600,000 people. Even as the automobile industry moves out of the recession, truck sales continue to slump. I think it is in the best interests of the workingman that we remove the 10-percent excise tax and get on with the stimulus necessary to provide sharply increased employment.

The CHAIRMAN. Thank you, gentlemen.

[The prepared statement of Senator Griffin follows:]

STATEMENT OF U.S. SENATOR ROBERT P. GRIFFIN BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and members of the committee, I appreciate the opportunity to testify today in support of legislation to repeal the 10-percent Federal excise tax on new trucks and buses, and the 8 percent tax on parts and accessories for those motor vehicles.

Just over a year ago, on March 6, 1975, I joined with my distinguished colleague Senator Hart in introducing a bill, S. 974, to repeal these discriminatory excise taxes. At that time, sales of both autos and trucks were down sharply. And the unemployment rate in the auto industry was nearly 25 percent—the highest jobless rate of any major industry in the United States.

It will be recalled that your committee responded appropriately by incorporating this proposal as an amendment to the tax reduction legislation. The committee-approved amendment was passed by the Senate but was dropped in the House-Senate Conference.

Today, while the economic picture is generally brighter for the auto industry as a whole and its workers, the same cannot be said for that segment of the industry still subject to these excise taxes. In fact, during 1975, truck sales dropped 40 percent below 1974 levels. One major company—Diamond Reo—went out of business—which left nearly 2,000 jobless. And truck sales are still down. In the first three months of this year, heavy truck sales declined more than 20 percent from the comparable period in 1975.

It will be recalled that, in 1971, Congress repealed the remaining 7 per cent Federal excise tax on *passenger* automobiles. That action stimulated higher sales and generated thousands of jobs in the auto industry.

If the remaining excise tax on trucks and parts were to be repealed now, the action would provide a needed "shot in the arm," not only for Michigan—which still suffers from an unemployment rate of about 13 per cent—but also for many other States. In fact, in California, Illinois, Indiana, Missouri, North Carolina, Ohio, Pennsylvania and Texas, there are more workers employed in manufacturing bodies and trailers for trucks and buses than in my own state of Michigan.

Throughout the country there are 895 businesses, employing more than 63,000 workers, involved just in the manufacture of truck trailers and bodies for trucks and buses. And more than 150,000 workers are engaged in all phases of truck and bus production, including the manufacture of parts, accessories and related equipment. All of these companies and their workers have been severely hurt by the sales decline in their part of the industry.

Furthermore, to remove the excise tax and reduce the purchase price of trucks, buses and parts, would contribute to the progress that has already been made in slowing the inflation rate. And lowering the purchase cost of these vehicles would be particularly helpful to small businessmen, including farmers and independent owner-operators of semi-trailer rigs, who have been hard hit by the recent bout with inflation.

Whatever justification once existed for these taxes, it has long since passed. They are the last vestiges of the "emergency and temporary" excise taxes enacted during the Great Depression and World War II.

Congress has already repealed excise taxes levied on everything from refrigerators to jewelry. And we have repealed excise taxes on all other forms of transportation, including motorcycles, local transit buses, refuse collection truck assemblies, automobiles, light-duty trucks and automobile parts.

In the tax bill now pending before this Committee—H.R. 6860—the House has included provisions to repeal the excise tax on intercity buses. The time has come I suggest, to complete the reform by repealing the taxes on the sales of heavy-duty trucks and truck and bus parts.

These taxes have been dedicated to the Highway Trust Fund, but truck and bus operators are subject to fuel taxes and other user charges, like everyone else. Of course, all highway users should pay their fair share of the costs of maintaining this system, but it is not fair to continue a discriminatory sales tax, which applies to no other form of transportation.

Furthermore, the impact of repeal on the Highway Trust Fund would not be great. These taxes account for only about 10—11 per cent of Trust Fund revenues—and the Trust Fund has a surplus which has increased in recent years to more than $9 billion. Despite a slight revenue drop in FY 1976, due to the effects of the recession, the FY 1977 budget projects that the surplus will increase by nearly $200 million during the next fiscal year.

Mr. Chairman, I strongly urge that whatever tax legislation is reported by the Committee include provisions for the repeal of these excise taxes. This is a long-overdue tax reform measure which will stimulate employment and sales in an industry which is still suffering the effects of the past recession. Thank you.

The CHAIRMAN. I have one question that I am going to submit to the panel of witnesses in writing.

Senator Packwood?

Senator PACKWOOD. Mr. Chairman, I did not know about written questions.

The CHAIRMAN. You may ask whatever questions you wish, but I would like to limit questions to five minutes for each Senator.

Senator PACKWOOD. What competitive product is there to these trucks over $10,000? Do you people substitute something else?

Mr. DAVIS. No; there is no substitute for a heavy-duty vehicle. When you say over $10,000, that takes in a great range of trucks and equipment.

Senator PACKWOOD. You said $10,000, or 10,000 pounds? I meant pounds.

Mr. DAVIS. All right. This is the movement of all types of products throughout the United States and all parts of the world.

All forms of transportation such as railroads, water transportation and air cargo do move a lot of goods, but, however, the truck is the thing that brings it to the door. It is the city-to-city movement. It takes over from the railroad. It takes over from the airplane in the areas that they obviously cannot reach. There is no substitute.

Senator PACKWOOD. Do you have any serious foreign competition? Are there large heavy foreign trucks coming into this country?

Mr. DAVIS. Not at this time.

Senator PACKWOOD. I am at a loss to understand. I remember the argument over rule 121 and the safety brakes, because we have a manufacturer in Oregon, but I am at a loss to understand if there is no foreign competition, and there is no alternative form of domestic transportation, the sales fell from 191,000 in 1974 to 68,000 last year. That cannot be the excise tax.

Is it just a postponement of people purchasing? These trucks have to be purchased. What happens?

Mr. DAVIS. There is a great deal of postponement of purchases. Trucks usually, or many times, are traded in or are converted after 3 to 4 years of use and then they go into a secondary use in other areas.

So the net result is a reduction in sales. I wish to point out, also, on the Federal excise tax, years ago it was, I believe, 6 percent on a much smaller dollar value. A truck sold, say, for $15,000, and there was 6 percent on that. It went to 8 percent, and now it is 10 percent. It is now on a sales price, however, of $38,000 to $40,000. So the percentage increased and the dollars increased.

What is happening with the various forms of increases, some of the increases came about because raw goods increased, and other regular commodities increased. A substantial amount of price increases in trucks, however, came about because of federally imposed regulations, the brake laws, the noise abatement laws, and many of those things. That represents $3,000 to $4,000 or more in the price of a motor truck.

Now, what has happened is that customers are postponing their purchases. You might say ultimately they will have to purchase. Well, the alternative is, perhaps, to run trucks longer. They are still trying to run trucks that do not have the MBS 121 brake system on them. If they were already in service before the law was passed, they can do these things.

It has all added up to a drastic reduction in truck sales, that with the economy.

Senator PACKWOOD. It seems to me given the premise that there is no foreign competition and no domestic alternative transportation, that you have to have an upswing. People have to have these for their business.

Mr. DAVIS. We agree with that. There will be an improvement in our business in the normal course of events. We must face the fact, though, that already many truck companies and truck manufacturers have already had to go out of business. Dodge and the Chrysler corporations stopped building heavy-duty trucks. Diamond-Reo went out of business. Mormon Trucks is out of business, and there are others at this time that are having financial problems because of the things that have been—the things they have been required to face up to in the heavy-duty truck industry.

The fact remains that you can get to a condition—for example, we are selling trucks today. When we sell a truck, it is in the heavy-duty truck only, not the trailer with it, but the area of the price is $38,000 to $40,000. That is an increase of almost double. Not many years ago it was $21,000 or $22,000 for the truck to haul the same load, or actually a little less payload, because the truck was not as heavy. But it gets to the point of no return, because there is so much revenue, and so much expense.

With the mounting amount of taxes that have been imposed, as I have tried to illustrate here, the 10 percent on a greater amount of the vehicle, along with all the other Government-imposed regulations, with all due respect, it has come to the point that the price of the vehicle is just almost out of range to buy.

Mr. CALVIN. If I may inject a comment, that you are now seeing repairing and rebuilding operations that the industry has never seen

in its existence. These older vehicles are being brought out from God knows where, and especially the truck trailer manufacturing industry has been knocked in the head.

Senator PACKWOOD. Thank you. My time is up.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Mr. Chairman, I think I can be a little bit helpful in telling what has been happening to the truck industry. I happen to be in the livestock business. It is badly depressed, and farming is not all that profitable, as you gentlemen know. I do not know how many trucks are sold to the farmers and ranchers of America, but I assure you a great number are.

The repeal of this tax would certainly help those individuals who need to purchase trucks to more easily afford them. I think the best thing that could happen would be to repeal this tax.

I commend Senator Griffin for his leadership in seeing that this tax is repealed. I think at times we in the Congress are unduly myopic in looking at what we think is the immediate Treasury impact of a tax. We assume that if we want to retain or increase a tax the Treasury is going to get more money. However, many times it works the other way around. It appears to be working the other way around in this instance. What is happening in my opinion is that we have added unnecessarily to the cost of a truck, and two things have occurred: Farmers and ranchers are not able to buy used trucks from industry, because industry won't buy new ones. As a consequence both the trucking industry and the potential truck purchasers suffer. It appears, Mr. Davis, that the best thing Congress could do would be to repeal this tax. If we did, truck production would increase, which would increase employment. The result would be a positive impact on the Treasury, rather than a negative impact. When you put people to work, when you get them on the payroll and they start becoming taxpayers instead of tax consumers, a number of positive things happen.

I commend this panel for an excellent presentation, and I shall support our chairman and other members of the committee to see if we can get this tax removed.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Just one question. It was brought out that the price of the truck has gone from $15,000 to $38,000. What period of time would that be?

Mr. DAVIS. It is a long period of time. We were at $21,000 5 years ago. We were at $15,000, and some of this included the conversion from gasoline to diesel power. We were at $15,000 10 or 11 years ago.

Mr. GRISKIVICH. May I add to that? One manufacturer, International Harvester, has estimated that a heavy-duty truck that sold for $22,000 in 1971 rose in cost to over $33,000 in 1975. That is a 50-percent increase.

Senator BYRD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. I am very much interested in your presentation here today, and I am interested particularly as it applies to truck parts.

We have several rather important manufacturers of truck parts in Nebraska. For example, they may make something such as a filter.

The manufacturer has no way of knowing whether the filter is used on a truck subject to tax, or whether it is used on a vehicle that is not taxed. Many of these filters are also sold for replacement, and there, again, the manfuacturer has no way of knowing until someone pulls up to a filling station to get a filter whether it carries a tax or not.

The problem is further complicated by the fact that in some IRS regions, the manufacturers have been taxed, and in other regions they found they were not subject to the tax. In some instances these manufacturers are facing not only the imposition of the tax, but on a retroactive basis.

The CHAIRMAN. I would like to ask one question in addition to what I will submit in writing.

It you were manufacturing these trucks in a European country, they would give you the excise tax back when you export the truck. They have a value added tax averaging about 15 percent, and they refund it when the product leaves the country. Is that tax rebated to you on your exports?

Mr. HACKNEY. Yes, sir, it is exempted from tax if it is exported.

The CHAIRMAN. Maybe they could go further and give you back the income tax.

Thank you very much, gentlemen.

[The prepared statements of the preceding panel follows:]

STATEMENT OF PETER GRISKIVICH, DIRECTOR, MOTOR TRUCK MANUFACTURERS DIVISION OF MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF THE UNITED STATES, INC.

Mr. Chairman and Members of the Committee. I am Peter Griskivich, Director of the Motor Truck Manufacturers Division of the Motor Vehicle Manufacturers Association of the United States, Inc. (MCVA). We appreciate the opportunity to present testimony on tax reform issues. MVMA represents nine of the major motor vehicle manufacturers who account for more than 99% of the automobiles, truck, and buses made in the United States, including 98% of the trucks produced.

I am appearing today to urge that the Committee reaffirm its previous support for the repeal of the 10% Federal excise tax on new medium and heavy duty trucks, truck trailers, intercity buses [under 26 USC 4061(a)(1)] and the 8% tax on truck and bus parts and accessories [26 USC 4061(b)]. This proposal is contained in S. 974 introduced by Senators Robert Griffin and Philip Hart and S. 2495 sponsored by Senator Hartke of this Committee.

It is our belief that the repeal of these taxes is entirely in the public interest and in harmony with the goals of stimulating the economy and controlling inflation. Repeal of these excise taxes will furthermore remove a long-standing tax inequity and help to offset the rapidly rising material and manufacturing costs. By so doing, it will additionally serve to protect and bolster employment in the commercial vehicle and related supplier industries at a time when such action is particularly needed.

THE NEED FOR GREATER TAX EQUITY

These taxes represent some of the last vestiges of a form of taxation which has its origins in either "temporary" or "emergency" measures adopted during wartime or the Depression. Their purpose was largely to discourage production or make adjustments in the national economy. The vaset majority of products subject to these taxes, some dating back to World War I, have since been exempted. Such things, for example, as motorcycles, automobile parts, air conditioners, business machines, refrigerators, freezers, refuse collection truck assemblies, radios, TV's, phonographs, local urban mass transit buses, electric appliances of all kinds, furs, luggage, and jewelry were exempted five to ten years ago.

In 1956, at the time that the truck and parts taxes were earmarked for the Highway Trust Fund to finance the Interstate System, most if not all the products cited above were still subject to excise taxes. Since 1956, however, they have been substantially wiped from the tax books. As a consequence, the Federal excise tax system has become progressively more selective in the types of products subject to it—and thus, increasingly more discriminatory.

In 1971, for instance, Congress exempted passenger automobiles and that portion of the tax which applies to new trucks of up to 10,000 lbs. GVW, leaving medium and heavy-duty trucks, trailers, and intercity buses alone burdened with this tax and the 8% tax on truck and bus parts and accessories. No similar taxes are levied on the manufacture of competing forms of surface transportation—e.g., trains, river barges, sea freighters or pipelines.

The major purpose of these hearings is to enable this Committee to report out a comprehensive tax reform bill. The inclusion in this legislation of the proposals we are urging would be completely consistent with your enlightened actions in 1965 and 1971 when you repealed all of the temporary excise taxes mentioned before. Now is an appropriate time for the Committee, and the Congress, to continue and complete this reform effort by repealing these discriminatory taxes which serve as an unfair yoke around the neck of the truck, trailer, bus and parts manufacturing industries.

DECLINING SALES AND DECLINING TAX REVENUES

During the past two calendar years, trucks in the over 10,000 lb. class experienced a 40% decline in retail sales from 495,768 units in 1973 to 298,105 units in 1975. This is double the rate of sales decline of non-taxed trucks (0–10,000 lbs. GVW) which in the same 2-year period dropped 19% from 2,152,490 units in 1973 to 2,052,952 units in 1975. This downward trend has continued through the first two months of this year which saw retail sales of these taxed vehicles at 43,607 units as compared to 72,339 units in January-February of 1973.

We hope this trend reverses itself. Nevertheless, it underscores the fact that when there are fewer sales there are fewer tax revenues collected.

For example, based on last year's sales decline, truck, bus and trailer excise tax collections for FY 1976 are estimated in the proposed FY 1977 Federal Budget to drop to $375 million. This would be a decline of $226 billion from FY 1975 Highway Trust Fund receipts of $601 million. Again, however, we hope truck sales recover to a far greater degree than these estimates indicate.

Furthermore, a decline in the sales of the vehicles means not only a decline in excise tax collections, but also a loss of Federal, state, and local revenues from other sources including corporate and employee income taxes. This is coupled with an increasing demand for government services in the way of unemployment compensation and welfare payments.

The president of White Motor Corporation, John E. Sheehan, testified a few weeks ago before the House Commerce Committee's Subcommittee on Consumer Protection and Finance. He reported that White's truck sales dropped from $840 million in 1974 to $528 million in 1975. As a result, White experienced a net operating loss of $41 million in 1975 from the steep downturn in truck sales. As an example of what this has meant to the company, Mr. Sheehan indicated that 1,270 employees currently were on layoff last month at the company's Cleveland plant. Some of those employees include men and women with as much as 13 years seniority.

The major reverses experienced in the past two years in commercial vehicle markets have taken a severe toll in the truck manufacturing industry. One other manufacturer has permanently closed one of its facilities. Another manufacturer has decided to withdraw from the heavy truck market. Still another manufacturer has gone into bankruptcy. White has been forced to seek a merger partner in order to ovecome its financial difficulties.

THE RISING COST OF GOVERNMENT REGULATIONS

The sales decline of taxable commercial vehicles has been compounded by sharply increased costs. One manufacturer, International Harvester, has estimated that a heavy duty class truck which sold for $22,000 in 1971, rose in cost to over $33,000 in 1975—a 50 percent increase. This $11,000 price increase reflects the cost of $2,500 to meet Federal regulations, $3,000 for product improvement and $5,530 due to inflation. Of the $2,500 increase in the factory sales price due to

Federally mandated standards, approximately $1,650 is attributed to the (FMVSS 121) antilock air brake standard in the stringent form as originally proposed.

In the testimony referred to earlier, the president of the White Motor Corporation told the House Commerce Subcommittee that the impact of this Standard had been, "catastrophic." It has both served to artificially stimulate and then deeply depress the truck manufacturing industry. The air brake system standard originally was to become effective on trailers in January of 1975, and with respect to trucks and buses on March 1, 1975. Since these initial effective dates, the standard has been amended significantly in its performance requirements. Furthermore, a number of exceptions and exemptions have been granted from full application of the standards on various grounds. The entire matter of the standard setting has been in the courts for a number of months, thus further confusing the situation.

The uncertainty produced massive truck orders in mid-1974 as buyers sought to obtain trucks without the expensive device which consists of a computer, certain associated hardware, and a much heavier front axle and front wheel brakes. With the onslaught of the recession later in 1974, many of these orders were cancelled. The impact of this reversal is still being felt. The prolonged uncertainty over FMVSS 121 in the Federal government and in the courts has created continuing difficulties for the truck manufacturing industry.

The next round of Federal regulations in the aggregate promise to add substantial additional costs. For example, the Environmental Protection Agency estimates that the cost of noise control equipment necessary to reach the proposed 80 decibel level standard would add approximately 2–11.5% to the average price of a truck, depending on the type of unit. The cost of more stringent heavy-duty vehicle emissions standards currently being considered by the Congress is likely to add several hundred more dollars per vehicle.

Because the additional government-required equipment adds substantially to the total wholesale price of the truck (which is the basis for calculating the excise tax due), the buyer is penalized by having to pay substantially higher taxes. He is caught in a squeeze between the right hand and left hand of the Federal government. On the one hand, the buyer is having to pay the basic cost of the equipment mandated by the regulations, only to find that each time the basic cost goes up, the tax collector's hand is digging deeper into his pocket.

EFFECTS ON CONSUMER PRICES

The vital importance of truck transportation to the economic well-being of business and individual consumers is well known. For example, the American Trucking Association's estimates that 80.7% of all meat, 84.3% of all beverages and 82.3% of all clothing is delivered by trucks. Overall, motor trucks accounted for nearly 80% of all freight revenues in 1973, according to the Transportation Association of America. Therefore, one cost element in almost all goods and services purchased by the consuming public is the cost of transportation via trucks.

Obviously, then, it follows that any increase in the manufacturers' price of new trucks and any increase in costs to the trucker will be reflected in the price the consuming public must pay for the goods it purchases. Therefore, the repeal of these excise taxes will help ease the inflationary burdens imposed on consumers by serving to lower or at least stabilize transportation costs.

The rising cost of labor and materials has contributed greatly to the manufacturer's. Dealers selling costs have risen substantially. And all of these costs are ultimately passed on in final consumer prices.

The truck operator has, as a consequence of the nation's energy problems, experienced increased fuel costs. There is every indication these costs will continue to rise, and result in further increased prices in consumer products.

TRUCK AND BUS PARTS AND ACCESSORIES TAX

The Excise Tax Reduction Act of 1965 exempted passenger *automobile* parts from the 8% excise tax, but it remains on truck parts and accessories including parts for trucks *under* 10,000 lbs. GVW even though such light duty trucks themselves are exempted from the 10% tax in 1971. This tax yields relatively little as a percentage of Highway Trust Fund revenues (2.3% in FY 1975), and is cumbersome and expensive to administer. Because this tax is assessed on the initial factory price of the part, its effect is increased as it is passed along through the usual three to five step distribution system, thus, repeal of the tax could result in savings to the consumer.

The truck parts tax in some cases presents competitive problems for manufacturers who produce both tax-exempt passenger cars and light trucks, and tax-

able heavy trucks. These problems arise because of the difficulties of distinguishing between taxable truck parts and tax-exempt parts.

TRUCKS AND TAX REVENUES

More trucks provide substantial revenues from a variety of Federal and state tax sources. Latest available data * indicate that in calendar 1974 trucks comprised 17.7% of total motor vehicle registrations, traveled approximately 20% of the total vehicle-miles, and contributed over 37.7%, or $7.1 billion, of the combined Federal and state highway-user tax revenues collected.

At the Federal level, $2.5 billion or 43% of the Highway Trust Fund was generated by trucks. Of this percentage, only about 11% was collected through the new truck and parts excise taxes. The remaining portion, or approximately 32% of total Fund revenues, were derived from fuel, vehicle use and tire excise taxes paid by truck owners and operators.*

At the state level, trucks accounted for $4.6 billion in revenues, or about 35.3% of the total collected.*

The Motor Vehicle Manufacturers Association has long been on record as a supporter of the user charge concept for paying for road building and maintenance expenditures. In the hearings last summer on the Federal-Aid Highway legislation before the House Public Works Committee, W. D. Eberle, MVMA president, testified concerning our support for repeal of the new truck, trailer, bus and parts and accessories taxes. At that time, he indicated that if the resulting revenue loss to the Trust Fund was needed for highway system construction, it should be made up by adjusting highway user charges.

The excise tax, we believe, because it is not a user charge tends to discriminate against a specialized segment of our transportation system. We believe that in the true spirit of the user charge concept, the costs of construction and maintenance for the highway system should be spread among the users of the system in the broadest possible way.

THE LEGISLATIVE SITUATION

Mr. Chairman, as you know under present law, unless the Highway Trust Fund is extended, the 10% excise tax on trucks, truck-trailers, intercity buses, chassis, etc., is scheduled to drop to 5% on October 1, 1977, with revenues then reverting to the general treasury. The 8% parts and accessories tax would likewise drop to 5%. The Federal-Aid Highway Bills (H.R. 8235 and S. 2711) now pending final approval would extend these and all other excises devoted to the Highway Trust Fund, at their present rates, through September 30, 1979.

Last year, the Senate adopted the recommendation of this Committee during consideration of H.R. 2166, the Tax Reduction Act of 1975, ot appeal the 10% truck, trailer and bus tax and the 8% parts tax. Unfortunately, this provision was dropped by the conferees.

The Committee has before it for consideration during markup on the omnibus tax bill, the House-passed Energy Conservation legislation H.R. 6860. Section 221 of this bill contains language repealing the excise tax on intercity buses.

We urge the Committee and the Senate to include repeal of the 10% excise tax on new trucks and truck trailers and the 8% tax on the parts and accessories for these vehicles, as well.

Mr. Chairman, it had been anticipated that the 94th Congress would fully address the question of the future course of the Federal Highway Program and of the nation's overall transportation policy. Such an examination would have provided an appropriate opportunity to review the equity of the present financing system, particularly with regard to the new truck and parts taxes. Unfortunately, such a comprehensive reassessment has been deferred until the 95th Congress. However, the trucking industry is in need of action now, not two years from now. While it would be logical that the question of repeal of these taxes be considered in the broader context of overall transportation policies, we believe this tax reform issue should not be delayed further.

Nevertheless, MVMA continues to believe that the whole question of Federal transportation policy needs to be thoroughly examined and resolved at the earliest possible date. In this regard, we have urged a broadly-based review of the many facets of this problem. Such a review must, of course, include the question of how future Federal transportation programs should be equitably financed.

*Source: American Trucking Associations.

We are not advocating that the trucking industry should pay anything less than its fair share of the costs for using the Federally-aided highway system. What we do urge, however, is that the discriminatory excise tax, which is not levied on any other mode of surface transportation, no longer be imposed on truck buyers. The point we want to make very clearly is that all users of the highway system should be providing their fair share of the funds needed, rather than through a tax that acts as an economic disincentive.

We submit, therefore, that the repeal of the excises would serve to stimulate truck manufacturing and its related industries, encourage employment, provide relief to the consumer, and end a discriminatory, burdensome tax.

FEDERAL EXCISE TAX RATES ON TRUCKS, BUSES, TRAILERS, PARTS AND ACCESSORIES

EFFECTIVE DATE OF NEW TAX OR REVISION OF EXISTING TAX	BUSES	TRUCKS	TRAILERS	PARTS AND ACCESSORIES
	(PERCENT OF MANUFACTURER'S SALES PRICE)	(PERCENT OF MANUFACTURER'S SALES PRICE)	(PERCENT OF MANUFACTURER'S SALES PRICE)	(PERCENT OF MANUFACTURER'S SALES PRICE)
October 4, 1917	3 percent	3 percent	-	-
February 25, 1919	5 percent		-	5 percent
July 3, 1924		Exempted truck chassis sold for $1,000 or under and truck bodies for $200 or under	-	2-1/2 percent
February 26, 1926		Repealed	-	Repealed
March 29, 1926	3 percent	-	-	-
May 29, 1928	Repealed	-	-	-
June 21, 1932	3 percent	2 percent	-	2 percent
July 1, 1940	3-1/2 percent	2-1/2 percent	-	2-1/2 percent
October 1, 1941	5 percent	5 percent	House trailers, 7 percent; others 5 percent	5 percent
November 1, 1951	8 percent	8 percent	8 percent [a]	8 percent
July 1, 1956	10 percent	10 percent	10 percent [a]	
July 1, 1961				
June 22, 1965	10 percent [a]	10 percent [a]		
January 1, 1966				8 percent [a]
Existing rates, January 1, 1974	10 percent [a]	10 percent [a]	10 percent [a]	8 percent [a]
(Scheduled change or reversion under laws existing January 1, 1974)	5 percent Oct. 1, 1977	5 percent Oct. 1, 1977	5 percent Oct. 1, 1977	5 percent Oct. 1, 1977 [b]

[a] Exemptions from stated taxes are: House trailers, November 1, 1951; school buses, camper bodies, motor homes, truck or trailer bodies designed for seed, feed, and fertilizer, small three-wheeled vehicles, June 22, 1965; cutting oil and automobile parts and accessories, January 1, 1966; trucks, buses and trailers 10,000 pounds or less gross weight, September 23, 1971; and, local transit buses in urban use, and trash container bodies for trucks, December 11, 1971.

[b] Although the "basic" tax on parts and accessories is 5 percent of the manufacturer's wholesale price, the 8 percent rate that became effective on a temporary basis November 1, 1951, has remained in effect through periodic extensions.

Source: U.S. Federal Highway Administration, Highway Statistics, 1973.

RETAIL SALES OF TRUCKS SUBJECT TO 10 PERCENT FEDERAL EXCISE TAX (INCLUDING IMPORTS OF U.S. MANUFACTURERS)

Calendar year	10,001 to 14,000	Medium			Heavy		Total
		14,001 to 16,000	16,001 to 19,500	19,501 to 26,000	26,001 to 33,000	33,001 and over	
1973	49,771	3,118	15,709	235,569	37,030	154,571	495,768
1974	21,038	2,693	14,455	207,001	31,036	147,533	423,756
1975	23,054	1,253	9,073	158,584	22,993	83,148	298,105

JANUARY-FEBRUARY NEW TRUCK RETAIL SALES IN THE UNITED STATES—(1973-76) (INCLUDING IMPORTS OF U.S. MANUFACTURERS)

Calendar year	10,001 to 14,000	Medium			Heavy		Monthly total
		14,001 to 16,001	16,001 to 19,500	19,501 to 26,000	26,001 to 33,000	33,001 and over	
1973:							
January	2,039	211	1,111	17,816	3,024	11,327	35,528
February	4,119	155	1,358	17,143	2,826	11,210	36,811
Total							72,339
1974:							
January	390	245	1,127	14,091	2,452	11,355	29,660
February	435	225	1,078	16,116	2,630	12,388	32,872
Total							62,532
1975:							
January	1,709	155	581	11,091	1,857	7,894	23,287
February	1,276	120	812	11,061	1,921	7,945	23,135
Total							46,422
1976:							
January	1,942	43	544	9,432	1,620	5,975	20,556
February	2,460	21	647	10,650	1,615	6,008	23,051
Total							43,607

TRUCK AND BUS FACTORY SALES BY GROSS VEHICLE WEIGHT EXCEPT EXPORTS

	0 to 6,000	6,001 10,000	subtotal	10,001 to 14,000	14,001 to 16,000	16,001 to 19,500	19,501 to 26,000	26,001 to 33,000	33,000 and over	Sub-total	Grand total
1973	1,639,663	713,210	2,352,873	44,272	6,443	15,543	180,345	37,834	149,503	433,940	2,786,813
1974	1,417,282	652,616	2,069,898	8,911	3,220	10,271	197,450	29,091	150,785	399,728	2,469,626
1975	897,292	853,310	1,750,602	13,914	917	5,718	139,769	21,555	70,283	252,156	2,002,758

U.S. INTERNAL REVENUE EXCISE TAX COLLECTIONS

[In thousands of dollars]

Calendar year	1973	1974	1975
TRUCKS, BUSES, CHASSIS, BODIES, ETC. (10,000 LB GVW AND OVER)—(10 PERCENT TAX)			
1st quarter	$117,138	$119,071	$138,038
2d quarter	145,959	142,817	104,152
3d quarter	137,522	148,516	81,719
4th quarter	120,289	143,453	69,648
Total	520,908	553,857	393,557
PARTS AND ACCESSORIES—(8 PERCENT TAX)			
1st quarter	26,772	30,155	31,411
2d quarter	29,886	31,036	27,723
3d quarter	29,875	34,500	28,629
4th quarter	29,538	31,418	28,648
Total	116,071	127,109	116,411

Source: U.S. Internal Revenue Service, press releases issued quarterly up to Mar. 17, 1976.

SELECTED FEDERAL EXCISE TAX COLLECTIONS TRANSFERRED TO THE HIGHWAY TRUST FUND, FY's 1974-77

[In millions]

Fiscal year—	Truck, bus, trailer (10 percent)	Truck, bus parts, accessories (8 percent)	Total trust fund
1974	$614.1	$130.4	$6,674.9
1975	601.6	143.1	6,773.8
1976 estimate	375.0	130.0	6,328.0
1st quarter	128.6	51.4	
2d quarter	9.7	25.1	
3d quarter	99.1	33.1	
4th quarter			
Total	237.4	109.6	
Transition quarter [1]	129.0	41.0	1,902.0
1977 estimate [2]	578.0	163.0	7,115.0

[1] July 1, 1976, to Sept. 30, 1976.
[2] Oct. 1, 1976, to Sept. 30, 1977.

Source: U.S. Federal Budget, fiscal year 1976, fiscal year 1977. U.S. Department of Transportation, Federal Highway Administration. Press release dated Mar. 11, 1976.

STATEMENT OF JAMES A. HACKNEY III ON BEHALF OF THE TRUCK BODY AND EQUIPMENT ASSOCIATION

Mr. Chairman and members of the Committee, my name is James Hackney and I am Chairman of the Taxation Committee of the Truck Body and Equipment Association. TBEA is a nationwide organization of manufacturers, distributors, and dealers of truck bodies, bus bodies, fire engine bodies and equipment, parts, and accessories used in connection with these items. All of these items at the present time are subject to the federal manufacturers excise tax imposed by Section 4061 of the Internal Revenue Code of 1954. Truck bodies and chassis are taxed at a 10% rate and parts and accessories at 8%. The members of the Association believe that it is time for the excise tax to be repealed or, at the very least, certain provisions of the Internal Revenue Code involving the tax should be amended to eliminate certain inequities in the tax which put some members of our industry at a competitive disadvantage with respect to others.

The manufacturers excise tax on truck bodies, chassis, parts and accessories is the last excise tax on vehicles. In 1971 the excise tax was removed from automobiles because of high unemployment in the industry and a desire to alleviate the problems of a recession-weakened industry. Virtually the same situation that existed at that time in the automobile industry now exists in the truck industry. Our industry is now in the midst of a general recession and is faring far worse than industry as a whole.

Heavy duty truck sales in 1975 were 37% lower than sales in 1974. Truck-trailer manufacturing was off an alarming 77% during the first ten months of 1975 from the already low 1974 levels. Plants for the manufacture of truck bodies and chassis have been closed all over the country, including the states of Tennessee, Missouri, Oregon, Indiana, California, New York, Kentucky, and Michigan. Chrysler has ceased producing heavy trucks and Mack and General Motors have reduced their production. At least one major truck manufacturer, Diamond Reo, is bankrupt. Unemployment is much higher in the industry than in the economy at large.

The repeal of the 10% tax on truck bodies and chassis and the 8% tax on parts and accessories would affect more than 800,000 automotive-related businesses in an industry which accounts for ⅙ of the entire gross national product. Repeal would not only reduce inflation in the cost of trucks and trailers, but would be passed along to the consumer in the reduced cost of all those everyday items which are transported to market by truck.

The manufacturers excise tax is an extremely regressive tax. The tax is passed on to every consumer in the price of the goods he buys and falls equally on the poor and the well-to-do. Repeal will put more dollars in the hands of the consumer to help keep the economy moving.

A more detailed discussion of the economic effects of repeal may be found in a study conducted in 1975 by Rinfret-Boston Associates. Copies of this study have been made available to members of the Committee and their staffs.*

The truck excise tax is supported by some as a user tax allocating the cost of maintaining the national system of highways on those persons and companies which use the highways. As a user tax the truck excise is arbitrary and inefficient, since it is imposed at a flat rate irrespective of the vehicle's use of the roads. It is imposed at the same rate on a truck which is demolished in an accident the day after its sale as on a truck which may use the highway for years.

The tax is incredibly cumbersome to administer. Its complexity imposes on manufacturers and the government costs far out of proportion to the revenue which it produces. This added cost is again passed along to the consumer in the price of the goods which he purchases that are transported by truck. Unlike the true user fees, taxes on gasoline and diesel fuel, the manufacturers tax is not a simple one to assess and collect. Innumerable variables in the base to which the tax rate is to be imposed, the person to be taxed and the use to which the taxed item is to be put, make it infinitely more difficult to administer than a simple sales tax or a tax on gas and oil.

The revenue effects of repeal would be just over $500,000,000 in the first year, and *approximately half that after 1977*, when the rate of tax is to be reduced to 5% under present law. The reduction would stimulate sales and *increase production*, thus increasing the revenue from other highway taxes and the income tax. When that $500,000,000 revenue loss is reduced by an increased income and highway tax revenues and the administrative savings at the Internal Revenue Service, it should be very slight indeed.

In 1974 the Highway Trust Fund received $6,675,000,000 in revenue and disbursed $4,576,000,000. Had the excise tax on truck chassis and bodies been repealed at that time, the fund would still have had a $400,000,000 surplus for the year. The Trust's annual surpluses have accumulated to a figure exceeding $11,000,000 in its reserve fund, and President Ford has suggested that 2 cents of the federal tax on a gallon of gasoline be remitted to the general fund and 1 cent to the states because the Highway Trust Fund has more money than it needs. It is clear that at this time and in the foreseeable future, the Fund has no need for the revenues raised by the truck excise tax.

For these reasons, we urge this committee to adopt a provision repealing the manufacturers excise tax on truck bodies, chassis and equipment. Moreover, we feel that the administrative complexity of the tax also compels repeal. There are over 2,000 I.R.S. rulings outstanding concerning the excise tax. These rulings are not published by the Internal Revenue Service and are often in conflict with each other. This not only illustrates the complexity of the statute and the difficulty with which it is applied, but also leads to discrimination in favor of those with favorable rulings *vis a vis* those with unfavorable rulings or no ruling at all. I would like to describe several situations which are illustrative of inequities in the imposition of the tax and the administrative burdens it imposes on the IRS and the industry alike.

One of the problems with the tax is establishing the tax base to which the tax rate is to be applied to arrive at the tax. The original intent of the tax was to tax all of the items at the price at which they would be sold by a manufacturer to a wholesale distributor. But as the tax is imposed by the Code and administered by the Internal Revenue Service different excise tax bases are established for identical taxable articles, dependig on who sells them. This creates disparities in price between competitors at the same level of distribution. If a taxpayer purchases a truck body from one manufacturer and a hoist from another and assembles them for sale to a consumer, the tax base will be his sales price to the consumer, because the Internal Revenue Service will consider him to be a manufacturer of a taxable article. The tax base will thus include the taxpayer's cost of assembling and marketing the item at a higher level of distribution, as well as his markup. If another taxpayer, purchases an identical truck body and hoist from a single manufacturer, the tax will be paid by the original manufacturer on his selling price and no further tax will be due from the distributor.

This treatment obviously places the manufacturer of only one product at a competitive disadvantage. What is more, it is an extremely difficult policy to apply. Thousands of hours of work are expended annually by Internal Revenue Service agents and attorneys, company executives and accountants, and legal

*This document was made a part of the official files of the committee

counsel in determining just which operations constitute further manufacture and which constitute the tax-exempt installation of a body on a chassis. This is time which produces little revenue and which could be more productively used by government and taxpayer alike.

The application of the further manufacture rule can also lead to the imposition of the tax at an effective rate far exceeding 10%. The following calculation is an actual case, involving the assessment of a tax on the ultimate consumer who obtained the installation of a tag axle on a previously purchased truck chassis.

Chassis purchased	$21,500
Tag axle installed	2,500
State tax	100
Subtotal	24,100
Because the user held title to the chassis he was classed as a manufacturer and since the IRS presumes that manufacturers do not manufacture without adding profit, the IRS agent added 10 percent	2,410
New tax base	26,510
10 percent FET	2,651
Credits:	
Tax paid by chassis manufacturer	1,600
Tax paid by tag axle installer	53
Subtotal	1,653
Total	998

The user is liable for an additional $998.00 of tax on a $2,500 purchase. If he had bought the tag axle from the seller of the chassis, his tax would have been $250.00, for a savings of about $748.00.

This is an actual case and the IRS Agent did nothing more than his job. He was right according to the law.

The above example is applicable for any truck equipment, including liftgates, cranes, chassis modification, and so on. The tax is discriminatory and creates an unfair competitive advantage that the truck equipment distributor has no way of combating unless the tax is repealed.

Since the original purpose of the manufacturers excise tax was to tax a product at the price at which it is sold by a manufacturer to a wholesale distributor, the statute allows the use of a constructive sales price as the tax base on sales by a manufacturer to the ultimate consumer. If a manufacturer sells a taxable truck body to a retailer, however, rather than to the ultimate consumer, the Internal Revenue Code dictates that his tax base is the sales price to the retailer. Due to the increased cost of selling to retailers as opposed to wholesale distributors practically the same as the cost of selling at retail), the tax base of such a manufactive sales price. Again, there is no valid economic reason for the distinction, and higher than the manufacturer selling at retail who is allowed to use a constructive sales price. Again, there is no valid economic reason for the distinction, and it results in extensive and unnecessary conflict and litigation.

The Internal Revenue Service allows manufacturers who do not normally sell at wholesale to use a constructive sales price equal to 75% of the manufacturer's price at retail. If the tax base computed in this fashion is less than the manufacturer's cost, however, the manufacturer is required by the Internal Revenue Service to use as his tax base his cost for the item sold, or in some cases, cost plus ten percent. This is clearly anticompetitive, as it discriminates against the manufacturer whose costs are high, such as a manufacturer in the process of expansion, who has a higher debt load than his competitors. The excise base should have no relation to the taxpayer's cost since it is supposed to represent the price at which the manufacturer customarily sells the item to a wholesale distributor. Cost has no relevance to this price. The application of this concept, too, has resulted in much conflict. Additionally, it is very difficult to establish cost, particularly the allocation of overhead to particular products, again resulting in much unnecessary and unproductive work for the Internal Revenue Service and the taxpayer alike.

In closing, we reiterate that the only real solution to the economic and administrative burdens of the tax is to repeal it entirely. Repeal would strengthen the industry, reduce unemployment and help to minimize inflation, all at an acceptable cost in loss of revenue. It would remove a source of competitive discrimination and free IRS personnel to deal with the more productive taxes. The tax was enacted as a wartime measure and has outlived the need for which it was adopted. The Congress removed the tax on passenger automobiles in 1971, and the House of Representatives has passed and sent to the Senate an energy bill which would remove those on intercity buses and radial tires in this session. The time has come to eliminate all such taxes.

Comments on the Effect of the Continued Imposition of the Federal Excise Tax on the Heavy Duty Truck Manufacturing Industry

In the early 1970's, Federal regulations were first introduced governing the manufacture of Heavy Duty Trucks. These regulations, covering such items as noise, emissions, etc., while creating vehicles which were more socially acceptable, also had the end result of increasing the prices of trucks. At the same time, the American economy was expanding at an unprecedented rate, and the demand for Heavy Duty Trucks needed to move the resulting freight showed no signs of abating. With the onset of inflation, prices of trucks increased rapidly along with all other products. At the same time, shortages of key raw materials increased the demand for Heavy Duty Trucks, due to lack of availability.

Because of the fuel shortage the Federal Government has imposed a maximum speed limit of 55 MPH for all highways. For the Trucking Industry a slower speed means a longer time period for a given haul and this has increased the cost of driver wages by some 9% for any given load. In addition to the extra labor costs, the actual cost of diesel fuel has risen an average of 84% in the past four years.

In 1974 a final decision was made by the Department of Transportation to enforce MVSS121 requiring the installation of anti-wheel lock devices on all air braked trucks (which encompass all Heavy Duty Trucks). The result was not only a heavier chassis (necessitated by the general strengthening of brakes, axles and wheels to withstand the stress created by short stops), which meant lighter, less economical, pay loads, but an increase of up to $1200.00 for the average truck plus a substantial increase in the price of the trailer.

Because of increased costs, brought about partially by Federally mandated expenses, the price of heavy duty trucks, both as an initial investment and as an operating expense, has risen to the point where it has become uneconomical for users to purchase new equipment. This is equally true of the owner-operator of single vehicles to the largest fleets operating coast to coast. (Attachment D) The cost of buying and operating heavy duty diesel trucks is growing at a rate far greater than the revenues available to potential customers. If this economic impasse continues, the result will be a totally inadequate transportation system which can only work to the detriment of the national economy. This occurred at the same time as the recession's full effects were felt.

The results have been catastrophic for the heavy duty truck industry, both manufacturers and users. In the course of providing vehicles which are safer than ever before, with emissions cleaner than any other form of transportation, the Industry has been forced into an untenable position. Attachments E, F and G show the results of the near collapse of the Industry—a decline of 54% in Industry Sales from 1974 to 1975, and a decline of 46% in Mack deliveries.

All indications are that 1976 will show a substantial economic recovery for the entire U.S., however, because of the factors outlined previously, the consensus of truck manufacturers is that the Heavy Duty Diesel Truck market will not share in this general recovery. It is anticipated that sales will increase only about 20% from the low of 62,841 in 1975 to approximately 75,000. This figure is still some 45% below 1974 sales and indicates the condition of our industry.

Not only has the collapse of the Heavy Duty Truck Industry resulted in tremendous loss in sales, but the unemployment rate experienced in our industry has been at an extremely high level. As an example, Mack Trucks, Inc. employment has fallen from a high of 14,186 in 1974 to the present level of 12,057. (Attachment H). It should be borne in mind that Mack Trucks, Inc. has been extremely fortunate in its major participation in the export market which has helped to alleviate the high unemployment rates suffered by other Heavy Duty Truck Manufacturers.

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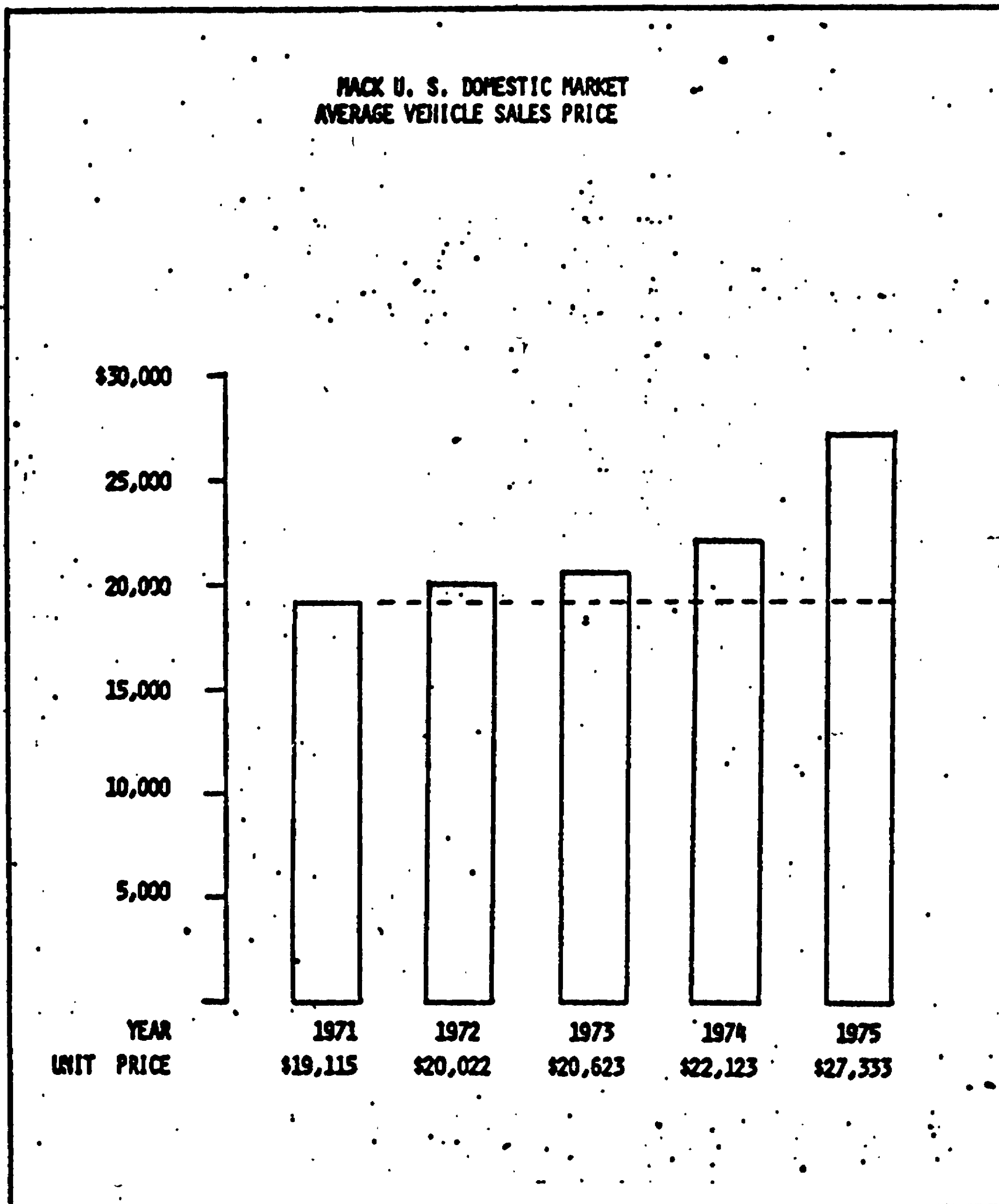
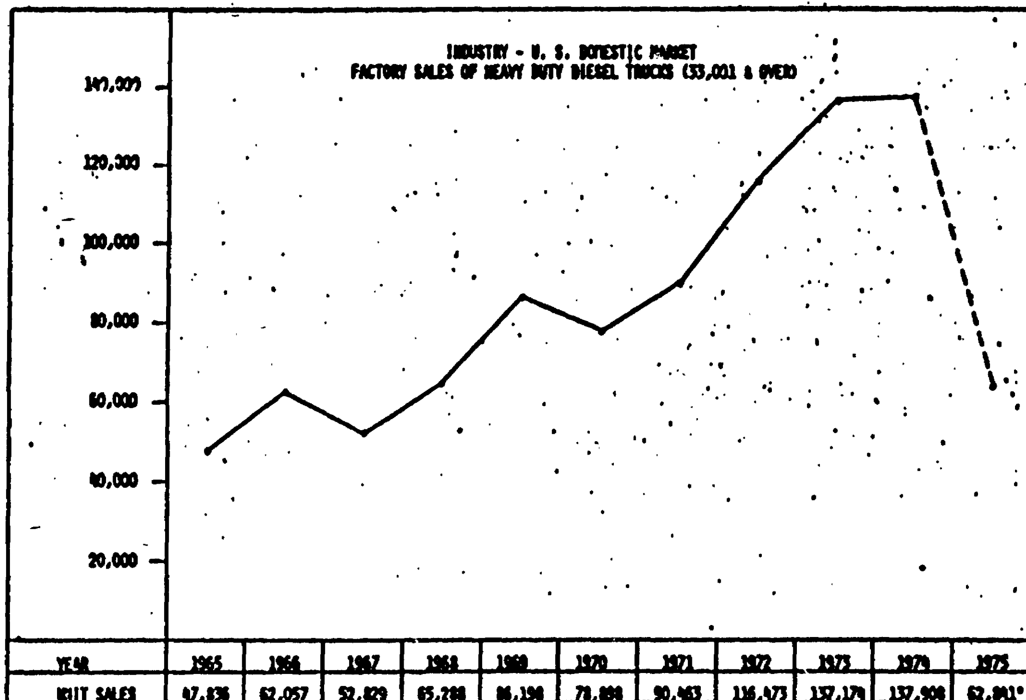
One large item included in the price of all heavy duty diesel trucks is the Federal Excise Tax, an impost previously removed from other forms of transportation. We feel that the elimination of this tax would make it feasible for truck manufacturers to reduce the price of their vehicles to a level where users could economically re-enter the market, and to enable the Transportation Industry to experience the revival necessary for the health not only of the Truck Manufacturing Industry, but the whole economy.

Respectfully submitted.

GARNER L. DAVIS,
Vice President, Sales.

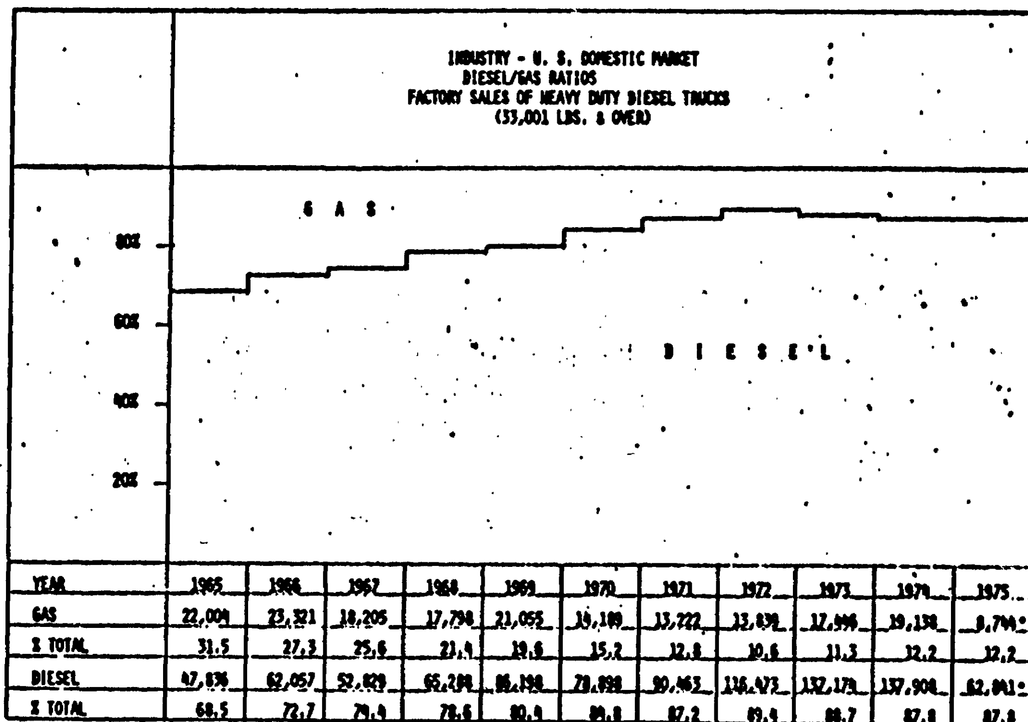




YEAR	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
UNIT SALES	47,836	62,057	52,829	65,208	86,198	78,898	90,463	116,473	137,179	137,908	62,881*

SOURCE - MOTOR VEHICLE MANUFACTURERS ASSOCIATION, INC.

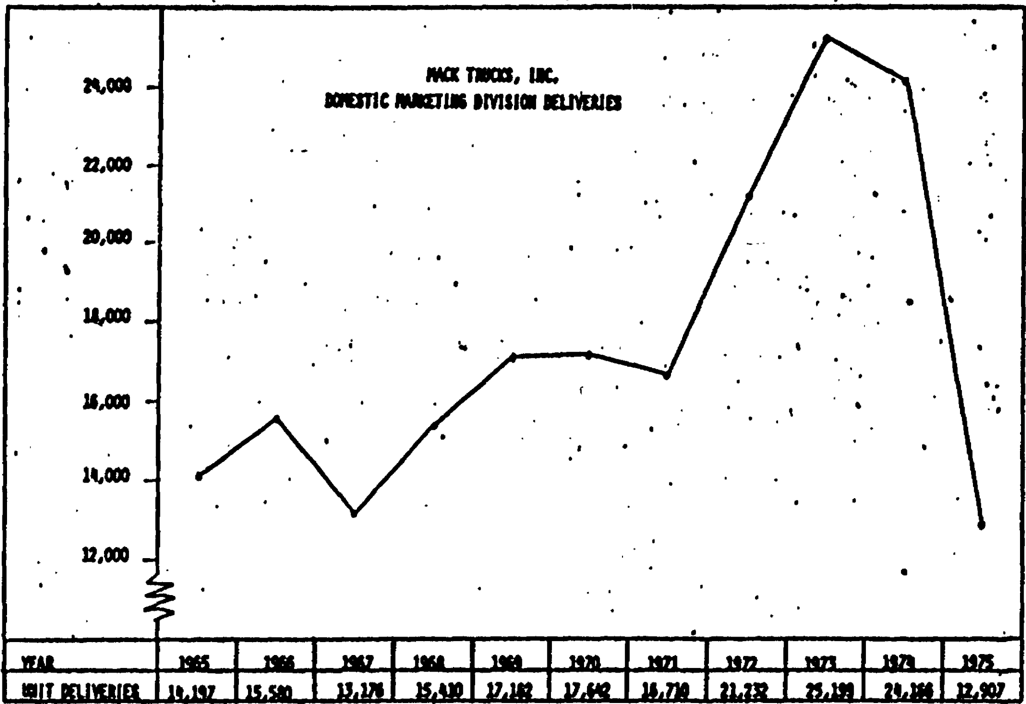
* BASED ON 11 MONTHS 1975 DATA



YEAR	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
GAS	22,004	23,321	18,205	17,798	21,055	14,180	13,222	13,839	17,496	19,138	8,744*
% TOTAL	31.5	27.3	25.6	21.4	19.6	15.2	12.8	10.6	11.3	12.2	12.2
DIESEL	47,836	62,057	52,829	65,208	86,198	78,898	90,463	116,473	137,179	137,908	62,881*
% TOTAL	68.5	72.7	74.4	78.6	80.4	84.8	87.2	89.4	88.7	87.8	87.8

SOURCE - MOTOR VEHICLE MANUFACTURERS ASSOCIATION, INC.

* BASED ON 11 MONTHS 1975 DATA



YEAR	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
UNIT DELIVERIES	14,197	15,580	13,176	15,410	17,182	17,642	16,730	21,232	25,199	24,166	12,907

MACK TRUCKS, INC.
PRODUCTION VS. EMPLOYMENT

PRODUCTION

INTERNATIONAL OPERATIONS
DOMESTIC

EMPLOYMENT

11350
13469
14146
14186
12057

2676
5457
10648

15818
22034
24803
22408
12132

1971
1972
1973
1974
1975

STATEMENT OF CHARLES J. CALVIN, PRESIDENT, TRUCK TRAILER MANUFACTURERS ASSOCIATION

My name is Charles J. Calvin. I am president of the Truck Trailer Manufacturers Association, which represents the manufacturers of over 90 percent of the truck trailers, tank trailers, cargo containers, and container chassis produced annually in the United States. The vast majority of trailer builders are classified as small businesses. In addition, over 100 major materiel and component suppliers to the industry are associate members.

My sole purpose for appearing before this Committee is to urge the repeal of the 10 percent Federal excise tax on truck trailers, truck bodies and trucks, and the 8 percent Federal excise tax on related parts and accessories. All the remarks made in this prepared statement should be interpreted with that point in mind.

Gentlemen, to the best of our knowledge no other industry suffered a greater decline in 1975 than the truck trailer manufacturing industry. While government economic indicators showed other industries down 10, 20, 30, 40 and in some cases 50 percent, our industry was operating at a 75.4-percent decrease! In no single month during 1975 did we operate at more than 25 percent of capacity! In some months our production was down 79.8 percent and 79.9 percent.

We might say that business is now improving but the fact is that January 1976 production remains down 66.6 percent and February down 61.0 percent.

Another indicator, the Federal Reserve Board's Industrial Production Index, shows that for 1975 the truck trailer industry averaged 61.8 percent of the 1967 base year. It is noteworthy to point out that the base year of 1967 was quite a low year in truck trailer shipments as only 96,539 units were reported. In comparison, 1968 shipments were 113,329 units; 1969 shipments 138,347 units; 1972 shipments 145,424 units; 1973 shipments 164,641 units and 1974 shipments 191,262 units. Thus, it can readily be seen that if any of these other years were the base year, the Federal Reserve Board's Index would approximate our 75.4 percent production decrease in 1975. Shipments in this sad year totaled 68,044 units!

While our industry was averaging 61.8 percent, according to the FRB, the truck and bus industry averaged 142.1 percent during 1975. For January 1976, the latest FRB Index available, we operated at 50.4 percent in comparison to 160.3 percent for trucks and buses. We would like to comment at this point that undoubtedly the trucks referred to were in the lighter gross vehicle weight category, many of which were 10,000 pounds or less and exempt from the Federal Excise Tax. This latest FRB Index of 50.4 percent for January 1976, when the economy is supposedly looking up, shows our industry still in serious straits. In fact, eleven of the twelve months of 1975 showed a higher index while only one, July 1975, was lower, at 49.1 percent!

The one bright feature of 1975 for our industry was a jump in exports. During the twelve months of 1974 we exported 9,218 units; during the first ten months of 1975 (latest Commerce Department figures available) we exported 13,119 units. If it were not for this export business our industry's suffering would have been even greater.

Naturally, this tremendous decrease in plant production hurt all segments of our industry. Hardest hit of all were 65 out of every 100 employees who were laid off, and most of the remaining 35 were retained for their special skills because of management's desire to keep some plants open with the hope that business would improve. In January and February 1976 we find that there are still 35 to 50 percent of the employees not working.

As can be imagined, the multiplier effect of this unemployment is also being felt in our associated supplier industries. As an example, one component supplier found it necessary to reduce his work force of 940 employees to 140 when a six-month backlog of orders fell to a one week backlog over the course of a weekend!

The truck trailer manufacturing industry has had to cope with reversals in the national economy as has any other industry. However, there are other Federally mandated burdens on our industry in addition to those universal factors. One of these, a serious and worsening problem for more than twenty years, is the 10 percent Federal Excise Tax on truck trailers, trucks and truck bodies, and the 8 percent Federal excise tax on related parts and accessories. The other burden is the inflationary increase of approximately $800 to the cost of new equipment manufactured after January 1, 1975. This was brought about by

Federal Motor Vehicle Safety Standard 121 which requires the installation of an antilock braking system. The 10 percent excise tax also applies to the cost of this new equipment.

Realco Services, Inc., a company which leases over 32,000 trailers to railroad intermodal operations, and the Illinois Central Gulf Railroad, an operator of a substantial number of piggyback trailers, have stated these burdens are strong deterrents to the purchase of any new equipment, and both have suggested that excise tax repeal would offer urgently needed business stimulation.

Late last October the National Highway Traffic Safety Administration conducted a series of meetings, during which testimony from representatives of the motor carrier and bus operator industries indicated that their reluctance to purchase new vehicles was due, to a great extent, to the added expense of 121 equipment. Testimony by antilock systems manufacturers pointed out that the relatively few 121 vehicles in use, out of the total commercial vehicle population, severely hampered efforts to evaluate these systems. In a November 6 letter to Dr. James B. Gregory, Administrator of NHTSA, we suggested that the motor carrier industry perhaps would more readily accept the challenge of working with antilock if the burden of the 10% Federal excise tax on truck trailers, truck bodies, trucks and buses, and the 8 percent excise tax on related parts and accessories were lifted. The suggested "trade-off" would not only serve the interests of highway safety, but offset the disastrous effect that the added expense of antilock is having on our industry.

If the present status quo is maintained, the Excise Tax Branch of the Internal Revenue Service cannot collect excise taxes on trailers that are not being built; the S. 121 braking systems cannot be installed on non-existent new trailers; and the carrier will continue using pre-1975 transportation equipment. Who wins? . . . or more sensibly, don't we all lose? The excise tax repeal would help offset the high cost of added safety equipment and undoubtedly result in greater sales, higher employment, and a stimulated economy.

Not only is this tax discriminatory and financially burdening, but the sheer complexities involved in interpreting, applying, and administering the regulation and its rules have necessitated undue expenditures in time and manpower by trailer manufacturers, tax attorneys, and government administrators. We would venture to say that the cost of *collecting* the truck trailer excise tax quite possibly exceeds the income.

To add emphasis we quote a former Chief of the Excise Tax Branch of the IRS:

"Before the Excise Tax Reduction Act of 1965, we covered a wide variety of industries. Industries that had different distribution patterns than you (truck trailer manufacturers) may have. Industries having the conventional distribution, patterns—that is, the sale to the wholesale distributor level and beyond that possibly a sale to a jobber level who is an intermediate wholesale distributor and then to the dealer or retailer and finally to the consumer. . . .

"Where we run into problems is where manufacturers sell directly to consumers, thus constituting a sale at retail. Or, they may sell to dealers who, in turn, sell to consumers. But, we are aware there is no wholesale distribution pattern in the (truck trailer manufacturing) industry and I suspect this is one of the problems that bugs this industry."

As pointed out, this tax law was conceived for another industry and another distribution pattern (the automobile wholesale and retail sales method). Our industry does not have a wholesaler-to-dealer pattern, but operates mainly on a manufacturer-to-user concept.

We quote another excise tax expert:

"Until the existing selective excise taxes are repealed in their entirety or replaced by a uniform tax, any improvement . . . is a step forward. However, many interpretative problems remain for subsequent resolution, and in view of the deficiencies as indicated, the administrative problems of compliance, enforcement, and uniform application continue to be difficult."

All of these difficulties are magnified even more when consideration is given to the fact that there are probably no more than ten individuals who are "bona fide" excise tax experts who are presently active in industry or government.

The excise tax was originally imposed as a "temporary" measure. The majority of similar selective excise taxes have been repealed. The remaining truck-related excise taxes are thus unfair in that similar taxes are no longer levied on competing forms of transportation; e.g., trains, planes, river barges, freighters, and

pipelines. Nor does a similar tax apply to other goods which enter into the production process, such as machinery and equipment. Nevertheless, the most basic transportation for the most basic essentials of life—food and clothing—is still being devoured by this parasitical remnant. The manufacturing segment of the trucking industry might well be considered the only target left for the Excise Tax Branch of the Internal Revenue Service and the number of rulings and determinations have extended coverage, not just to trailer manufacturers, but also to equipment distributors, dealers, and owners.

An excise tax law should not lend itself to the possibility of being used as a competitive factor. However, we believe that this law, and its thousands of private tax rulings which are not available to the industry as a whole, are subject to varying interpretations which may unintentionally result in unfair competitive practices.

As you know, the Senate last Spring passed legislation to repeal these unfair and burdensome taxes. House-Senate Conferees, however, deleted the provision and on August 6, 1975 the Committee on Ways and Means advised this office that, "In the Conference Report, the conferees have indicated awareness of the depressed condition in the truck and bus manufacturing and marketing industry. However, the conferees felt that the repeal of these excise taxes should more properly be considered in conjunction with the Committee on Public Works, at a later date when Congress considers the Federal Highway Act and the Trust Funds of which these two taxes are a part."

Well, Gentlemen, time has passed, Federal Highway Act and Trust Fund legislation has been enacted and still we're waiting for relief. There is one very interesting point, however. The Committee on Ways and Means, and the House have approved legislation to repeal the excise tax on buses and radial tires! On July 25, 1975 the Senate Finance Committee issued a press release advising that it had agreed to repeal the excise tax on *all* buses and repeal the tax on all tread rubber used to recap or retread all tires, not only radials.

Once again the truck trailer manufacturing industry is forced to tighten its belt and continue its suffering.

In an effort to assist manufacturers, the Truck Trailer Manufacturers Association has published a Federal Excise Tax Guide. Over the years, this loose-leaf publication has become a valuable aid, not only to trailer manufacturers and component suppliers, but to manufacturers of trucks, truck bodies, truck tractors, and buses and special passenger vehicles, who are all subject to the tax law. Dealers, distributors, and motor carrier OWNERS who make certain types of modifications or 'repairs' to vehicles are considered statutory manufacturers and subject to the tax. Even though this guide book has 740 pages and weighs almost eight pounds, it still cannot be considered the ultimate panacea to the interpreters of this difficult excise tax regulation.

As an example of some of the frustration involved in dealing with the tax, Howard Upton of the Petroleum Equipment Institute tells his members about a trip to Washington on tax-related matters. He continued:—

"On the plane returning home, I pulled from my brief case the proposed new IRS excise regulations which re-define "highway vehicles". I read away at these regulations, sentence by sentence, throughout the two-hour flight, and by the time we landed here I was in a state of genuine depression.

"It was not that I was upset by what I could understand of the substance of either the new regulations covering association income or the proposed new regulations covering excise taxes. Neither will have much effect on us. Rather, I was depressed by the sheer incomprehensibility of the regulations.

"I have a law degree. For many years I have spent three hours or so each morning reading the Federal Register and a variety of legal services we subscribe to here. I have been rather deeply involved in the subject of excise taxes on truck bodies and accessories for nearly 15 years. If anyone should be able to read new tax regulations and comprehend what they mean, I should be. But I confess that the language of the rules overwhelms me. And if I can't figure what the regulations say or mean, how is the average citizen—with a business to run or a job to do— ever to comprehend them?

"I acknowledge the need for government regulation. We have to pay taxes. We have to clean up the air and water. We have to do a lot of other things that can be accomplished only through laws and regulations. But there is something fundamentally wrong with a regulatory system that cannot communicate in a style that a man or woman of reasonable intelligence can understand.

"To use one narrow example, our own members do not object to paying excise taxes on truck bodies and accessories. Rather, it is the outrageous abstrusity of the rules—the uneveness and the uncertainty—which frustrates them, and erodes their confidence in government.

"I think we are going to have to make massive changes in the entire regulatory concept. Congress has largely abdicated to the bureaucratic establishment the authority to make the rules which impinge most intimately on our lives. The people in the regulatory agencies are generally good people. They are trying to do their jobs. But it is impossible for a man sitting in a Washington agency office to draft, say, a detailed set of fair and understandable vehicle safety design rules that will apply with equal relevance to General Motors and Ted's Body & Frame Shop. Yet, that is what the rule-makers are trying to do. And it is no wonder that the regulations come out so tortuously worded that we cannot even understand them, much less abide by them.

"I think the present approach to promulgation of regulations must be radically changed.

"If my sense of indignation on this subject does not subside, I suppose I shall feel compelled to (a) stop reading the Federal Register, (b) take up transcendental mediation, or (c) run for Congress."—and work for repeal.

To further emphasize the complexities of the excise tax, the IRS, on February 13 and March 1, 1976, published notices in the Federal Register to the effect that portions of the Code of Federal Regulations pertaining to excise taxes had been "inadvertently omitted" since 1971 and would be reinstated. The failure to publish these regulations for five years certainly carries their omission beyond "inadvertent error" and for a period of 5 years taxpayers have not had notice of their alleged existence. In addition, these notices offer Treasury Decision 6091 as a basis for reinstatement of these sections. TD 6091 was handed down for the sole purpose of making the 1939 Internal Revenue Code applicable to the 1954 IR Code until regulations for the 1954 Code could be promulgated. Yet, more than 20 years later, TD 6091 is still being asserted as a basis for reinstatement of regulations. In this particular instance, one of the sections of the Code of Federal Regulations which the IRS would reinstate was not promulgated until 4 years after TD 6091 was handed down. Furthermore, the regulations that IRS would reinstate have been superseded since their original promulgation.

To those who would remind us of the sacrosanctness of the Highway Trust Fund we ask that, as one example, they refer to the exercise tax repeals of 1971 to stimulate industries building autos, certain buses, and trucks and trailers under 10,000 lb. gross weight.

During the 20-year period from 1956 through 1975 the excise taxes collected from the truck trailer manufacturing industry averaged approximately $40 million annually. The tax, while it has been a financial burden to our industry and an administrative nightmare to both our industry and the government, has contributed only 1.1% of the trust fund total. Certainly this tax on truck trailers cannot be considered a lucrative source of revenue. The fact that this tax, as a source of funds, is relatively insignificant, while it has constantly created confusion and untold collection and administrative expense, would lead us to believe that IRS officials themselves would welcome repeal of the law.

Since its inception, the Highway Trust has been a target source of funds to finance projects other than construction of the Nation's highways. Mass transit is one of these projects. We would like to point out that mass transit problems are not created by truck trailers and that every dollar removed from the trust fund to further mass transit interests makes the punitive tax on truck trailers even more inequitable.

It is also interesting to note that the fiscal 1976 funding level for the Federal Aid Highway Program is $7.56 billion and while it is anticipated that the Fund will raise this amount, the Administration proposed 1977 budget spending limit is only $6.7 billion, thus indicating the Fund is once again collecting more than it needs.

If all automotive taxes were repealed the Fund would stand to "lose" between $500–$700 million (truck trailer excise taxes receipts for Calendar 1975 were approximately $40 million).

Secretary of Transportation William T. Coleman in his "Statement of National Transportation Policy" states, "The Federal gasoline tax has provided more than adequate capital funds for highway construction."

Let's say Congress does repeal the automotive excise taxes. It must know that highway experts point out that a one-cent increase in the fuel tax would result in an increase of $1 Billion in receipts to the Fund annually! Imagine, a relatively simple collection task replacing a complicated $500–$700 million 10% excise tax on equipment and 8% excise tax on related parts and accessories!

Incidentally, Canada last November saw fit to repeal its 12% tax on transportation equipment.

There is one more very important matter to be considered. *Outright repeal is the only sensible solution to this troublesome tax problem.* A reduction would, of course, help the purchaser; however, every single administrative problem created by the 10% and 8% taxes would remain intact even if they were reduced to 1% or less! In fact, any reduction would only serve to greatly intensify the collection burden which, in the truck trailer manufacturing industry, is believed to already exceed the value of the revenue collected. In other words, we believe it costs industry and government $1.00 to collect $1.00. If the tax were reduced we might find ourselves spending $1.00 to collect 10 cents!

It is our sincere belief that the production decreases, plant closings, and the unemployment that has so devastated the truck trailer manufacturing industry in 1975 and continuing in 1976 can be reversed in the near future. However, the remedy must be administered immediately and that remedy is Congressional repeal of this "*luxury*" *tax on the most basic transportation for the most basic essentials of life-food and clothing.* We urge you to consider the vital necessity of repealing the discriminatory and punitive 10% Federal excise tax on truck trailers and the 8% excise tax on related parts & accessories. We are not requesting Federal protection nor billions of dollars in Federal funds in order to "reorganize". Our plea is for an opportunity to put our people back to work and help stimulate the recovery of the National economy.

The CHAIRMAN. We will next call Mr. Stephen Ailes, president of the American Association of Railroads, and we will ask him to identify those who are testifying with him.

PANEL OF STEPHEN AILES, PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS, ACCOMPANIED BY JOHN P. FISHWICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORFOLK & WESTERN RAILWAY CO.; DR. WILLIAM J. HARRIS, JR., VICE PRESIDENT, RESEARCH AND TEST DEPARTMENT, ASSOCIATION OF AMERICAN RAILROADS; W. GRAHAM CLAYTOR, JR., CHIEF EXECUTIVE OFFICER, SOUTHERN RAILWAY SYSTEM, AND F. E. BARNETT, CHAIRMAN, BOARD OF DIRECTORS AND CHIEF EXECUTIVE OFFICER, UNION PACIFIC RAILROAD

Mr. AILES. Good morning.

The CHAIRMAN. Senator Byrd wanted to be recognized at this point.

Senator BYRD. Thank you, Mr. Chairman. I just wanted to welcome to the committee two distinguished Virginians, Mr. John P. Fishwick, president and chief executive officer of the Norfolk & Western Railway, and W. Graham Claytor, Jr., chief executive officer of the Southern Railway System. We are pleased to have these two distinguished Virginians before the committee this morning, and I would like to welcome Mr. Ailes, too, who rendered such fine service to his Nation here some years ago.

The CHAIRMAN. We are happy to have you gentlemen.

Mr. AILES. Thank you, gentlemen.

These gentlemen are representing their railroads, and we have here the executive officer of the Union Pacific. The gentleman on my right is

Dr. Harris, director of research and testing for the Association of American Railroads. These gentlemen wish to testify about some of the tax problems that do affect our industry and each has a statement which he will submit and summarize.

Dr. Harris these three railroads are tax-paying railroads, and they are interested in the problems you are studying here.

The CHAIRMAN. All of them would like to be tax-free railroads.

Mr. AILES. You are right.

The CHAIRMAN. It is not their fault that they are not, I might say.

Mr. AILES. That is correct.

Dr. Harris does supervise extensive programs in track structure research, and is an expert on subjects like track wear and track life and so on. He does have something to contribute in that way.

So we will begin, with your permission, with Mr. Barnett. Do you want to start with Mr. Fishwick?

Mr. FISHWICK. Thank you, I am John Fishwick, chairman of the Norfolk & Western. I have filed a statement which I would like to be put in the record.

The CHAIRMAN. All your statements will be put in the record in their entirety.

Mr. FISHWICK. I appreciate the opportunity to appear before this committee on behalf of the railroad industry and Norfolk & Western Railway Co. to present my views on the important tax policy decisions this committee can make to help solve the problems facing our industry. I am sure this committee is well aware that the railroad industry is entering a period of great challenge. The next few years will determine whether railroads can continue to exist as a strong free enterprise segment of the American economy or most become part of a nationalized transportation industry. Railroads, not only in the East and Midwest but throughout the country, are faced with severe problems of developing plant and equipment to meet expanding transportation needs of the economy while experiencing chronic cash flow shortages.

Industry projections of traffic forecasts make it clear that the railroad industry must concentrate on improvements in the utilization of cars in order to handle the traffic produced by the economy in the next 10 years. Here is a real opportunity for capital investments to pay off in increased productivity which will directly benefit the consumers and the economy. Our studies show that improving car utilization by 2 percent annually—compared with a 1-percent historic improvement in utilization—would enable a savings of $5 billion of the nearly $20 billion of investment purchases anticipated by the industry during the next decade.

Presently a freight car moves on the average only about 57 miles per day. Obviously this presents dramatic opportunities for increasing car utilization. This can be done in two basic ways—first, by increasing train speed through track improvements and the elimination of slow orders and second, by improvements to existing yards and the development of new yard facilities to eliminate switching delays. Investments in yard and track improvements will greatly enhance equipment usage and improve our ability to meet the Nation's transportation needs at the lowest possible cost.

These needed capital investments must be financed from internally generated funds since railroad mortgages preclude new financing for most road projects. Moreover, many of these investments are depreciated under the requirement-replacement method which defers recovery through tax deductions until the assets are actually retired which may be many years in the future. When these factors are considered with the industry's low return on investment and shortage of cash flow, it is clear that railroads will be hard-pressed to form the capital needed to pay for the improvements. By enacting far-sighted tax provisions this committee can be the key factor in making these investments possible so railroads can meet their responsibilities to the Nation.

First, I believe it is important for this committee to recognize, as it has before, the need for the railroad industry to realize tax deductions for its substantial investments in the cost of grading and tunnels. Railroads have capitalized substantial costs for grading and tunnels, but generally have been unable to depreciate them because of uncertainties as to the length of the useful life of these assets. In the Tax Reform Act of 1969, this committee and the Senate-passed legislation which would have permitted railroads at their option to amortize all railroad grading and tunnel bores on the basis of a 50-year life. Present law provides only partial relief and perpetuates the railroads' inability to recover their investment in these assets acquired before 1969. This is the only industry with such substantial costs in business assets which cannot be recovered by tax reductions. We should be allowed to recover our investment over the same reasonable 50-year period. Recently, the U.S. Tax Court recognized that obsolescence is inherent in railroad grading and tunnels. While this is a welcome judicial recognition of the principle that tax recovery should be allowed on these investments, railroads should not be required to utilize their already scarce cash flow fund in extensive and lengthy litigation to prove the precise remaining useful life of grading. First, we believe this case, along with a large-scale abandonment of track which is now occurring in connection with the eastern railroads reorganization plan, graphically illustrates the need for this committee to make it clear through legislation that railroads are entitled to a reasonable recovery of their investment of these assets. At the same time, it would be appropriate for this committee to act with respect to the other major areas of frozen railroad investment not now subject to tax deduction.

Under present law, costs of track construction are capitalized and no deduction is assured until the investment in the track is retired at some time in the future. This involves the same wasteful deferral of tax deductions as in the case of grading. It freezes large amounts of investment which are becoming obsolete and permits no recognition of their obsolescence. We believe it would be appropriate for the railroads to be allowed tax deductions to recover their frozen investment in track accounts over a reasonable period of time similar to that of grading.

The grading and track construction to which I refer are comparable operating rights-of-way of our competitors, trucks and barges, who have had these assets provided at taxpayer expense. Railroads, on the other hand, have not only been required to purchase, build and maintain their operating rights-of-way, and at a very substantial costs, but

to pay local and State taxes on it, and then to cap it all, the allowance of amortization and deductions to recover our frozen costs from these assets is not allowed, and at a minimum that should be allowed.

Further, we strongly support every action of this committee in recommending a 12-percent investment credit on the acquisition of qualified railroad track improvements, communications and signal systems, rolling stock, including freight cars and locomotives, classification yards, and so forth.

As a complement to the increased investment credit, we believe the committee should approve a provision for 10-year amortization for investments in the track structure to eliminate the problems caused by the industry's present inability to recover tax deductions on these investments until they are retired.

We think this would be sound tax policy and would enable our industry to meet its responsibilities as a viable part of the American economy. Railroads, as the most energy efficient form of transportation, must make a vital contribution to the Nation's economic strength. To meet this challenge, however, we need the capital formation that will result from the constructive tax legislation we have outlined.

Dr. HARRIS. I am William J. Harris, Jr.

The present configuration of track structure is the most notable element that can be observed about the railroad system. The track structure we have today stems from 1832, when rail was put on cross ties for the first time.

The most obvious component of the track is the rail. The rail has changed in shape over the years so as to obtain additional metal to resist the wear of the heavier cars and to provide greater stiffness against bending of the rail as it bridges from one tie to the next.

The tie is a very important part of that track structure in that it helps distribute the load of the railroad car on the steel wheel rests on it, but the tie is not enough structure to provide for a sound engineering response to the loads of the train on the track.

In fact, the tie has to be solidly imbedded in material called ballast which is designed to prevent the rail from moving aside as the train bears on it, and in long welded rail, to provide against the lateral movement under loads of that rail itself introduced by the heating of the sun.

This combination of rail, ties and ballast is a fascinating engineering structure which has been developed over many years. Over that period of time, since 1832, the design of the track structure was related to the cars that moved over the track. The first cars were quite small, on the order of 10 tons.

Senator BYRD [presiding]. I regret the time has expired. Mr. Ailes, you still have additional witnesses.

Mr. AILES. Yes, sir.

Senator BYRD. I wonder if these two witnesses could very briefly summarize their views, because the time has expired.

Mr. AILES. Yes, sir, we can do that.

Can Dr. Harris state a concluding sentence here with what he has got and then we will turn to Mr. Claytor?

Dr. HARRIS. We have been able to invest in cars, and we have improved a substantial amount of track, but not all respond to the

heavier cars. The heavier cars require a very rapid rate of change to complete the upgrading of the track structure. That rate of change cannot be accommodated within our fiscal capability. We believe the funding for that investment can be pursued more effectively if the proposals before you for amortization of the cost of track are accepted. The balance of my views are contained in my written testimony which has been submitted for the record.

Mr. AILES. Mr. Claytor?

Mr. CLAYTOR. I am Graham Claytor, chairman of the board and chief executive officer of the Southern, here in Washington. I would like to mention just briefly what I think is a very important proposal, to include a new provision in the Internal Revenue Code that will enable our industry to expedite the upgrading of its railroad track to meet the needs of an expanding economy by providing 10 years amortization for additions and betterments to track.

As Mr. Fishwick pointed out, the capital costs are not depreciated at all on an annual basis for tax or other purposes, and accordingly cannot be recovered until it is replaced. Under an amendment in 1969, the Congress permitted the amortization of new grading and tunnel boring on a 50-year basis at 2 percent, but the capital costs of other components of track improvement cannot be recovered at all. So what I propose here is that investment in new lines of track and additions and betterments to existing track be allowed a 10-year straight-line amortization for tax purposes.

Now, as I put it once before, in testimony before this committee, I look upon this proposal not so much as a tax incentive provision as a tax enabling provision. With the expansion of the importance of moving coal, ore, and other heavy materials, we are having to use almost entierly 100-ton cars. These cars in turn require a very substantial upgrading in the track structure, the increasing of the weight of the rail anywhere from 120 to 132 pounds, which is the minimum we can use for these heavy cars. This additional capital cost is greater than the railroads have the cash to meet on the kind of schedule that is needed. I look on this not as the tax incentive, but as a tax enabling provision. A 10-year amortization of these important capital costs would enable us to do the job that much faster, and we need it very badly.

Finally, in conclusion, I would like to emphasize that this provision would result in a deferral of taxes, not an outright reduction in tax liability. What we seek fundamentally is a difference in timing of the taxpayment so as to produce the favorable cash flow that will enable us to meet the heavy expanding capital requirements of our industry in upgrading our track.

Thank you.

Senator HANSEN. Mr. Chairman, if I could interrupt, let me say that the last distinguished witness represents the Union Pacific Railroad and also the States of Wyoming and Nebraska, and indeed much of the entire West. I join with Senator Curtis in welcoming here today Frank Barnett, the chairman of the board and chief executive officer of the Union Pacific, a railroad that has contributed mightily to development and employment of people.

Senator CURTIS. I concur in that.

Mr. BARNETT. Thank you, Senator Hansen.

I am sure that you will be interested to know that we have 10 new spur track construction programs in the State of Wyoming alone.

That is not to say that many programs are going on in the State of Nebraska.

My function today is to summarize the points made by my colleagues, which I will try to do very briefly.

We have three different provisions in mind, and we urge congressional enactment of specific provisions which would:

(1) Permit our industry the right to amortize over a 10-year period additions and betterments for track structure.

(2) Provisions which would permit our industry the right to amortize over a 50-year period, commencing upon the effective date of enactment, our frozen investment in grading and tunnel bores, representing expenditures made prior to 1969.

(3) Along with other capital intensive industries, we would urge cash refunds for investment credit carryovers which expire without tax advantage to the investors. Short of this, we would call this committee's attention to the fact that many members of our industry are still precluded from taking full advantage of the intended economic benefits of the investment credit because of the current limitation on the availability that credit 50 percent of the tax.

As of the end of 1974, the latest year for which industrywide figures are available, total unused investment carryovers for all class 1 railroads was approximately $320 million. Of this total, about $214 million are attributable to the 17 tax-paying railroads. A removal of this limitation would allow these taxpaying roads to generate additional capital so critically needed for capital additions and improvements.

Moreover, nontaxpaying members of our industry will derive benefits by way of reduced rentals under investment credit leases where the nature of the underlying property will permit such leasing.

With respect to unused investment credit carryovers, we urge this committee to consider amending section 46 of the Code to permit taxpayers to utilize these carryover credits on a first-in, first-out basis.

For example, for the taxable year 1976, a taxpayer would utilize unexpired credit carryovers generated in the earliest carryover year, 1969. Carryovers from years following 1969 would be used in chronological order before credits generated by investments made in 1976.

Finally, we strongly support this committee's recommendation of a 12-percent investment credit with respect to the acquisition of qualified railroad track improvements, communications and signal systems, rolling stock, classification yards, and trailer and container facilities.

Thank you very much, and we will be glad to try to answer any questions the committee may have.

Senator HANSEN. May we submit questions in writing?

The CHAIRMAN. Yes. I have one question to ask now, however.

Personally, I think that the investment tax credit ought to be made a refundable credit, because I think a new company ought to get it regardless of whether it is making a profit in the first few years or not, and the company should not be denied it just because it is not showing a profit at the moment.

I think they earn the credit when they buy the equipment. But it might be too much of a departure from previous thinking to urge an

amendment doing that at this time. I would like to know what you would think about changing that so that the credit could be claimed on it up to perhaps 80 percent of earnings or 90 percent of earnings, or something of that sort.

How does that strike you?

Mr. AILES. Frank, do you want to speak to that?

Mr. BARNETT. What is the question?

Mr. AILES. If the 50-percent limitation is lifted to 80 or 90, Senator Long's question is how would the industry respond to that?

He said, on the refund problem maybe more could be done.

The CHAIRMAN. Rather than make it a total refund, maybe give you a carryback, and say that you could claim the credit up to 80 or 90 percent, or something of that sort. How does that appeal to your group?

Mr. BARNETT. It would appeal to us very much. It is true, as you say, Senator, that perhaps the totally refundable tax credit is too much of a departure from present congressional thinking. And if we could go up to a credit of 75 percent or 80 percent of the tax, I am sure that you would find universal acceptance for such an arrangement.

The CHAIRMAN. It seems to me if you want to modernize the railroads, you shouldn't wait until all the railroads are in the black to start getting the credit. They need the money now, don't they?

Mr. BARNETT. They need the money right now, and I talked with Senator Hartke about this many, many times, and as he well knows, and we have pointed out with all the vigor at our command that what is needed as of now is to place orders for steel rail, to be sure that it is available, and there are those of us who have been working toward that end.

The rehabilitation of the Northeast will not be done, or completed, next month. It is going to take time. It has taken a great deal of planning, and we need to go on the entire program now.

The CHAIRMAN. It seems to me that all the record indicates that we make money with the investment tax credit. We are going to have a chart to demonstrate it. President Kennedy contended that that was how it would work out, and I think the charts and graphs would show that that is how it has worked out. Given this incentive to industry, we have made money. They can call it a tax expenditure if they want to. That doesn't plague me.

This is one case where we are sharing with industry the chore of getting something done to move the economy ahead, and while it costs something on first blush, if you look at the sum total effect, it makes this Government a great deal of money to give business this incentive.

Now, if you look at it for what it is, it is a carefully considered tax expenditure. That is one I don't mind calling a tax expenditure, because that is not where you say you pay a certain amount of taxes based on income, but it says, "If you buy this equipment, we will give you funds out of the Treasury."

We could make it a refundable tax credit. We have precedent for that type of thing, but if we are not going to do that, we could claim it up to 90 percent, say, or what the taxes might be, and you could then have a carryback.

Mr. CLAYTOR. I think we are in agreement with that. In the best of all possible worlds the refundable tax credit is the best. Short of that, the next best thing would be to raise the limit, which prevents us from

using the credit we have earned in prior years to at least 90 percent, or eliminate the limitation altogether. To me that is the single most important issue now, because that would produce the fastest result in money spent on railroad improvement that I know of——

The CHAIRMAN. We tried to do something for the maritime industry and then found out it didn't work out that way at all, because of something we didn't foresee at that time. You are trying to help move a depressed industry and because they are depressed, what you did to move the industry failed to accomplish its purpose.

I don't think we should discriminate against a poor soul because at the moment he is not able to pay an income tax. We could give you a credit against what you are paying in social security taxes.

Mr. BARNETT. Senator, I testified before this committee on the enactment of the first investment tax credit in May of 1961. Since that time the railroad industry has been solidly in opposition to the repeal of the credit. We have been solidly in support of the reenactment of the investment tax credit, and we are now solidly in favor of making it a permanent part of our tax structure.

Why? Because we know it works. We have seen it.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. I think I agree with your position almost totally. Let me compliment you, Dr. Harris, on your statement. I was fascinated by the history of the wheel and tie and why 100 tons is as large as we can practically get at the moment. It is the kind of evidence in much of the testimony we get, and I found it very compelling.

Dr. HARRIS. Thank you.

Senator PACKWOOD. No other questions.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. I would like to ask this question of whomever wishes to respond. I am concerned about—I think that the investment tax credit has been a very useful, worthwhile tool to accomplish objectives, and I think that is fine. I can't really decide where I come down on making it refundable.

I know that the airlines have strongly urged this, and when you look at their situation, their deteriorating revenues, and how their costs have gone up, they make a pretty persuasive case. But if you could help me, I have to believe that the element of competition ought to continue to be a viable tool in sorting out good from poor operations, and I am wondering if we use this, if it might not happen to work the other way. That is, supposing my operation continues to lose money, 3 or 4 percent, and if I can get a refund on the taxes that—let me state it differently.

If I can have refunded the credit that I would otherwise be able to take on income taxes that I would have to pay, then I am not sure that this is the direction that we ought to be taking as the drafters of laws. Could you help us?

Mr. CLAYTOR. Senator, could I answer that? The three of us here represent the—the three railroads here—represent all profitable railroads, among the more profitable railroads in the country. So if this would help a competitor take our business away, we would worry about it perhaps more than you. The problem is that the railroads of this country are all interdependent. I lose business every day because my connections, which are broken down, some of them, are unable to pro-

vide the service that I need to give my shipper, because he wants to go all the way from my railroad to a point on the connecting railroad.

The ability of the connecting railroads that have this large investment tax credit build up and are unable to use it; the ability of them to use it and put their railroad back in shape would not only help me far more than any competition to hurt me, but it would also help all our shippers because our shippers are having to turn to other modes of transportation. Although I can give them the service they need as far as my line goes, I can't give it to them after they cross the river.

So I think the ability to enable the unprofitable railroads, the non-income-taxpaying railroads, who are, generally speaking, in need of improving their lines more than anybody else, and the ability to get these funds to do it would be of help to all of the railroads, including the three of us here.

Senator HANSEN. If I could be permitted one other question, I don't deny that at all, and I am fully aware of the interconnection between the railroads. We generate a lot of freight in the West, and if it weren't for the eastern lines we wouldn't be loading cars in Green River and wherever it may be.

But I am wondering if this is the crux of the problem. It seems to me if you have a guy in the mountains and he is starving to death and freezing to death at the same time, the full answer isn't to just put more clothing on him. You might give him a little food, too.

When you look at the work rules and all that have been imposed on the railroads, and the inability to write off investments in such things as tunnels, to name but a few. Maybe we ought to examine the full spectrum of those factors that have contributed to the deteriorating economic situation of the railroads rather than to say the refundable investment tax credit is the full answer.

I am not sure, but I don't think it is.

Mr. BARNETT. Senator, I don't think the refundable tax credit is the full answer. It is one answer that could be helpful.

Now, we have a rehabilitation program for the Northwest. That is great. We need it, because about 27 percent of the business that the Union Pacific hauls originates and terminates in the Northwest, which is precisely what Mr. Claytor is talking about.

Senator HANSEN. Yes.

Mr. BARNETT. Now, we need a program which would help nationally in fixing up or helping to fix up our connecting lines. Certainly the refundable tax credit is not the entire answer, but if you have a tax credit, an investment tax credit which has accrued to the benefit of a railroad which may be losing money this year, that tax credit wouldn't be there at all unless there had been an investment in the first place.

Mr. FISHWICK. May I make this comment? I think to put it into perspective as far as I am concerned, this is not as important as these other programs that we have spoken of, and I would not put this in the same class as the ones we have advocated, but I would like to comment on the first question you asked, about the man who was a poor manager really in investing money in order to get a refund. I don't think that is so, because even a poor manager is not going to put up a dollar on what he thinks is a poor investment simply because he is going to get 10 or 12 percent back from the Government.

Senator HANSEN. Mr. Chairman, I insist on having the last word. Let me say that I don't think the railroads manage their operations. You are a lot better managers than your profit and loss statement would indicate. The Government has been managing you, and it has done one hell of a poor job.

Mr. CLAYTOR. Yes, sir.

Mr. BARNETT. We agree.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

This has been an interesting panel discussion this morning. I have no questions except a somewhat local one for Mr. Fishwick.

When I was in the Virginia Senate, the Norfolk & Western Railway was either the largest or second-largest taxpayer to the State of Virginia. I am wondering whether you are still in that category.

Mr. FISHWICK. Unfortunately, yes. [Laughter.]

Senator BYRD. Thank you.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I won't take a great deal of time. I just have one question. If the Congress were to grant your request for amortizing future expenditures for rails over 10 years, and the other requests you have made in reference to amortization, what would that do to employment—not alone in the railroad industry, but across our entire economy?

Mr. BARNETT. I think I can answer that, Senator Curtis.

In your neighboring State, Wyoming, our plans call for the construction of 10 different coal spur tracks. There is going to have to be additional development in the mines in and around Rock Springs, Wyo. Employment has increased in Wyoming to a startling degree, and it will continue to do so for the foreseeable future.

Now, all 10 of the spur tracks that we are going to build in Wyoming, and they go all the way from Rock Springs back to Rawlins, have varying economic characteristics. We keep looking at a thing we call rate of return on investment, and the amortization would add to the cash flow to be expected from those investments, and it would bring into being and cause the construction of things which would certainly otherwise be marginal.

So the effect on employment of the 10-year amortization of new track investment cannot lead to anything but good, and I don't mean just the employment involved in building that spur track, but I mean getting the business going on the other end of it, which may well be a large employer.

Senator CURTIS. In what State do you buy the rails?

Mr. BARNETT. Mostly Colorado Fuel & Iron, and some United States Steel.

Senator CURTIS. So there would be an employment effect there.

Mr. BARNETT. Yes, sir.

Senator CURTIS. I am sorry to know there are only three taxpaying railroads left. I knew the little train we run from here to the Capitol was losing money, but I didn't realize we were down to three.

Mr. AILES. I think you misunderstood what Mr. Claytor said. There are a substantial number of taxpaying railroads in the country today.

There must be 30 of the major railroads in that category. Let me supply the figures.

[The following was subsequently supplied for the record:]

TAXPAYING CLASS I RAILROADS—1975

Akron, Canton & Youngstown.
Atchison, Topeka and Santa Fe.
Atlanta and West Point.
Baltimore and Ohio.
Bangor and Aroostook.
Bessemer and Lake Erie.
Boston and Maine.
Burlington Northern.
Chesapeake and Ohio.
Chicago & Eastern Illinois.
Clinchfield.
Colorado and Southern.
Denver and Rio Grande Western.
Detroit and Toledo Shore Line.
Duluth, Missabe and Iron Range.
Elgin, Joliet and Eastern.
Florida East Coast.
Fort Worth and Denver.
Green Bay and Western.
Illinois Central Gulf.
Kansas City Southern.
Lake Superior & Ishpeming.
Louisville and Nashville.
Maine Central.
Minneapolis, Northfield and Southern.
Missouri-Illinois.
Missouri Pacific.
Norfolk and Western.
Northwestern Pacific.
Oregon Electric.
Penn Central Transportation.
Pittsburgh and Lake Erie.
Reading.
Richmond, Fredericksburg and Potomac.
St. Louis-San Francisco.
St. Louis Southwestern.
Seaboard Coast Line.
Soo Line.
Southern Pacific Transportation.
Southern Railway System.
Spokane International.
Texas and Pacific.
Texas Mexican.
Toledo, Peoria & Western.
Union Pacific.
Western Maryland.
Western Pacific.
Western Railway of Alabama.

Mr. AILES. All but the bankrupts are in there. There are some that are very close, but you know, the Santa Fe could be represented here today. The Burlington, the Chessie, the Seaboard Coastline. There are a series of railroads that could have been here.

Senator CURTIS. I am glad to know they haven't all gone the way of our little railroad here.

Mr. CLAYTOR. I didn't mean to say that.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. Let me say that I have worked with these gentlemen for some time concerning the Rail Reorganization and Revitalization Act. You have a lot of unmet needs, don't you?

Mr. BARNETT. That is true.

Senator HARTKE. You would like to move forward, and every railroad out there would be very desirous of modernizing their entire operation, not alone their track, but the rest of their equipment.

Mr. BARNETT. We would all like to do that, without exception, and the necessity is that we create a heavier track structure which will have the effect of providing us with facilities to haul coal the way it should be hauled.

Now, we presently are able to do that. We sell coal today all the way from Portland, Oreg., to Mobile, Ala., and that coal, however, has to go over some connecting lines, and we want to see those connecting lines rehabilitated to the point where they can really do the job.

Senator HARTKE. I think the thing I have found it difficult to convince people about is that people like the Union Pacific were interested in revitalizing the railroads in the Northeast. You take 27 percent of your traffic either originates or terminates in the Northeast.

Mr. BARNETT. Or terminates in the Northeast, right.

Senator HARTKE. That is why a national transportation policy in this regard is necessary, and I would like to say to the chairman that the refundable tax credit is one item. My judgment is that if you follow the recommendations, the three major points in this field alone on amortization and on the investment credit, that those two alone would probably increase employment, would reduce the cost to shippers, and thereby, since it is one of the major costs of any item in the marketplace, transportation being a major cost-of-living item, it could really have a substantial effect upon the cost of living.

So that there isn't any reason not to do this unless we want to get frozen into some old concepts which never were any good for the people.

I might point out, and I remember when you were here in 1961 testifying on the investment tax credit, but I will say that I think of all the Members of Congress today that I was the only one who held a consistent position for that investment tax credit all the way through. So I would hope that we would not play any more yo-yo business with the investment tax credit—on again, off again; up again, down again, and crossways—and do that kind of thing.

Mr. BARNETT. Yes, sir.

Mr. CLAYTOR. Yes, sir.

The CHAIRMAN. It took a while to convince me that we ought to have an investment tax credit, or that we ought to go all the way with it, but having been convinced, I think we ought to go all the way with it.

Thank you, gentlemen.

Mr. AILES. Thank you, Mr. Chairman.

[The prepared statements of the preceding panel follow:]

STATEMENT OF JOHN P. FISHWICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORFOLK & WESTERN RAILROAD CO.

I appreciate the opportunity to appear before this committee on behalf of the railroad industry and Norfolk and Western Railway Company to present my views on the important tax policy decisions this committee can make to help solve the problems facing our industry. I am sure this committee is well aware that the railroad industry is entering a period of great challenge. The next few years will determine whether railroads can continue to exist as a strong free enterprise segment of the American economy or must become part of a nationalized transportation industry. Railroads, not only into the East and Midwest but throughout the country, are faced with severe problems of developing plant and equipment to meet expanding transportation needs of the economy while experiencing chronic cash flow shortages.

Our industry in the past ten years has been required to make capital expenditures far exceeding its cash flow. Many railroads have had to neglect plant and equipment maintenance and have not been able to make sufficient capital expenditures to modernize facilities and improve service. In the face of capital shortages railroads are now being asked to deal with the increasing demands for equipment produced by economic recovery. As the most energy efficient form of transportation railroads should be expected to assume primary responsibility for traffic increases in all types of freight.

The emphasis on coal production will require substantial investments in lines and improved track to serve the mines as well as in hopper cars and the equipment necessary to move the coal. Increasing demands on American agriculture to meet greater domestic and export requirements produce further pressure on railroads to move the crops promptly and efficiently.

Industry projections of traffic forecasts make it clear that the railroad industry must concentrate on improvements in the utilization of cars in order to handle

the traffic produced by the economy in the next ten years. Here is a real opportunity for capital investments to pay off in increased productivity which will directly benefit the consumers and the economy. Our studies show that improving car utilization by 2 percent annually (compared with a 1 percent historic improvement in utilization) would enable a saving of $5 billion of the nearly $20 billion of investment purchases anticipated by the industry during the next decade.

Presently a freight car moves on the average only about 57 miles per day. Obviously this presents dramatic opportunities for increasing car utilization. This can be done in two basic ways—first, by increasing train speed through track improvements and the elimination of slow orders and second, by improvements to existing yards and the development of new yard facilities to eliminate switching delays. Investments in yard and track improvements will greatly enhance equipment usage and improve our ability to meet the nation's transportation needs at the lowest possible cost.

These needed capital investments must be financed from internally generated funds since railroad mortgages preclude new financing for most road projects. Moreover, many of these investments are depreciated under the retirement-replacement method which defers recovery through tax deductions until the assets are actually retired which may be many years in the future. When these factors are considered with the industry's low return on investment and shortage of cash flow, it is clear that railroads will be hard-pressed to form the capital needed to pay for the improvements. By enacting far-sighted tax provisions this committee can be the key factor in making these investments possible so railroads can meet their responsibilities to the nation.

First, I believe it is important for this committee to recognize, as it has before, the need for the railroad industry to realize tax deductions for its substantial investments in the cost of grading and tunnels. Railroads have capitalized substantial costs for grading and tunnels, but generally have been unable to depreciate them because of uncertainties as to the length of the useful life of these assets. In the Tax Reform Act of 1969, this committee and the Senate passed legislation which would have permitted railroads at their option to amortize all railroad grading and tunnel bores on the basis of a 50-year life. However, the provision on grading and tunnel bores was amended in conference to permit deductions only for costs incurred after 1968. Thus, present law grants only very partial and minor relief and perpetuates the historical inequity of railroads' inability to recover their investment in these assets acquired before 1969. The House recognized the need for capital recovery in these assets and included a provision in H.R. 10612 permitting 50-year amortization of pre-1969 investments in grading and tunnel bores. This committee should approve this provision which follows its own past action.

Grading and tunnels are productive assets used in our business. Grading, simply stated, is the foundation for our track structure. It is not a land improvement. Railroads simply could not operate without incurring costs for grading and tunnels to provide the base for track. They are business assets for us like the business assets of any other industry. This is the only industry with such substantial frozen costs in business assets which cannot be recovered by tax deductions. Fairness requires that we be permitted for tax purposes to recover our investment in them over a reasonable period of time.

These assets have not previously been depreciated because the useful life of grading and tunnel bores is not measured by physical life but rather by usefulness in our business. Inability to predict obsolescence with the required precision has generally precluded railroads from sustaining depreciation deductions. Only in a few cases, spur lines serving coal mines, for example, where the asset's useful life is tied to the mineral resources, have railroads been able to ratably recover the cost.

Recently the United States Tax Court recognized that obsolescence is inherent in railroad grading and tunnels and permitted one railroad on the basis of the facts proved in the litigation to recover its cost in these investments. While this is a welcome judicial recognition of the principle that tax recovery should be allowable on these investments, other cases are still in litigation and their outcome is uncertain. Nor should railroads be required to utilize their already scarce cash flow in expensive and lengthy litigation to prove the precise remaining useful lives which would be required under the Tax Court decision. Rather, we believe that these cases, along with the large-scale abandonments of track which are now

occurring in connection with the Eastern railroad reorganization plans, graphically illustrate the need for this committee to make it clear through legislation that railroads are entitled to a reasonable recovery of their investments in these assets.

It is important to recognize that the railroad industry is now experiencing a period of rapid technological and economic change. Certainly 50 years does not at this time seem too short a period over which to recognize the recovery of existing business investments in grading and tunnels. This committee has previously recognized that these deductions should be allowed and I hope you will again.

At the same time it would also be appropriate for this committee to act with respect to the other major area of frozen railroad investments not now subject to tax deductions. We are unable under the retirement-replacement method of depreciation to realize deductions for the obsolescence of track investments made in the past. Under retirement-replacement depreciation, annual depreciation deductions are measured by the cost of replacements unless lines of track are actually retired. The result of this method has been the accumulation by the railroads of large amounts of frozen investments in track, representing the original cost of the track structure plus betterments, on which no deduction is assured until retirement under present tax rules. To recognize economic and technological obsolescence we believe it would be appropriate for railroads to be allowed tax deductions to recover the frozen investments in track accounts over a reasonable period of time similar to that for grading. This could easily and appropriately be implemented along with the legislation on grading and tunnels.

Further, we strongly support the action of this committee in recommending a 12 percent investment credit on the acquisition of qualified railroad track improvements, communications and signal systems, rolling stock classification yards and trailer and container facilities. The committee decision properly recognized what an important tool investment credit can be in our efforts to raise capital to acquire these badly needed investments. As previously mentioned, investments of this type are precisely what the industry must have to achieve productivity increases through better equipment utilization. I know of no better way to aid railroads to make these vital expenditures than the investment credit as proposed by this committee. Investment credit has immediate value not only to the profitable taxpaying railroads but more importantly, through the use of leasing, to marginal and loss roads. It amounts to a direct reduction in the cost of financing and is an excellent way for this committee to help all segments of the railroad industry. I hope the committee will continue to recognize the wisdom of its decision to provide a 12 percent investment tax credit for purchases of qualified railroad equipment.

As a complement to the increased investment credit, we believe the committee should approve a provision for ten-year amortization of additions and betterments to the track structure to eliminate the problems caused by the industry's present inability to recover tax deductions on these investments until they are retired. Mr. Claytor will amplify the need for such a provision.

We believe the tax proposals which we are requesting you to enact represent sound tax policy which your committee can make to enable our industry to meet its responsibilities as a viable part of the American economy. Railroads, as the most energy efficient form of transportation, must make a vital contribution to the nation's economic strength. To meet this challenge, however, we need the capital formation that will result from the constructive tax legislation we have outlined.

STATEMENT OF WILLIAM J. HARRIS, JR., VICE PRESIDENT, RESEARCH AND TEST, ASSOCIATION OF AMERICAN RAILROADS

My name is William J. Harris, Jr., and I am Vice President of the Research and Test Department of the Association of American Railroads (the AAR). The AAR is a voluntary, unincorporated, non-profit organization composed of member railroads operating in the United States, Canada, and Mexico. Its members operate 97 percent of the railroad mileage and produce 97 percent of the revenues of all United States railroads.

I should like to discuss with you the technical and the engineering economic issues affecting track structure in the United States. We have approximately 320,000 miles of railroad track in this country. About 160,000 miles can be considered mainline; the remainder represents important branchlines and feeder

lines, yard tracks, and other elements of the system, some of which may be surplus in future years.

The conventional railroad track of today has a heritage which goes back to 1832 when Robert Stevens first spiked flat bottom rail to timber cross ties in his building of the Camden and Amboy Railroad. Today's track has evolved through technological advances in metallurgy, rail design, tie selection, production, and treatment, fastener design, and in the type, disposition and manner of ballast use.

The most obvious component of track is the rail. A cross section of the rail, Figures 1, 2, and 3, includes a top part, the head or ball, designed to resist the pressure of the wheel rolling on top and the contact of the flange against the side of the rail. The rail includes a web section which must be sufficiently strong to prevent crushing of the rail under the weight of the car. The rest of the metal in the rail goes into the rail base which must be wide enough in proportion to the rail's height to prevent the rail from overturning under lateral load. The height of the rail from the top of the ball to the bottom of the base is critical because it is that height and the configuration of the metal that establishes the stiffness of the rail to resist bending between the cross ties.

The rail is supported on cross ties. One function of the cross tie is to distribute rail load over a wider area and thus keeps the rail from sinking in the ground. The rail is fastened to the cross tie through a tie plate in which there are holes through which the spikes or other fasteners are driven. The track spikes hold the tie plate to the tie. Thus, the combination of tie plate, fasteners, and cross ties hold the rails against lateral movement introduced by forces from the wheel as well as from heating of the rail and any restraint of its thermal expansion. The cross tie and tie plate system keeps the rails in the proper relationship to one another so that the wheels of the car will maintain contact with both rails and not drop between the rails. Laying the cross tie and the rail on the ground would not be a satisfactory engineering structure because the cross tie, while it introduces less pressure per unit area on its support than the wheel does on the rails, is still too heavily loaded for earth to support. Furthermore, the lateral forces on the cross tie/rail combination introduced by the wheel flange or by thermal loads would not be controlled by simple contact of the tie with the ground.

Accordingly, ballast is placed around the cross tie and tamped beneath it so as to be as dense as is feasible. Ballast is made up of crushed rock, blast furnace or open hearth slag, gravel, or crushed gravel all of which are intended to provide a good bearing surface on the sides, ends and bottoms of the tie and provide elastic support, vibration reduction, and restrain the tie from movement. The ballast also has to be permeable to permit drainage of surface water without reducing its strength.

In turn, the ballast section must be deep enough that the pressures on the earth or subgrade are gradually distributed such that ultimately when the ballast is in contact with the subgrade, the pressures will be sufficiently low that the ballast is not pressed into the earth.

The track system (Figure 4), then, distributes load from a point on the rail, about the size of a dime (the contact area between wheel and rail) to the bearing surface of the ballast on the subgrade. In so doing, it has reduced the unit load by a factor of about 6000, the equivalent of reducing the weight of twelve elephants balanced on a single postage stamp to that of a good size house cat on the same area. Track, as you can see, is a complex, interrelated and effective engineering structure.

The original railroad cars carried no more than 10 tons of lading. The railroads have always attempted to improve productivity and efficiency through economies of scale. Therefore, cars were increased in size. Over a period of about 100 years, the average freight car capacity grew from about 10 tons to 50 tons in 1940. By 1960, the average capacity was 55 tons.

During this extended time, there was an evolutionary upgrading of track. The weight of rail was increased and attendant changes made in the ties and ballast, as required by the gradual change in the size of cars. In the decades of 1940 and 1950, these 50 to 55 ton cars naturally dictated the design of the track structure, and the track was optimized from the standpoint of initial cost and maintenance.

However, after World War II, the creation of the interstate highway system and the government financed improvements of the waterway system made barges and trucks much more competitive. Since neither of those modes paid the full cost of their rights-of-way, they were able to establish rates which were lower than their true costs, the difference being made up, of course, by the public

investment in the waterway and the highway. The railroads which had enjoyed a tremendous technological advantage because of the great efficiency of the steel wheel on the steel rail had to maintain a competitive relationship. Since their rates had to meet those of other modes, it was necessary to achieve still further economies of scale. The railroads made a major commitment to replace smaller retired cars with 100 ton cars. Today approximately 20 percent of the fleet consists of 100 ton cars. A 100 ton car is more efficient than a 50 ton car. For a given amount of cargo, a 100 ton car has eight wheels; two 50 ton cars have sixteen wheels. A 100 ton car has four axles; a 50 ton car has eight axles. While the wheels are a little larger and the axles are a little larger, there are, never-the less, real economies in terms of equipment cost and handling expense with the larger car.

The larger car, however, does put greater stress on the track structure. Although the unit stress on the rail of the heavier cars is not increased by a factor of two to-one because the wheels are made somewhat larger so as to increase the contact area, there is a limit to the size of wheels because of clearance considerations.

Therefore, the heavier cars place more stress on the rail. This leads to more deflection of the rail as it bridges between one tie and the next. Smaller, lighter rails, especially, are so affected and, therefore, deteriorated more rapidly. With higher unit pressures, there is more damage to the ties. The ties in turn subject the ballast to higher pressures, and the ballast section may not adequately distribute the loads into the subgrade. Unless the ballast section is enlarged, the track will go out of surface and alignment more rapidly. Thus, the introduction of 100 ton cars clearly increases track maintenance costs. Moreover, operation of this heavy equipment on suboptimal track reduces permissible train speed from that which would be possible on track of more substantial design.

For these reasons, there is clear need to improve much of the nation's track structure. Competent engineers can and do design optimal track structures through the judicious combination of components to meet most demands of anticipated traffic and loading.

We have made progress on our own. Over 60,000 miles of track are now built with rail of 130 lbs. per yard or over. But we have an estimated 40,000 miles of mainline track still laid in older, inadequate rail. as are large segments of branchline serving coal mines, coal depots, or other major industries that are efficiently served only by the use of the maximum size car compatible with the best track in the country. Too often we have to use lighter cars in that territory or operate at reduced speeds, and thus lose the efficiencies that we should be able to achieve if we had a more appropriate track structure.

Track accidents resulting from suboptimal track structures are not the kind of accidents that generally cause fatalities or injuries. In fact, while the number of accidents due to track defects has risen significantly in recent years, fatalities and injuries caused by all rail accidents has trended steadily downward to new lows. But track related accidents do cost money; they do delay service and they are another drain on the resources of this industry. Eventually, they result in lost customers.

We do not believe that there will be a trend above the 100 ton car level for the reason that I cited earlier. We cannot significantly increase wheel diameter; therefore, we cannot use this technique to accommodate larger wheel loads. Since we are at the upper limit of the capacity of the steel in the rail to accommodate the pressures on it, we think we have stabilized the situation for some time in terms of car size. In fact, we have extensive research in progress on the dynamic reaction of trains with track structure that will eliminate some peak loads from improper train operations. However, we can do nothing about the higher average loads associated with the continued installation of 100 ton cars. Therefore, we must move rapidly, in the next five to ten years, to increase the rate at which we install improved rail if we are going to maintain a viable railroad system in the United States.

The initial costs of track betterment are extremely high.

To change from 70 lbs. per yard rail to 132 lbs., which can bring about a 50% reduction in rail bending stress, requires 110 additional tons of rail per mile. At $270 per ton, such a betterment represents an additional capital investment of $29,700 per mile. We have estimated the total capital expenditure necessary to bring the 67,000 track miles of rail currently in use, of less than 100 lbs. per yard, up to minimal standards to be over half a billion dollars. Reducing the

space between cross ties reduces rail deflection and stress and lowers the pressure on subgrade, but to decrease tie spacing a mere two inches requires 270 additional ties a mile. At $20 per tie installed, plus some $7 for the additional tie plates, this amounts to an additional investment of about $7,300 per mile. Trap rock ballast now costs about $2.50 per ton. Six additional inches of ballast can reduce the load on subgrade by 25%, but represents about 1,800 tons per mile, an additional investment of $4,500. If modern continuously welded rail is to be used, additional ballast beyond this is needed to restrain the track from the high thermal buckling loads.

Outside financing of track betterments is usually possible only at very high interest rates reflecting the fact that such loans must be unsecured since much of the existing rail plant and any improvements to it are already pledged under general mortgages.

Another factor militating against track improvements is the low rate of return from such projects. Freight cars earn money. They are rented as empty vehicles from one railroad to the other, and a charge is placed against a user for the actual use of a car. Because cars earn identifiable returns and because new equipment can be pledged as collateral that is secure in the event of bankruptcy, it is much easier to finance equipment improvements than track improvements.

Accordingly, to upgrade track, railroads must generate more money internally. Given the tight competitive circumstances, there is little possibility of raising rates in the near term to the extent necessary to earn the hundreds of millions of dollars needed to bring track to this desired level. The present inability to recover capital investment in track improvements[1] through depreciation or amortization gives rise to the very high rates of interest for money borrowed for use in track improvement and the low rates of return on invested capital. The railroad industry urgently requires the financial means to increase track improvements that would be established by action permitting amortization over ten years of future investment in improved track to make the kinds of improvements we have discussed.

We believe that a viable railroad system is very much in the public interest because of the high efficiency of the railroad system. We believe that the technology is at hand to design, construct, and maintain track of sufficient quality and engineering strength to provide effective service and to eliminate the slow orders that plague operations and to eliminate the operating restrictions which cause us to own more cars than we should because we can't operate them efficiently. Accordingly, we believe that affirmative action on amortization of track improvement will make a significant improvement in the capability of the railroad industry to serve the public interest and the growing economy of this country and to do so without having to appeal for additional direct federal support.

I shall be very pleased to answer your questions.

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[1] Account 8 (ties), 9 (rails), 10 (other track material), and 11 (ballast).

70 Lbs.
CAMBRIA STEEL CO.
No. 504

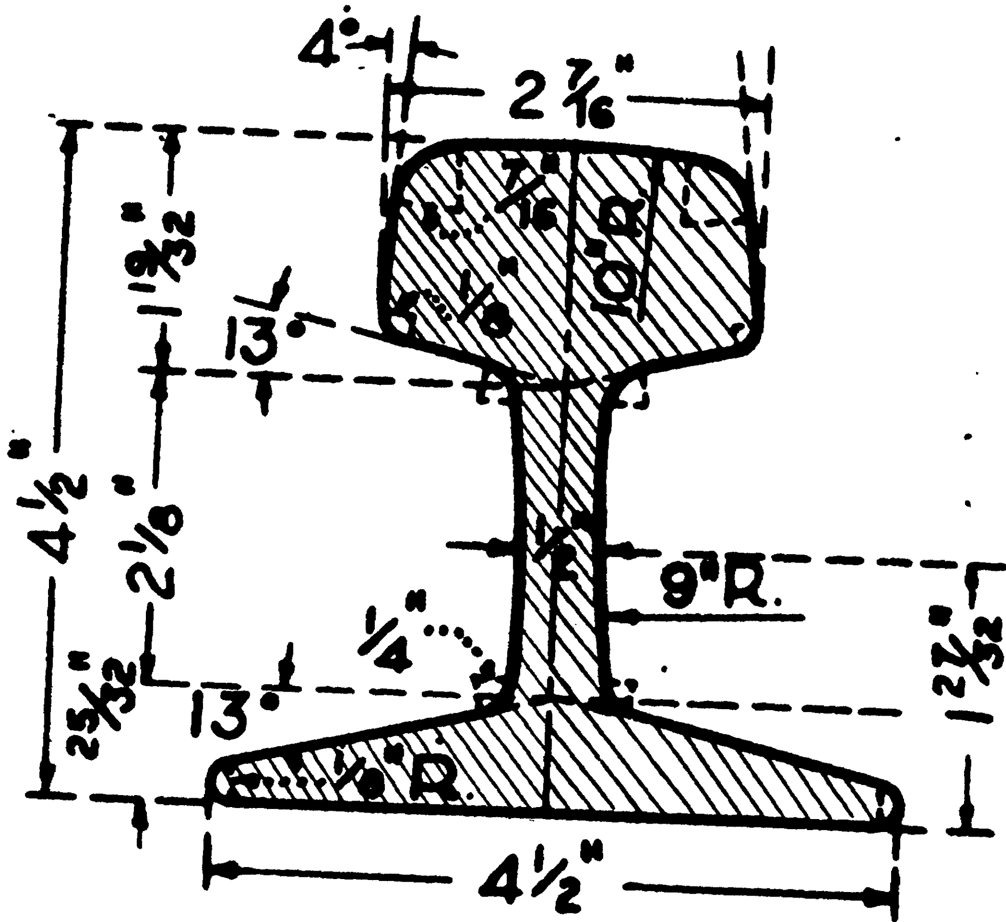


Figure 1

1936

100 LB. A.S.C.E.

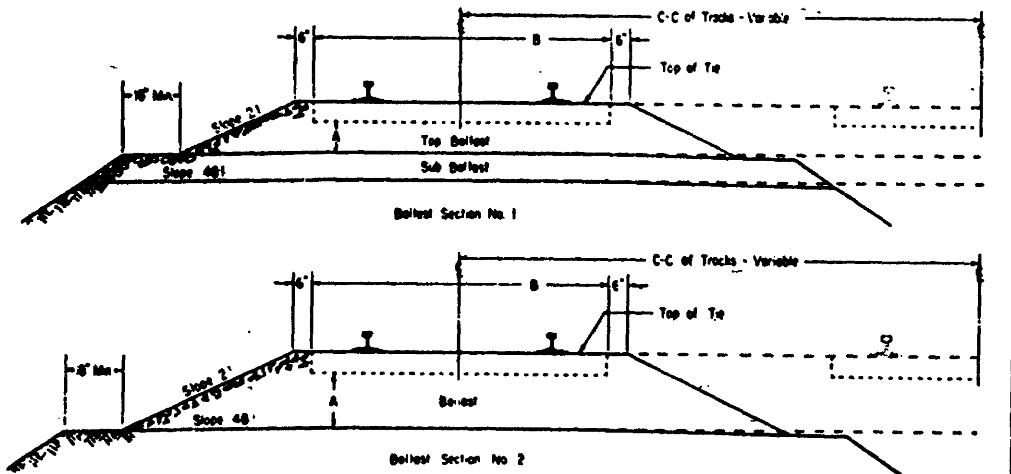
FIGURE 2

1937

132 RE

NEUTRAL AXIS

FIGURE 3



AREA ballast sections, single and multiple track, tangent.

FIGURE 4

Statement of W. Graham Claytor, Chairman of the Board of Southern Railway System

Subject: Rapid Amortization of Railroad Property

My name is Graham Claytor. I am Chairman of the Board of Southern Railway Company with headquarters here in Washington, D.C. I am appearing today on behalf of the railroad industry as well as for my own Company to encourage you to adopt a new provision to the Internal Revenue Code which would enable the industry to upgrade its railroad track to meet the needs of an expanding economy. In the Energy Tax Bill, H.R. 6860, passed by the House last year, provision was made for five-year amortization of the following types of railroad property:

(1) Communications, signals and traffic control systems;

(2) Rolling stock classification yards;

(3) Facilities for loading and unloading trailers and containers on railroad cars; and

(4) Improvements or betterment of railroad track.

Your committee concluded, along with other changes in the House-passed bill, that an increase in investment credit, from 10% to 12%, would be a desirable alternative to five-year amortization. It seems to us that this would be an acceptable alternative for the industry and its capital needs.

However, in addition, the industry faces the problem that the capital cost of new additions and improvements to track can not be recovered until it is replaced or abandoned at some indeterminate time in the future. The industry needs some means to recover its capital investment in railroad track. Accordingly, I would propose here that investment in new lines of track and additions and betterments to existing track be allowed a 10-year straight-line amortization for tax purposes.

The cost of upgrading track involves an increase in the weight of the rail in use; a typical example would be the replacement of rail weighing 100 pounds a yard with rail weighing 132 pounds per yard. Further, the new rail should be welded to form a continuous track of "ribbon rail". In turn, this requires substantial improvement in the track structure, such as widening of cuts in the right-of-way and other additional grading. Similarly, when a line is to be upgraded for heavy traffic it is frequently necessary to improve the clearances, particularly in tunnels.

This type of upgrading of our rail lines is going to be needed more and more to carry the heavier loads of coal and other heavy minerals, as well as grain, which the railroads are more and more being called upon to transport. Over the next several years, for example, the demand for coal will increase as more utilities convert from oil and gas to coal-burning facilities and improvements to railroad track that we are proposing would be of considerable help in solving this problem.

The upgrading of track property, rail, ties, related track material and ballast presents financing problems not encountered in the acquisition of freight cars and locomotives. In general it is difficult and often impossible for a number of roads to finance the cost of improvements to railroad right-of-way. The properties of almost all railroads are encumbered by mortgage debt with long periods yet to run and in many cases no additional bonds can be issued under these mortgages. Thus, investors and lenders are understandably reluctant to provide money for additions or improvements of existing right-of-way of even relatively prosperous railroads since such additions and improvements cannot be offered as security for new money. As a result, we have to look primarily to internally generated funds for upgrading our track and roadway property.

I really look upon this proposal not so much as a tax incentive provision, but rather a tax "enabling" provision. The railroad industry does not need an incentive to do the job required of it; we do not lack motivation. The motivation is there, but the ability to generate cash required to accomplish these tasks is not. For example, if we had additional resources, we could move forward promptly to improve our right-of-way from the coal fields of East Tennessee through Chattanooga and Birmingham to a power plant in Jackson, Alabama, and then from Jackson on to the important port of Mobile. Of the 168 miles of new 132-pound welded rail needed, 118 miles would replace 100-pound jointed rail, a necessary improvement to handle heavy loads not only of coal, but also of kaolin

clay, iron ore, bauxite, alumina, stone, rock and gravel. In addition, this road will be better equipped to safely haul the 100-ton tank cars which handle hazardous chemical materials over much of the route.

Another important project, which urgently needs to be done, is the replacement of 100-pound rail from Valdosta, Georgia to Jacksonville, Florida with 132-pound welded rail. This 110-mile stretch of our main line to Florida carries 100-tons cars of phosphate chemicals and fertilizers for both domestic use and export, as well as heavy tonnage of other traffic inbound and outbound from Florida.

When we acquired the Norfolk Southern Railroad in 1974 the track structure in North Carolina was in a state of considerable deterioration. Most of the track averages 85 pounds in weight. While some improvements have been made to the Eastern portion of the old Norfolk Southern property, we have not been able to move as fast as we should to provide the really efficient service we need, even on the main line between Norfolk and Raleigh.

The total capital cost of just the projects outlined above would involve an expenditure in excess of $20 million. Of course, we also have a substantial number of other capital projects which fall into this category and which have almost equally high priority.

Rapid amortization of railroad assets under the Internal Revenue Code is not a new concept. In the Tax Reform Act of 1969 five-year amortization was permitted for investment in new railroad rolling stock, including locomotives, from 1970 through 1975. During the Korean War railroads were permitted a five-year write-off of improvements to roadway facilities and yards in order to move goods more expeditiously in support of the national interest. Such tax deferral through fast write-off of investments in new and improved roadway property and expanded yards helped us significantly during the Korean conflict.

I would emphasize that this new provision would create a deferral of income taxes not an outright reduction in tax liability. What we seek is a difference in timing of the tax liability only, so as to produce a favorable cash-flow to help meet the capital requirements of our industry. The benefit of this tax deferral will improve the cash position of many railroads and contribute to the increased cost of upgrading our railroad track. The railroad companies of this country operate through a network of interconnecting systems, so that improvements in the plant of one or more railroads will help all roads provide better, more efficient and reliable service to the public.

In conclusion, I should emphasize that railroads can do the job of meeting the country's expanding transportation needs better than any other mode of transportation. Your help in adopting this provision and other changes discussed today will go a long way toward realizing that goal.

STATEMENT OF FRANK E. BARNETT, CHAIRMAN OF THE BOARD OF DIRECTORS AND CHIEF EXECUTIVE OFFICER, UNION PACIFIC RAILROAD CO.

Mr. Chairman and members of the committee: My name is Frank E. Barnett. I am Chairman of the Board of Directors and Chief Executive Officer of the Union Pacific Railroad Company with offices at 345 Park Avenue, New York City.

My function today is to summarize for the Committee the remarks which have been made by my colleagues. Simply stated, we are asking for three specific items of tax relief: The right to amortize over a ten-year period the additions and betterments to our track structure, the right to amortize over a 50-year period our frozen investment in grading and tunnel bores made prior to 1969, and the removal of certain present limitations on the investment tax credit.

Other witnesses in these Hearings have commented generally on the need for new incentives for capital formation as a result of current economic conditions, and today we have tried to explain the particular problems of capital formation as they affect the railroad industry. Except for amendments which we urge with respect to the investment credit, our specific proposals would have no application to taxpayers outside of our industry. However, they would have a beneficial impact on the economy as a whole, and are consistent with this Committee's objective of formulating meaningful incentives to responsible capital investment policies. The provisions which we have presented for your consideration today are

also responsive to the Administration's objective, as expressed by Secretary Simon, of a tax policy which is fair, complementary and supplementary to a goal of achieving a growing, vigorous and noninflationary economy, and contributory to a sound energy policy. While reasonable men might differ as to the best means of implementing these laudable goals, I believe our proposals are certainly a step in the right direction.

Non-tax considerations such as those discussed by my colleagues have frequently been the motivating factors underlying meaningful revisions to our tax laws. For example, Dr. Harris has described the current condition of our national rail system and has noted the need for constant improvements to our physical plant to combat technical obsolescence within the industry, and to effectively compete with other modes of transportation. Changes in our national energy policy have increased this pressure as a result of the sudden immediate priority given to the development of our coal reserves. Not only must our track structure be upgraded to accommodate heavier loads at reasonable speeds, but also we are called upon to construct new spur lines to reach previously undeveloped mineral deposits. For example, we at Union Pacific have under active consideration the construction of several new spur lines of this nature.

Capital formation incentives are particularly critical to the railroad industry because of the interconnecting track structure. Thus, if a contiguous line of track is substandard, the full benefit of the investment in interconnecting structures cannot be realized. The cumulative detrimental impact of slow orders on the movement of freight is an additional significant factor which must be considered in evaluating programs for improving our national rail system. At this point I feel compelled to mention one other non-tax policy consideration—that is, that a properly functioning rail system offers this country the optimal nationwide mode of transportation from the viewpoint of cost, energy conservation, environmental impact, and efficency.

As noted by my colleagues, amortization of our frozen investment in grading and tunnel bores and the costs of new additions and betterments to the track structure will help generate the additional cash flow necessary to finance needed capital investment. As Secretary Simon noted there exists today a disturbing trend in American business toward a growing dependence on outside funds to finance growth. It is felt by many that this trend, particularly the reliance on debt financing, has caused enormous inflationary pressures on our economy. Our amortization proposals, generating as they will internal sources of cash reserves, are totally consistent will current efforts to reverse this trend.

Moreover, as discussed in greater detail by both Mr. Claytor and Mr. Fishwick, the railroads have traditionally been precluded from seeking significant amounts of debt-financing for improvements and additions to their track structure due to the fact that most of the land on which the railroads operate is subject to after-acquired property mortgages. Thus, aside from certain funds made available under the Railroad Revitalization and Regulatory Reform Act of 1976, internally generated cash produced by the amortization provisions which we have urged for your consideration to us is the only realistic source of funds for capital improvements. This Committee has, in the past, recognized the efficacy of more liberalized amortization provisions in meeting the traditional cash flow problems of our railroad industry, and we urge you to do so once more.

In addition to the foregoing, the unique method of depreciation of our track structure, imposed on the railroads by the Interstate Commerce Commission since 1914, makes the proposed amortization provisions an efficient and equitable means of generating additional capital within the industry. As Mr. Fishwick noted, the Class I railroads have billions of dollars of unrecovered capital investments in frozen assets. Prospective amortization of pre-1969 investment in grading and tunnel bores will thus generate additional cash flow without requiring current expenditures. However, this represents no windfall since these investments have already been made, and such an allowance for capital recovery is comparable, if less advantageous, than depreciation available to taxpayers in other industries. Thus, we are not asking for a double recovery for the same investment, but merely a single recovery as is currently available to other taxpayers including our competitors. Finally, in this regard, I would commend for this Committee's consideration Mr. Fishwick's suggestion that we be permitted to recover our frozen investment in the track structure in a manner similar to that which we propose for grading and tunnel bores.

Similarly, ten-year amortization of additions and betterments to the track structure, although requiring the requisite investment, would provide an equitable method of capital recovery from which would be generated the cash needed to undertake the improvements necessary to upgrade our national rail system.

The railroad industry has long championed the role of the investment tax credit as a mean of stimulating capital investment. Since first appearing before this Committee in May of 1961 to urge its enactment at a time when other industries regarded the credit with suspicion, the railroads have come forth at every opportunity to support its enactment, oppose its suspension, urge its restoration, and finally ask that it be made a permanent part of our tax structure.

To us, the credit has proven itself to be a necessary incentive and stimulus for modernization and expansion of plant, equipment and machinery. As a capital intensive industry, with historic cash flow problems, the railroads have relied heavily on the credit as a source of cash needed for capital investment. Through leasing transactions, many marginal roads have been able to lease at advantageous rates needed equipment which they could not afford to purchase. Thus it is that we vigorously support this Committee's recommendation of a 12 percent investment credit with respect to the acquistion of qualified railroad track improvements, communications and signal systems, rolling stock classification yards, and trailer and container facilities.

At the same time we would call this Committee's attention to the fact that many members of our industry are still precluded from taking full advantage of the intended economic benefits of the investment credit because of the current limitation on the availability of the credit to 50 percent of tax. As of the end of 1974, the latest year for which industry-wide figures are available, total unused investment carryovers for all Class I railroads was approximately $320 million. Of this total, about $214 million are attributable to the 17 taxpaying railroads. A removal of this limitation would allow these taxpaying roads to generate additional capital so critically needed for deferred maintenance and capital improvements.

Moreover, non-taxpaying members of our industry will derive increased benefits by way of reduced rentals under traditional investment credit leases, as well as have available to them, through interchange, a greatly expanded and modernized car fleet, and an upgraded track structure.

With respect to unused investment credit carryovers, we urge this committee to consider amending Section 46 of the Code to permit taxpayers to utilize these carryover credits on a first-in-first-out basis. We propose that a taxpayer be permitted to utilize unexpired credit carryovers before using credits generated in the current taxable year. For example, for the taxable year 1976, a taxpayer would utilize unexpired credit carryovers generated in the earliest carryover year, 1969. Carryovers from years following 1969 would be used in chronological order before credits generated by investments made in 1976.

On behalf of my colleagues and myself, I wish to express our appreciation for the courtesies extended to us today by this committee

The CHAIRMAN. Our next witness is Mr. Luther Stearns. We are pleased to have you.

STATEMENT OF LUTHER STEARNS, PRESIDENT, CONNECTICUT FARM BUREAU ASSOCIATION, INC.

Mr. STEARNS. Thank you.

My name is Luther Stearns. I am a member of the American Farm Bureau Federation board of directors and president of the Connecticut Farm Bureau Association.

We appreciate the opportunity to present Farm Bureau's views on amendments to update and reform the provisions of the Federal estate tax law.

Farm Bureau is the largest general farm organization in the United States, with a membership of 2,505,258 families in 49 States and Puerto Rico. It is a voluntary, nongovernmental organization representing

farmers and ranchers who produce virtually every agricultural commodity that is produced on a commercial basis in this country. As a consequence, we have a deep interest in all Federal taxes, including estate taxes, that affect our farmers and ranchers.

Estate taxes have been a matter of increasing concern to Farm Bureau members for several years. Farming and ranching are predominantly family enterprises, and farmers and ranchers are deeply interested in the orderly transfer of their businesses to succeeding generations.

The Federal estate tax is essentially the same today as it was in the 1940's. The last significant change, the addition of the marital deduction, was made in 1948. The present rates and schedules were adopted in 1941, and the present specific exemption went into effect in 1942.

Since the basic provisions of the present estate tax were adopted, the purchasing power of the dollar has been eroded by inflation, and the size and the value of an economic farming unit have undergone drastic changes. In 1942, the U.S. average value of land and buildings per operating farm unit was only $6,100, and very few farmers were affected by the Federal estate tax. In March 1975, the average value of land and buildings per operating farm unit was $143,000, and the amount of machinery and equipment required to operate a farm was much greater than in 1942.

As a result, estate taxes have became a matter of deep concern to a great many farmers.

Senator BYRD. Would you give those figures again?

Mr. STEARNS. Yes. The average value per farm unit in 1942 was $6,100. In March 1975, the average farm unit was worth $143,000.

Senator BYRD. Thank you.

Senator CURTIS. Is that both land and equipment?

Mr. STEARNS. No; land and buildings, and the amount of machinery required is now much greater than in 1942. As a result, estate taxes have become a matter of deep concern to many farmers.

The impact of the estate tax on farmers is greatest on the estates that consist primarily of efficient, productive commercial farming operations and thus do not have large amounts of liquid assets that can be used to pay estate taxes. These are the farms that produce the bulk of the farm products that have made American agriculture the envy of most of the rest of the world.

Higher estate taxes brought on by inflation and the estate appraisals based on the market value of farmland for nonfarm uses are making it increasingly difficult for farmers to transfer family farming businesses to succeeding generations and are threatening to eliminate farming and desirable privately owned open space from any populous areas.

When a farmer or rancher dies, his heirs often find themselves faced with such high estate taxes that they are forced to sell the farm or ranch regardless of their desire to keep it in the family. Unfortunately, many families are not aware of their potential Federal estate tax liability until after an unexpected death. Thus, farm families often fail to take advantage of the numerous provisions of the estate and gift tax laws that can be used—with the help of proper legal advice—to reduce or postpone estate taxes.

Our policy with respect to estate and gift taxes was summarized in a policy resolution, which was adopted by the voting delegates of the

member State Farm Bureaus at the 1976 annual meeting of the American Farm Bureau Federation in St. Louis, Mo., last January, as follows:

Laws covering the taxation of estates and gifts have not been changed materially since 1942.

We place a high priority on major amendments to the estate and gift tax provisions of the Internal Revenue Code. At a minimum these amendments should include (1) an increase in the standard estate tax exemption to reflect the effects of inflation since the present $60,000 exemption was set in 1942; (2) a substantial increase in the marital deduction to minimize the problem of the so-called "widow's tax" and (3) provisions for basing the value of farmland and open spaces at levels reflecting their current use rather than their highest possible use.

Immediate passage of such legislation is necessary if we are to allow farms and small businesses to be passed from one generation to another, if we are to relieve unnecessary hardships on widows and widowers, and if, at the same time, we are to maintain open spaces in urban areas.

To offset the cumulative effect of more than 30 years of inflation and to help check the adverse effects to estate taxes on congestion and urban sprawl in populous areas, Farm Bureau recommends three changes in the present Federal estate tax law as follows:

1. Raise the specific estate tax exemption from $60,000 to $200,000. This would adjust the estate exemption for the inflation which has occurred since 1942, when the $60,000 exemption went into effect. (The consumer price index [1967=100] was 48.8 in 1942 and 161.2 in 1975. This means the purchasing power of $1 in 1975 was about equal to the purchasing power of 30 cents in 1942, and $60,000 divided by .30 equals $200,000.)

2. Raise the maximum marital deduction from 50 percent of the value of the adjusted gross estate passed to a surviving spouse to $100,000 plus 50 percent of the total value of the adjusted gross estate. This would recognize the importance of partnerships between husbands and wives, and the special problems of wives who are widowed at an early age.

3. Establish a procedure which would permit the executor of an estate to elect to have land used for farming, woodland, or scenic open space assessed for estate tax purposes on the basis of its current use rather than higher potential uses.

We are grateful to Senator Curtis and other members of the Senate who have introduced or co-sponsored bills to carry out these recommendations.

We are well aware that our proposals will be opposed by some people on the grounds of cost to the Treasury. We do not think this is a valid argument. Estate and gift taxes are a relatively minor source of Federal revenue. In the fiscal year 1975 (the last year for which final figures are available) Federal revenues from estate and gift taxes amounted to only $4.6 billion, or 2.5 percent of the $187.5 billion the Federal Government received in general revenues (that is, Federal revenues from all sources except trust funds). The fact of the matter is that the basic purpose of the Federal estate tax is to redistribute wealth rather than to raise revenue.

Our proposal with respect to the specific estate tax exemption would apply to all estates. If a specific estate tax exemption of $60,000 was justified in 1942, an increase in this exemption to $200,000 is fully justified to adjust for the inflation that has occurred since 1942.

Our proposal, with respect to the marital deduction also would apply to all estates. This deduction is essentially a device for deferring estate taxes until the death of a surviving spouse. As a matter of equity, we do not think that a tax should be levied on the transfer of property between spouses on the death of a husband or wife; however, we are not recommending a 100-percent marital deduction. The increase which we are proposing is designed to provide a measure of relief for the estates that most need it.

Our proposal with respect to the valuation of farmland, woodland and open space would apply only to estates that own such land. However, we believe that it would serve the public interest by helping to maintain open space in urban areas without extensive public expenditures for land acquisition and maintenance.

We would like to stress the fact that this proposal would be optional rather than mandatory. If an executor elected to have an estate assessed at its value for farming purposes, the land in the estate would be required to remain in farming or ranching for a period of 5 years. If such land is sold for a nonfarm use in less than 5 years, an additional tax based on the higher use value would be assessed and collected.

We are recommending that the recapture period be limited to 5 years because a longer period could create a hardship by clouding title to the land in an estate and thereby impairing its collateral value.

We also would like to point out that one effect of having land valued on the basis of its current use—rather than a higher market value—would be to increase the amount of capital gains that would be realized and subject to taxation if the property should subsequently be sold for more than its current use value.

We appreciate the opportunity to present our views on this important matter, and we urge that you take prompt and favorable action on our proposals, so that remedial legislation can be passed by the 94th Congress.

Thank you.

The CHAIRMAN. Thank you.

Are there any questions, gentlemen? Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. No questions, Mr. Chairman.

The CHAIRMAN. Senator Byrd?

Senator BYRD. No questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Yes.

You have directed your testimony very much to the way the estate tax affects agriculture. I thoroughly agree with you, but the proposal that you advocate would help everyone. Isn't that correct?

Mr. STEARNS. Yes, sir.

Senator CURTIS. It would help small businesses and professional men. Isn't it also true that some people whose homes are not pretentious are, due to the current inflation, facing an estate tax problem?

Mr. STEARNS. Yes.

Senator CURTIS. The estate tax was originally intended to be a tax on the transfer of the large estates in the country. It was never intended to be a tax of broad application, but it is now a threat to every

homeowner. It is a threat to a family-sized farm or a small business, or a professional man, or any other person, and it may now apply to a lot of employees as well.

Therefore, a revision of the estate tax is exceedingly important.

I not only agree with your proposals, but I appreciate the fine work that the Farm Bureau has done across the land.

Now, this committee will not be the sole group to determine what the Senate will do with respect to estate taxes. There was a time when the Senate generally followed the action of its committees, but we will be faced with a fight on the floor with respect to this tax matter.

The gentleman leading that fight on the floor appears to be the distinguished Senator from Massachusetts, Senator Kennedy. He stated in his testimony before this committee:

> I strongly urge the committee, whatever action it takes on the broader issues of the estate and gift tax, to reject outright the President's proposal to increase the estate tax exemption from $60,000 to $150,000. This proposal, ostensibly intended to help small farmers, would severely undercut the effectiveness of our estate and gift tax law.
>
> If the committee does wish to take some action at this time to relieve the liquidity of farmowners, I would suggest a proposal to achieve this goal without impairing the basic structure of the tax transfer system. Under the proposal farmers would be entitled to developed rights, such as charitable or government operations. In this way the land would be valued at its value, and not at the developed value, and a goal for preserving the Nation's open spaces.

Do you believe for us to deal with the estate tax and not raise the exemption or not do anything about the marital deduction would meet the needs of the country?

Mr. STEARNS. No, sir, I don't, and we did confine our testimony primarily to its effect on agriculture, because this is our primary concern.

Our experience in Connecticut and in our neighboring State of Massachusetts is that there is great and widespread interest in this problem. As you have mentioned, homes, for instance, will be subject to this tax, and it has been our experience that many people feel that this tax is unfair.

Senator CURTIS. Only last night I was informed of the sale of a house on the block where we live in this city. The house that originally sold not too long ago for less than $25,000. It sold last week for $107,000. This is clearly a tax on inflation, but as you have pointed out so well, it creates havoc for the surviving spouse and the rest of the family to do this.

Now, isn't it also true that, when a business or a farm unit has to be sold to pay estate taxes, oftentimes it is a larger operator that comes in and buys it. Isn't that correct?

Mr. STEARNS. Yes, sir.

Senator CURTIS. Now, I don't think the Government should make war on businesses just because they are large, but, on the other hand, I don't think that we should adopt a tax system that actually encourages economic concentration in fewer hands, whether it is agricultural property or small business.

Mr. STEARNS. Yes, sir, I would agree with that, and I would think, too, that we should recognize that there are mechanisms, stock options, and trusts and so forth, and sophisticated methods of avoiding

many of these taxes, which either are not understood or are not as available to the small businesses as they are for the large operators.

Senator CURTIS. That is very true. In a rural area, sophisticated estate planning advice is not often available and many are not even aware of the problem.

Also, we still have people dying young, and they are operating a going concern at a time when they have many financial problems, and because it was something they intend to work out in their lifetimes.

Thank you very much.

The CHAIRMAN. Thank you very much, sir.

Did you want to ask any questions, Senator Roth?

Senator ROTH. No questions.

The CHAIRMAN. Senator Packwood has to leave shortly, and he would like to hear the statement of Mr. Richard B. Covey before he leaves. I will call Mr. Covey at this time.

Would you come forward, please, sir.

STATEMENT OF RICHARD B. COVEY, OF CARTER, LEDYARD & MILBURN

Mr. COVEY. Thank you.

Senator PACKWOOD. Thank you, Mr. Chairman, I appreciate it.

Mr. COVEY. Mr. Chairman and members of this committee, I appreciate the opportunity to testify on what is currently the most significant issue involving the Federal estate tax, its effect on farms and closely held businesses. Senator Nelson and the other members of the Select Committee on Small Business should be commended for the interest which they have shown in this important subject and the time which they have devoted to it in hearings both here in Washington and in other parts of the country. Facts developed during the last year demonstrate that the Federal estate tax is having an increasing and adverse impact on the ability of family members to continue to operate a farm or closely held business after the death of the owner, particularly when the asset moves downstream from one generation to another. In response to this problem members of this committee, other Senators, and many Members of the House have introduced or sponsored bills to give estate tax relief.

It seems reasonable to assume an attempt will be made to include an estate tax relief provision in the Senate version of H.R. 10612. The chance of success would appear to be good, given the broad support that has developed for a change in the law. I will not discuss whether or not such relief should be enacted. This is a policy decision which you must make, I hope no special ability to enlighten you as to the right answer. I would, however, like to comment on the form which the relief might take.

S. 3139 introduced by Senators Packwood and Nelson provides an excellent point of departure. This bill shows a sensitivity and depth of analysis often lacking in tax relief measures. It contains a double credit approach. A $25,000 estate tax credit would be substituted for the present estate tax exemption of $60,000, and additional credit of up to $15,000 would be created for farms and other small businesses which are actively managed by a member of the decedent's family after his death and which satisfy other requirements.

Most of the estate tax relief bills introduced in the Senate and the House propose a substantial increase in the current estate tax exemption of $60,000. The difference between an estate tax exemption and an estate tax credit is beginning to be understood. Stated, simply, an exemption operates as a deduction against an estate's highest rate of tax, whereas a credit provides the same benefit to each estate, large and small, which can use the full amount of credit. I favor the use of an estate tax credit rather than an exemption operating as a deduction, because in my view the objective is to set the floor under which no tax will be imposed, not to give a benefit to estates which increases as the size of the estate increases.

If a credit of $20,700, which is the estate tax on a taxable estate of $100,000, were substituted for the current $60,000 exemption, approximately 45 percent of the estates now paying some estate tax would be taken off the estate tax rolls. The revenue loss would be somewhat more than $200 million, or roughly 5 percent of the estate tax revenues. S. 3139 proposes a credit of $25,000. The revenue loss from a $25,000 credit when compared to a $20,700 credit is in the range of $400 million. I personally would prefer to keep the general tax relief for all estates on the low side and to use the savings to grant special relief to farms and other small businesses.

Before leaving the exemption-credit issue, I would emphasize again that switching from an exemption to a credit would be a constructive change in the law, leaving aside its effect on farms and other small businesses.

The creation of special estate tax treatment for particular assets may be criticized by owners of other assets, particularly if the tax differential is substantial. When this occurs, there is also an incentive for wealthy people to acquire such assets for their estates tax savings.

Bearing these facts in mind, any special estate tax relief for farms and other small businesses should be directed narrowly to cover only deserving cases. S. 3139 does this by requiring that after the decedent's death a member of his immediate family own and actively manage the business. It also recognizes that the requirements of section 6166 are not sufficiently restrictive to justify tax forgiveneses, and adds a requirement for the credit that the business constitutes 65 percent of the decedent's adjusted gross estate.

The changes which I would make in 3139 are minor, and result primarily from my desire to avoid total tax forgiveness and to make heirs "wait" a longer period of time to receive all relief. Partial forgiveness keyed to the section 611 payments would do this, and also avoid some administrative problems that might occur if recapture of the tax credit occurs as a result of a member of the immediate family ceasing actively to manage the business within 5 years after the decedent's death.

Finally, I would unhesitatingly recommend a reinstatement of the special 4-percent interest rate for estate tax deferred under section 6166, and make some technical changes which would make this section a more useful provision.

Thank you.

Senator Byrd [presiding]. Thank you, Mr. Covey.

Senator Packwood.

Senator PACKWOOD. Thank you very much. I appreciate your coming. I heard this witness speak before the Small Business Committee, and I find his flattering references to my proposal and that of Senator Nelson, despite that, I find his comments helpful.

You are not here representing anybody today, are you?

Mr. COVEY. No, I am not.

Senator PACKWARD. There is a tendency to stick to what we know, but let's run down your tables in the back. If you were to have a $17,900 credit, and I am looking here at appendix A, page 1, you would have no tax on a taxable estate of $90,000 and below.

Mr. COVEY. Right.

Senator PACKWOOD. And you would have—well, explain to me the 41.7 percent of the $100,000.

Mr. COVEY. That means, Senator, there would be a tax savings to a $100,000 taxable estate before the exemption of 41.7 percent over the taxes he pays today.

Senator PACKWOOD. Now, going over to your tax credit of $20,700, you would have no tax on the taxable estate of $100,000 or less. You would have a 36- or 37-percent savings on a taxable estate of $120,000. Here, I emphasize taxable estates, because we take into account the marital deduction and other deductions.

Mr. COVEY. That is right.

Senator PACKWOOD. Then the one you have on the last page, $25,000 would mean an 82-percent reduction in a taxable estate of $120,000, and a 33-percent reduction in an estate of $160,000, and if we adopt the tax credit approach, whatever savings, as you have indicated, can be targeted into farms and small businesses, savings we get by not using the deductions approach.

Mr. COVEY. Yes; under Senator Curtis' approach of a $200,000 exemption, the cost in revenue would be $2.1 billion. I think that is the estimate. If you had a credit of $50,000, which essentially would be the estate tax on a taxable estate of $200,000, the cost would only be $1.35 billion. So you're saving is a little more than $700 million by using the credit approach as contrasted with the deduction approach.

But I think you have a policy question, more importantly, of what is the function of the exemption or credit. It is to provide a floor under which no estate pays an estate tax, or is it to give an estate in a 70-percent rate bracket the benefit of a deduction at its highest rate. The larger estate gets a lot more out of a deduction than an estate at 30 percent.

Senator PACKWOOD. What I am trying to do is to make sure that the average farm, the farm, the average small business, the stationery store, or the small manufacturing business with 20 or 25 employees that is not liquid, and the farm is not liquid, can be passed on, and not only to your spouse, but passed on to your children, or to your nephews and nieces if you want to, and encourage the continuance of these family owned farms and businesses. I think that is a justified policy that is not hard to defend.

I have no other comments, Mr. Chairman.

Senator BYRD. Senator Hansen?

Senator HANSEN. I have no question, Mr. Chairman.

Senator BYRD. Senator Curtis?

Senator CURTIS. Who would benefit less under your credit approach than they would under the exemption?

Mr. COVEY. The turning point on a $20,700 credit would be a taxable estate of $550,000 before the exemption today. If the estate were $550,000 or over today the credit would not be as valuable in tax savings as the $60,000 exemption.

I think you have to understand what estates we are talking about. Today, only about 8 percent of all decedents who die in this country pay some estate tax. Of that 8 percent, about 90 percent have taxable estates of half a million dollars and below. So that when you go above the half a million dollar figure, you are really talking about a very, very small part of the decedents in this country.

Senator CURTIS. In other words, you are saying that anyone whose estate did not exceed $500,000, would fare just as well with the $25,000 credit?

Senator PACKWOOD. $20,000.

Mr. COVEY. With a $20,700 credit, he would fare better than with the $60,000 exemption.

Senator CURTIS. No, I mean how would he fare as compared to a $200,000 exemption.

Mr. COVEY. Obviously, the exemption is better than the credit, because the exemption is taken off at the highest tax rate.

Senator CURTIS. What estates would fare better with a $25,000 credit than they would with a $200,000 exemption? Which ones would?

Mr. COVEY. None. The $200,000 exemption would be more beneficial to every estate.

Senator CURTIS. Including the small one.

Mr. COVEY. That is why the revenue cost of an exemption is substantially above the credit approach.

Senator CURTIS. What is the revenue offset?

Mr. COVEY. It depends on what you want to compare it with. The revenue loss of going from a $20,700 credit as contrasted to the present $60,000 exemption would be a little more than $200 million. Now, if we move the credit up to the figure in Senator Packwood's bill, when we go from $20,700 to $25,000, I think that figure would be about $600 million.

Senator PACKWOOD. In fairness to Senator Curtis——

Senator CURTIS. Compared to what?

Mr. COVEY. The present revenues that you get with the $60,000 exemption.

Senator CURTIS. But you are comparing present law with the bill you favor. What I am trying to find out is how do taxpayers fare under various proposed changes because I want the maximum relief for them.

Mr. COVEY. The taxpayers would fare better under exemption.

Senator PACKWOOD. But at a cost of over $1 billion.

Mr. COVEY. That is right.

Senator CURTIS. I think, though, that we have a social problem here. I happen to know a family that has owned a manufacturing business that was worth $3 or $4 or $5 million, and all the rest of us thought it was a large amount of money. However, in order to pay estate taxes, they had to sell the business and the only bidders were the conglomerates. It seems to me that, while it is true that a credit is not worth

very much to some of the businesses, the failure to grant relief to estates will promote monopoly and mergers in this country in a way that is not in public interest.

Mr. COVEY. I think there is much to be said for what you are saying, but doesn't Senator Packwood's bill answer in part that problem? Can't you then direct relief specifically to who you want to protect, so to speak, and don't direct it across the board to every single estate then causing the revenue loss to be much larger.

Now, on the other hand, if the committee decides as a matter of policy that the estate tax be returned to what its status was in 1942, then, of course, you can move it up to a $200,000 exemption and lose the $2.1 billion. The more difficult question, though, is can you pass a $200,000 exemption? From where I sit, I would say no, and then I have to see what is achievable and how much of the relief would be general relief, which would come from an increased exemption or a credit, and how much relief should be a special relief, which is targeted in on the case you want to solve, which is the small business that has to sell out to the conglomerate.

My quarrel with what you have in your bill is that it is too much general relief and not enough special relief. I would favor more special relief, and target it in on the small business and the farms.

Senator CURTIS. I see.

Mr. COVEY. I realize what this does. Five years from now somebody might be back in the committee saying, "You created the biggest loophole in the world 5 years ago," but I personally would prefer that and target your relief to special areas; $2.1 billion is a tremendous loss out of estate tax revenues in fiscal year 1975 of $4.2 billion.

Senator CURTIS. We have to do justice. If we lose revenue by doing justice, then we have to find a just way to pick up revenue. We should never continue an unjust tax merely because of the need for revenue.

Mr. COVEY. I would agree with that, but I would point out that I don't think you can do it within this area. In other words, if you are going to make a policy decision of giving up taxes of $2.1 billion for a $200,000 exemption, don't look for some other part of the estate and gift tax laws to pick it up, because it can't be done.

Senator CURTIS. Those who are opposing any estate tax relief that would be beneficial are also recommending that capital gains be taxed at death, whether the asset is actually sold or not.

So we are dealing with a philosophical problem that precludes much compromise. It is like someone threatening to shoot your grandmother. You can't satisfy them by offering them the right to pull off her arm. [Laughter.]

Mr. COVEY. That is a most difficult policy question.

Senator CURTIS. Please don't feel that I am hostile to your proposal. I am for anybody that wants to grant relief here, and if we can get the votes to grant relief, we won't quarrel about the terminology.

One question, though: The second credit you propose is on the basis of management. Is that a defined term?

Mr. COVEY. It would have to be a term that would be defiend in the regulations. I would agree with Senator Packwood. I see no reason to grant any special relief unless some members of the family continue in the business.

Senator CURTIS. So the second credit would not be available to the widow who placed the farm in the hands of the farm management company and did not actively manage it?

Mr. COVEY. No; I do not think that would necessarily be so. It depends on how you define your terms, and I would think and recommend in defining active management that the situation you posed would be covered as active.

Senator CURTIS. It would be almost synonymous with continued ownership?

Mr. COVEY. It could be in the case of a widow.

The CHAIRMAN. Senator Roth?

Senator ROTH. What are the advantages of a tax credit compared with an exemption?

Mr. COVEY. The deduction benefits the larger estates more. For example, the present $60,000 exemption for an estate which is in the 70-percent bracket results in a tax reduction of $42,000. That is 70 percent times $60,000.

If the estate, however, is only in a 30-percent top bracket, which applies from $100,000 to $250,000, the benefit from the $60,000 exemption is only 60 times 30 percent, or $18,000.

So you can see that the benefits to be derived by the two estate are quite different.

Senator ROTH. What are the disadvantages?

Mr. COVEY. I don't see any disadvantages in going to a credit approach.

Senator ROTH. If one of the objectives is to provide disincentives to mergers, I suppose you could argue that the deduction provides for an incentive to larger estates not to be merged into conglomerates.

Mr. COVEY. I don't really agree with that. If that were so, what we should do is abolish the estate tax altogether.

Senator ROTH. Let me ask you a second question. I think we are both sympathetic to the goals of estate tax reform.

You hear a lot of talk today about trying to simplify the taxes. Do you feel your proposal is a step in the direction of simplification of estate taxes?

Mr. COVEY. If you move to a credit of $20,700, or a higher credit of $25,000, you would take between 45 and 55 percent of your present estate taxpayers off the rolls and if they don't have to pay a tax, they don't have to file a return and that means less administrative costs.

At the present time, if you have an estate which is a taxable estate of $10,000, for example, the cost of preparing the estate tax return is more than the estate tax you are paying. That is a ridiculous situation.

Senator ROTH. The Farm Bureau supports an increase in the exemption to $200,000. Do you know what percentage of estate taxes would be exempted?

Mr. COVEY. The $200,000 exemption would cost you——

Senator ROTH. Not how much it would cost. What would be the percentage that would not be paying estate taxes, under the Farm Bureau proposal?

Mr. COVEY. I would say in the range of 75 percent of those estates presently paying some tax.

Senator ROTH. Thank you, Mr. Chairman.
The CHAIRMAN. Thank you.
Senator PACKWOOD. Could I ask a couple of other questions?
The CHAIRMAN. Senator Packwood.
Senator PACKWOOD. Senator Curtis mentioned a business worth $3 million or $4 million or $5 million. If you had a $5 million business and you had not found a way to pass it on, a $200,000 exemption would not help too much.
Mr. COVEY. That is correct. I think by proper estate planning, you could cut the impact down.
Senator PACKWOOD. You have to do a lot of planning for that.
Second, the distinction that I think I would be trying to make in this amendment is the difference between a family-owned and a family-run business. I understand how a business of $10 million or $20 million can be a family-owned business. It may have several thousand employees. That would not be in the definition of a family-managed business, or family-run business. That is approaching a large corporate size. A credit approach is not designed to pass that ownership on to descendants. It is trying to protect those who run their own businesses and try to pass those on.
If you were to take the $2.1 billion revenue loss, and I haven't got the figures, but do you know off the top of your head how far up we could run the credit if we were willing to absorb that kind of a loss?
Mr. COVEY. You could run the credit up to, I would say, in the range of $60,000 to $70,000.
Senator PACKWOOD. And if you ran the credit up that far, what size estates above and below would be exempt?
Mr. COVEY. I would say in the range—I can answer that for you definitely by a letter, Senator—but I would say in the range of $250,000 to $300,000. Probably it would be closer to $300,000.
Senator PACKWOOD. If you ran the credit up to $60,000?
Mr. COVEY. Yes.
Senator PACKWOOD. Thank you.
Senator BYRD [presiding]. Thank you.
[The prepared statement of Mr. Covey follows:]

STATEMENT OF RICHARD B. COVEY

SUMMARY

If this Committee should determine to grant estate tax relief to farms and other closely held businesses, I recommend it be done by
1. Substituting an estate tax credit of $20,700, the estate tax now payable on a taxable estate of $100,000, for the current estate tax exemption of $60,000;
2. Reinstating the 4% interest rate on estate tax deferred under section 6166;
3. Granting partial tax forgiveness of estate tax deferred under section 6166 to estates which satisfy certain other requirements; and
4. Making certain other changes which will increase the utility of section 6166.
S. 3139 provides an excellent focal point for the Committee's work in this area. Section 6 of S. 2819 contains two technical changes covered by item 4 above which would be helpful.

STATEMENT

I. Introduction

Mr. Chairman and members of this Committee, I appreciate the opportunity to testify on what is currently the most significant issue involving the federal estate

tax, namely, its effect on farms and closely held businesses. This is the third time during the last seven months that I have spoken before a congressional committee on this subject, the other two times being as an invited witness before the Senate Select Committee on Small Business on September 25, 1975 and the House Committee on Ways and Means on March 23, 1976. I commend Senator Nelson and the other members of the Select Committee for the interest which they have shown in this important subject and the time which they have devoted to it in hearings both here in Washington and in other parts of the country. Facts developed during the last year, indisputably demonstrate that the federal estate tax is having an increasing and adverse impact on the ability of family members to continue to operate a farm or closely held business after the death of the owner, particularly when the asset moves downstream from one generation to another. In response to this problem members of this Committee, other Senators, and many members of the House have introduced or sponsored bills to give estate tax relief.

I would like to discuss some of the approaches to the problem which are contained in these bills and to offer some suggestions for your consideration. Before doing so, I would point out that based upon the most recent Treasury estimates only 7.7% of all decedents pay some federal estate tax. Thus, as opponents of any relief in this area point out, the relief would be given to the wealthiest 10% of all Americans. This does not mean that relief is inappropriate, but only that it should be carefully considered in the light of the function of an estate tax in our overall tax system.

II. General Relief—Exemption Increase vs. Estate Tax Credit

One way to give relief is to increase the current $60,000 estate tax exemption. Many of the bills which have been introduced do so. Some of these bills have been supported by members of this Committee. Such an approach affords relief not only to estates consisting of farms and closely held businesses, but to every other estate which would benefit from increase in the exemption. Figures concerning what percentage of the aggregate annual gross estate amount consists of farms and closely held businesses are difficult to come by. My best guess is that these assets do not constitute more than 15% of the aggregate gross estate amount, and the figure is probably closer to 10%. Thus most of the relief to decedents' estates from an increase in exemption would not go to estates consisting of farms and closely held businesses, but to estates with other assets.

The loss in revenue from an increase in the exemption would be substantial. To illustrate, estimates indicate that increasing the exemption from $60,000 to $120,000 would result in a revenue loss of $1.3 billion; increasing the exemption to $150,000 would cost $1.7 billion; and increasing the exemption to $200,000 would cost $2.1 billion. Estate tax collections during fiscal 1975 were $4.2 billion. Thus, the revenue loss from an exemption increase in the $120,000 to $200,000 range would be between 30 and 50% of total estate tax for the most recent fiscal year. Such a revenue loss cannot be offset by any change affecting decedents' estates except taxing the unrealized appreciation including in an estate, which would have a severe impact on estates of farmers and decendents owning small businesses.

In my judgment increasing the exemption to solve the problem the estate tax presents for farms and closely held businesses is inappropriate. The exemption should be increased only if this Committee makes a policy decision that an increased exemption is appropriate for every estate. If you do not feel this way, why should tax relief in a large aggregate amount be granted to all decendents to solve a problem for 15% of them? The only way to answer this question that makes any sense is to say that creating distinctions between types of assets for estate tax purposes is so undesirable that in order to protect the 15% the same relief must be given to the other 85%. The point may be made most dramatically by pointing out that the revenue loss from granting total estate tax forgiveness for all closely held business assets would be less than increasing the exemption to $15,000 or more.

An alternative to increasing the exemption would be to change the exemption, which operates as a deduction against the estate tax at the estate's highest estate tax rate or rates, to a credit against the estate tax, which essentially provides the same tax benefit for all estates. I favor an estate tax credit over

an exemption because in my view the purpose of an "exemption" in the estate tax law should be to set the floor under which no tax will be imposed, not to give a benefit to estates which increases as the size of the estate increases. This is true whether or not this Committee decides to increase the relief given to smaller estates. However, the substitution of a credit for the current exemption would also minimize the revenue loss from such an increase, when compared with increasing the exemption, because there is less spillover of relief to larger estates.

The tables attached as Appendix A show the effect on estates of various sizes of eliminating the present $60,000 exemption and replacing it with credits of $17,800, $20,700 and $25,000, (representing respectively the tax on taxable estates of $90,000, $100,000 and $114,333). They show two somewhat surprising things. First, the size of estates benefiting to *some* extent from substitution of the credit for the exemption increases dramatically with relatively modest increases in the credit. Second, the benefits of any given credit in percentage terms diminish rapidly as estates increase in size beyond the no-tax point.

Thus, a credit of $17,900 is better than a $60,000 exemption only for taxable estate (before the exemption) at or below $155,000. The $20,700 credit benefits at or below $550,000, and $25,000 credit benefits estates at or below $1,303,333. Increasing the credit by 40% in this range increases the size of estates benefiting by more than eightfold.

These benefits are, however, weighted toward the smaller estates and diminish rapidly. Thus with the $17,900 credit an estate of $100,000 would pay 42% less tax than with a $60,000 exemption. An estate of $120,000 has its tax reduced by only 7%. With the $25,000 credit, an estate of $120,000 has its tax reduced by 82%, and an estate of $160,000 by only 34%.

My own preference would be to substitute an estate tax credit of $20,700—the tax on a taxable estate of $100,000—for the current $60,000 exemption. Such a change would take approximately 45% of the estates which pay an estate tax off the estate tax rolls. These estates would be those with taxable estates (after the $60,000 exemption) of less than $40,000 under current law.

Senators Nelson and Packwood of this Committee, who originally supported S. 2819 proposing increases in the estate tax and gift tax exemptions to $120,000 and $60,000, respectively, introduced bills S. 3130 and S. 3140, which substitute an estate tax credit for the current exemption. These bills deserve your most careful consideration. I will say more concerning S. 3139 later in this paper.

III. Special Relief for Farms and Closely Held Businesses

A. Introduction

In general, the proposals for giving estate tax relief only to farms and closely held businesses have been:

1. Reinstating a lower interest rate for estate tax deferred under section 6166;
2. The Administration's proposal for a five year moratorium on payments eligible for deferral under section 6166 and a stretch-out of the deferral period from 10 years to 20 years after the end of the moratorium;
3. Providing a special valuation method which would produce a lower estate tax than under the current fair market value approach; and
4. Partial or total forgiveness of the estate tax.

B. Analysis of Proposals

1. LOWER INTEREST RATE

The special 4% interest rate for estate tax deferred under section 6166 was eliminated in P.L. 93-625 where the normal 6% interest rate was changed to a floating rate (now 7%) tied to the prime rate. This action was unwise and made the liquidity problem for farms and closely held businesses more difficult. Three possibilities for a "return" to prior law exist—a fixed rate, a percentage of the floating rate and 2% under the floating rate. The obvious fixed rate is 4%, which was the old rate; the obvious percentage is two-thirds of the floating

rate, which would reestablish and maintain the percentage relationship between the former 4% and 6% rates. For the forseeable future, which is not long, the 4% rate would give slightly greater relief. A fixed rate has the advantage of permitting the estate to know that its tax liability (including interest) is fixed, which should make planning for payment somewhat easier. Originally, I favored a rate on amounts deferred under section 6166 equal to two-thirds of the floating rate. A return to the 4% rate is, I now believe, more desirable.

2. OTHER TAX RELIEF PROPOSALS

(1) Qualification Requirements.—The three other types of relief proposals summarized above contain qualification requirements which vary considerably. In general, there is a "before death" requirement and an "after death" requirement.

(a) *Time Requirement (I) Before Death*

One purpose of this requirement is to prevent acquisitions "in contemplation of death" in order to take advantage of the tax benefit. If the tax benefit is small, the problem is not serious. The problem increases in significance as the tax benefit increases. Yet any fixed period for which the business must be held prior to death arbitrarily affects those estates where the decedent bought for business reasons and died unexpectedly. A long holding period, say five years, is undesirable. If the object of the relief is to permit the family to *continue* in the business, as I believe it should be, the length of time the decedent has been in the business is not important.

(ii) *After Death*

The need for some "after death" requirement is obvious. If the estate sells the asset six months after the death of the decedent, there is no reason to give relief. The most frequently suggested period is five years. Such a fixed time requirement will exert a significant influence on the decision to continue the business even though it is not economically viable or only marginally productive, particularly when the tax benefit is great. This seems undesirable. To illustrate, one proposal would exempt from all estate tax a farm of less than a stated value if held for five years after death. If the farm were marginal, the family would have to decide whether they should hang on for five years to save the estate tax.

A fixed time requirement presents another problem when it is not satisfied. The estate will have taken advantage of the benefit, which must then be recaptured. Doing this will be troublesome. For example, if the benefit is an alternate method of valuing the assets which produces an estate tax savings, when is the fair market value of the asset to be determined? Will both valuations be made on the estate tax return, or will fair market value be determined only after the time requirement is violated? Suppose the asset goes to one beneficiary, but the potential tax liability to someone else, including a charity. This would create some potential problems.

C. S. 3139

I would like to focus upon what qualification requirements are desirable by analyzing those contained in S. 3139. In my judgment, this bill shown a sensitivity and depth of analysis which is most unusual. The requirements of S. 3139 are:

1. The business qualifies under section 6165;
2. The business has been actively managed by the decedent or his immediate family for five years prior to death;
3. The business constitutes at least 65% of the decedent's adjusted gross estate; and
4. The immediate family of the decedent continues to own and actively manage the business for five years after the decedent's death.

The use of the requirements of section 6166 as a point of departure is sound. This approach avoids the problem of differentiating between farms and other types of closely-held businesses. To illustrate, some bills which have been introduced provide an alternate valuation method for farms, which presumably would produce a lower estate tax, but not for non-farm closely-held business. Why should the farm be preferred over this other business? The answer is that it should not be.

In imposing a non-time requirement in addition to those contained in section 6166, S. 3139 exposes a weakness of the Administration proposal, which is keyed solely to section 6166 qualification. Section 6166 requires that the qualifying asset constitute 35% of the decedent's gross estate or 50% of his taxable estate. The taxable estate is determined after allowance of all deductions and the $60,000 exemption. One of these deductions is the marital deduction, which may be as much as 50% of the adjusted gross estate (gross estate less funeral and administration expenses and claims). Thus, an asset may qualify under section 6166 even though it is less than 25% of a decedent's adjusted gross estate. Put another way, qualification would exist even though liquid assets constituted 75% of the estate. It is not sound to grant relief in such a case. A higher percentage requirement than that contained in section 6166, in the range of 60% to 70% of the decedent's adjusted gross estate, is appropriate. S. 3139 uses a 65%. This will ferret out nondeserving cases.

The "before death" time requirement of S. 3139 is five years, the same period used by most other bills. As mentioned above, I regard this period as too long. It loses sight of the desired objective, which is to permit the family to continue to operate the business. Relief should not be denied merely because the business was not operated by the family for a full five years. A "before death" time requirement is needed only to prevent acquisitions "in contemplation of death" to obtain the relief. The likelihood of this occurring seems slight, particularly if the "after death" requirements are substantial, and the relief is spread out over a period of time. A one-year, or at most a two-year, "before death" requirement should be sufficient.

S. 3139 wisely does not require that the decedent actively manage the business prior to his death. Active management by any member of this immediate family is sufficient.

The "after death" requirement of S. 3139 is that a member of the decedent's immediate family own and actively manage the business for a five year period. Thus, relief is granted only where a member of the family does continue actively in the business. This requirement is desirable and will eliminate the cases that do not deserve relief. Such a factual test, which distinguishes between an "operator" and an "investor," will be difficult to apply in some cases, but usually the line between the two will be clear. All that is needed is for the Internal Revenue Service to interpret the law reasonably; a statement to this effect in legislative history would be helpful.

One problem which is not specifically dealt with in S. 3139 is the effect of a partial sale of the business within the five year period after death. Consideration should be given to how such a case would be handled.

D. Form of Relief

1. SPECIAL VALUATION METHOD

Two benefits would result from a special valuation method—(1) valuation of the asset would be simpler, thus reducing controversies with the Internal Revenue Service, and (2) the method would produce a lower valuation, thus reducing the estate tax on the asset. The amount of the tax reduction would necessarily be imprecise and depend upon what valuation resulted from the application of the special method. The selection of a special method which will produce fair results as between similarly situated estates is not easy. Also, the creation of a special valuation method for non-farm small businesses will be difficult, and I do not believe you should grant relief to farms but not to other small businesses.

2. ADMINISTRATION PROPOSAL

The relief under the Administration proposal is a five year moratorium on payment of the tax without interest and a stretch-out from ten years to twenty years of the deferred payment period. The moratorium is in effect a five year non-interest bearing loan in the amount of the estate tax attributable to the qualifying asset. Based upon a 6% interest rate (without compounding), which appears conservative, the "forgiveness' would be 25% of the tax on the asset. The use of a moratorium period seems questionable in several respects. First, its effect will be to delay sales of qualifying assets which for economic reasons (other than

delay in paying the estate tax) should be sold. A sale would not only cause an acceleration of the estate tax on the qualifying asset but would end the moratorium period. Second, the desirability of having all "forgiveness" in the first five years when the tax referral period is much longer may be questioned. Why not spread the relief over the entire deferral period? Also, the need for a payment period to twenty years—twenty-five years from the date of death when combined with the moratorium period—is debatable. My experience indicates that when the business is economically viable ten years is a sufficient period to raise funds to pay the estate tax.

3. TAX FORGIVENESS

The relief granted by S. 3139 is a tax credit—a forgiveness of tax—not to exceed $15,000. The credit would be reduced by 15% of the amount by which the taxable estate exceeds $300,000. Some limitation on the availability of the credit based upon the size of the estate seem desirable. What the limitation should be is a matter of judgment. The marital deduction is subtracted in arriving at the "taxable estate." Thus, there would be no reduction in the credit if the estate were $600,000 and took full advantage of the marital deduction.

I agree with the approach of S. 3139. If the relief is to be granted for certain assets, let it be done directly for all to see. How this should be done involves a matter of judgment. My own preference would be to grant the forgiveness more gradually than is done under S. 3139 and do so over the period the payment of the tax is deferred under section 6166 by reduced annual payments. If deemed desirable, the forgiveness could be coupled with a corresponding partial forgiveness of interest. Partial forgiveness of each installment payment has the advantage of not having the tax relief turn upon a single event, such as operation for five years, but rather upon continued operation during the entire deferral period. Giving the relief in this manner should minimize the likelihood that the tax benefit would have a significant bearing on decisions to continue the business or to dispose of it. Neutralizing the tax consequences of these decisions is desirable.

There remains the question of how the forgiveness should be handled. One approach would be to forgive a fixed percentage of each payment. Another approach would be to have the percentage forgiveness increase with the passage of time. The choice between these two approaches depends on how fast it is desired to give the rein *

To sum up, if this Committee desires to grant estate tax relief to certain types of assets—farms and other small businesses—S. 3139 introduced by two members of this Committee affords an excellent point of departure. The revenue loss would be modest, and its requirements are such that in my opinion non-meritorious cases would be eliminated. The changes which I would make in S. 3139 are minor and result primarily from my desire to avoid total tax forgiveness and to make the heirs "wait" a longer period of time to receive all relief. Also, partial forgiveness keyed to the section 6166 payments would avoid some administrative problems that might occur if recapture of the tax credit occurs as a result of a member of the immediate family ceasing to actively manage the business within the five years after the decedent's death.

IV. Other Estate Tax Changes

The preceding discussion has concentrated upon the problem of passing a small business downstream from one generation to another. There have also been comments above the difficulty in passing the business from husband to wife. I believe one of the other witnesses today will criticize the current law regarding joint property as being unjust because of the failure of section 2040 to recognize the non-financial contribution of a wife. This problem is, of course, not limited to widows whose husbands own farms or small businesses, but applies equally to all widows. Nevertheless, the liquidity problem presented by small business assets makes the case more dramatically than it is made in an estate with liquid assets. Two possible solutions come to mind—increasing the amount of the marital deduction to the greater of a fixed dollar amount, say $250,000, or one-half of the adjusted gross estate and changing the estate and gift tax provisions dealing with joint property to treat both spouses as equal co-owners of the property for tax purposes from the time the property is placed in joint names.

CREDIT OF $17,900—TAX ON $90,000 AFTER EXEMPTION—BREAK-EVEN ESTATE: $155,000 BEFORE EXEMPTION

Taxable estate before exemption of—	Tax payable with $60,000 exemption	Tax payable with above credit	Net benefit (detriment) to estate from substituting credit for exemption	Net benefit (detriment) as percent of tax due with $60,000 exemption
$30,000	0	0	0	
$50,000	0	0	0	
$80,000	1,600	0	1,600	100.0
$90,000	3,000	0	3,000	100.0
$100,000	4,800	2,800	2,000	41.7
$120,000	9,500	8,800	700	7.4
$160,000	20,700	20,800	(100)	(.5)
$200,000	32,700	32,800	(100)	(.3)
$300,000	62,700	63,800	(1,100)	(1.8)
$400,000	94,500	95,800	(1,300)	(1.4)
$500,000	126,500	127,800	(1,300)	(1.0)
$600,000	159,700	162,800	(3,100)	(1.9)
$1,000,000	303,500	307,800	(4,300)	(1.4)
$10,000,000	6,042,600	6,070,300	(27,700)	(.5)

CREDIT OF $20,700—TAX ON $100,000 AFTER EXEMPTION—BREAK-EVEN ESTATE: $550,000 BEFORE EXEMPTION

Taxable estate before exemption of—	Tax payable with 60,000 exemption	Tax payable with above credit	Net benefit (detriment) to estate from substituting credit for exemption	Net benefit (detriment) as percent of tax due with $60,000 exemption
$30,000	0	0	0	
$50,000	0	0	0	
$80,000	1,600	0	1,600	100.0
$90,000	3,000	0	3,000	100.0
$100,000	4,800	0	4,800	100.0
$120,000	9,500	6,000	3,500	36.8
$160,000	20,700	18,000	2,700	13.0
$200,000	32,700	30,000	2,700	8.3
$300,000	62,700	61,000	1,700	2.7
$400,000	94,500	93,000	1,500	1.6
$500,000	126,500	125,000	1,500	1.2
$600,000	159,700	160,000	(300)	(.2)
$1,000,000	303,500	305,000	(1,500)	(.5)
$10,000,000	6,042,600	6,067,500	(24,900)	(.4)

CREDIT OF $25,000—TAX ON $114,333 AFTER EXEMPTION—BREAK-EVEN ESTATE: $1,303,333 BEFORE EXEMPTION

Taxable estate before exemption of—	Tax payable with $60,000 exemption	Tax payable with above credit	Net benefit (detriment) to estate from substituting credit for exemption	Net benefit (detriment) as percent of tax due with $60,000 exemption
$30,000	0	0	0	
$50,000	0	0	0	
$80,000	1,600	0	1,600	100.0
$90,000	3,000	0	3,000	100.0
$100,000	4,800	0	4,800	100.0
$120,000	9,500	1,700	7,800	82.1
$160,000	20,700	13,700	7,000	33.8
$200,000	32,700	25,700	7,000	21.4
$300,000	62,700	56,700	6,000	9.6
$400,000	94,500	88,700	5,800	6.1
$500,000	126,500	120,700	5,800	4.6
$600,000	159,700	155,700	4,000	2.5
$1,000,000	303,500	300,700	2,800	.9
$10,000,000	6,042,600	6,063,200	(20,600)	(.3)

Senator BYRD. The next witness will be Mrs. Lloyd Royal, from Nebraska.

Senator Curtis?

Senator CURTIS. Thank you, Mr. Chairman. Will the other ladies who will accompany Mrs. Royal to the witness table please come forward?

A PANEL CONSISTING OF MRS. LLOYD ROYAL, SPRINGFIELD, NEBR.; MS. AUDREY SICKINGER, CATO, WIS.; MS. JACQUELINE FURBER, WOLCOTT, N.Y.; MS. LAURA LANE, FARM JOURNAL, PHILADELPHIA, PA.; AND MS. JO ANN VOGEL, CATO, WIS.

Mrs. ROYAL. Good morning.

Senator CURTIS. I would like to have the record show, Mr. Chairman, that Mrs. Royal is one of our leading citizens. Her family is involved in agriculture, and she has been very active in this matter. Her activity has attracted attention across the country, and one of those accompanying her today is the representative of the Farm Journal, who has been writing on this.

Mrs. Royal, after you give your full name and address, would you either have each of these ladies identify herself, with her name and address, or would you identify them for us?

Mrs. ROYAL. I will introduce them, Senator.

Mr. Chairman and members of the committee, I am Mrs. Lloyd Royal of Springfield, Nebr. My husband and I are family farmers in the true sense of the word with both of us working in the family operation. With me today are Miss Laura Lane—who has a 400-acre farm in Louisiana and is an editor for Farm Journal; Mrs. Jerome Sickinger and Mrs. Marcellus Vogel who run dairy farms with their husbands in Wisconsin; Mrs. Jacqueline Furber—she and her husband operate an apple farm in upstate New York.

Senator CURTIS. You may know Senator Byrd has apple farms in Virginia. You may proceed.

Mrs. ROYAL. The lady there with the petition is Mrs. Jerry Knapp—a fellow Nebraska farm wife and neighbor of mine who has been very active in the petition drive. They will help me with any questions you may have. Today I am presenting 160,262 signatures which were gathered in 49 States. Others were sent directly to Washington; 3,594 arrived at home yesterday, which will be presented at a later date.

I am not a "woman libber"; however, when I found that the IRS did not recognize the contribution of a spouse, it was a feeling of disbelief. Sir, I want to back up. In the interest of time, I will not follow my prepared statement word for word.

There is no logical reason why work should not count as a contribution. I wonder if the reason spouses were not allowed to show a contribution in the original law might be because the wealthy employed domestic help. I and many others can and do operate almost every piece of machinery on the farm. Just this last summer my husband was hospitalized during the cultivating time. My hours went from 4:30 until 10:30 at night. What difference should it make if I drive the tractor or work in town for wages with which to pay a hired hand?

Every husband I came in contact with declared emphatically their estate would not be as large if it had not been for the help of their wife. This is not just a farm problem. In Springfield almost every business is family operated.

I am very pleased to see that bills have been introduced allowing a tax-free transfer between spouses. It would be hard to devise a more efficient device for systematically snuffing out small businesses, farms, and ranches than the combined effects of Federal estate taxes, capital gains taxes, inflated real estate taxes and income taxes which presently exist. These are destroying profitable farming, a foul feat that depressions and wars have been unable to do.

FARMERS AND BUSINESSMEN AND RANCHERS ARE HAVING TO SELL

One of the saddest cases I have heard was a third-generation farm. The children had to mortgage their property to save their mother's farm home. Even then the Government showed an even greater lack of compassion by making them pay within 9 months. They say this can be avoided by estate planning. They had not one, but two, attorneys. The attorneys they used for all their business matters. Even they did not have the knowledge to write the deeds correctly.

It is time the estate tax laws are recognized for what they are: Not so much a tax on the rich, but a tax on members of the hard-working middle class. People who are truly wealthy hire expert tax advice to keep their estate intact. I wonder what our forefathers, who gave up so much to settle this country would think if they could return to life. Where will our children and grandchildren have to go to own a business of their own?

It is my hope Congress will move rapidly. I can think of no more fitting way to celebrate the Bicentennial than to pass legislation which will save the poor and middle class people from becoming dependent on State or Federal aid.

Revenue is very important; however, death is a very cruel time to be gathering money. It always brings many other bills—funeral, often lengthy hospital, and doctor bills, disruption of the business which, if a sale is necessary, means more income tax. Very often the estate tax is the so-called "straw that breaks the camel's back."

Also, those who stress revenue loss, quote the gross amount. The cost of administration has not been subtracted. The estate tax has now lost its effectiveness because so much of society's resources are spent paying lawyers and accountants to find ways to avoid it. They are the ones who gain the revenue.

A look at your schedule of tax reform bills shows so many are for tax exempt status. Just giving each of them a little bit less of a break would more than take care of the revenue problem. Mr. Vanik reported 240 residents of the District of Columbia—which can hardly be called a part of the farm belt—claimed farm losses of more than $11,000 each on their IRS returns last year. These "gentleman farmers" are not paying their fair share of taxes. While I strongly support the Curtis bill, I do feel it is lacking in the treatment of spouses. A monetary figure cannot apply to all estates. I, and those who have contacted me, feel the $200,000 figure is too low. In my petition, these figures were quoted merely because the Curtis-Burleson bills were

the best we had seen at the time the petition was written. The value per acre of farmland in Nebraska increased 1,023.8 percent from 1942 to 1975. If the specific exemption had raised by the same percentage—the $60,000 would now be $614,285.

POINTS WORTH CONSIDERING

Senator Nelson's tax credit instead of raising the exemption sounds good, but beware of changing the tax rate which would nullify the benefit to small estates. Combining the gift tax and estate tax exemption I fear we might lose the annual exclusion which is the only one small businesses and farmers might have assets to use. Small estates would undoubtedly lose more than would be gained with Senator Kennedy's proposal to tax unrealized capital gains at death. Any law passed should ease the burden, not create a new one.

Inflation and the rise in real incomes now means that 11 percent of estates are now subject to the estate tax against 1 percent prior to the 1940's, which means more than 75 percent of all Americans are involved. People who have never earned more than $4,000 or $5,000 a year have estates worth in excess of $60,000. Senator Pearson's S. 2879 has an automatic increase to reflect cost of living rises. From November 1, 1974 to November 1, 1975, Nebraska land rose 19.6 percent, which would already put the $200,000 equal to $239,200. It also has a retroactive clause.

Senator Bayh's bill requires living on the farm, which is not a practical requirement. All who have contacted me feel President Ford's first proposal to stretch out the tax payments does not solve the problem. The estate still pays. His second proposal to raise the exemption is still not realistic with inflation. All agree with his third proposal for tax-free transfers between spouses. Another gross discrimination—corporate and congressional retirement are not subject to Federal estate taxes. Keogh and IRA become a part of the estate.

I thank you for the opportunity to speak.

Senator BYRD. Senator Curtis?

Senator CURTIS. Mrs. Royal, have the other people in the panel submitted their statements?

Mrs. ROYAL. I don't know if they have submitted them yet, but they will.

Senator CURTIS. The staff will see they are included.

I would like to have you develop more the problem you have raised about the contribution——

Mrs. ROYAL. Could I interrupt you 1 minute? I neglected to introduce one man who has been very important in my campaign, Mr. Bill Jones of the National Livestock Feeders Association.

Mr. JONES. Thank you.

Senator CURTIS. We are delighted to have Mr. Jones here.

In reference to the present discrimination against the wife's contribution, does this arise in this manner? Here is a farm wife who assists with everything that is to be done over a long period of time, and her efforts go into building the farm, to the acquiring of more livestock, to the acquiring of more machinery, and to the conservation efforts.

It enhances the value of land even if we had no inflation. Isn't that correct?

Mrs. ROYAL. Yes.

Senator CURTIS. As far as all the growth is concerned, half of it is due to her efforts.

Mrs. ROYAL. Yes, and I think you will find that there are a good many women just as ourselves and the ladies with me, where we started with nothing. I envied a child who had a nickel for an ice cream cone when my husband and I didn't. So you can say our estate has been the result of our 31 years of working together and sacrificing in order to build the estate.

Senator CURTIS. In a situation like that when the husband dies, the entire operation is considered an asset in his estate.

Mrs. ROYAL. My attorney tells me that even if he were a complete cripple and I were the only one who had done anything, the law would say that he was the one who had contributed the entire estate.

Senator CURTIS. What is the advice you receive in reference to whether or not that problem can be overcome by estate planning?

Mrs. ROYAL. There are various ways of estate planning. I am well aware of the various ways. The point I make is, why should I have to or why should we have to do estate planning for me to get something which I already earned? I don't see why.

Senator CURTIS. That is correct, and also, as I mentioned a bit ago, there are people who die young, and their major attention is on the activity they are carrying on and not estate planning. They aren't like someone who is along in years and has retired and can look back and say, "This is what we have, how can I best plan to keep it?"

Mrs. ROYAL. Also most often we do not have a lot of cash resources. All of our cash goes back in our operation, and any kind of estate planning you take on is going to cost money, which cannot be put back into our farm.

Senator CURTIS. So what you are saying is that, for tax purposes, the true situation ought to be examined.

Mrs. ROYAL. Yes.

Senator CURTIS. And if half the value of the farm or the busines, or whatever it is, has resulted from the wife's efforts then that fact ought to be recognized?

Mrs. ROYAL. Definitely.

Senator CURTIS. Regardless of what kind of shuffling of the papers is taking place.

Mrs. ROYAL. Yes, and I think most husbands agree with that.

Senator CURTIS. Mr. Chairman, I know time has expired, but I hope these individuals could speak.

Miss Laura Lane, since you have done much investigation on this problem, do you have anything you want to say?

Ms. LANE. Yes. My testimony was filed with the committee for the record the week of March 15. In addition I would like to say that the trend toward incorporation of the family farm is a direct result of the unfair estate taxes as they now stand.

It is true that the greatest difficulty falls on the wife when the property is held in joint tenancy. It sounds easy to make a change to some other way of holding property, but in the event of a change to tenancy in common, often there is gift tax liability, in considerable amount.

Senator CURTIS. Is it true that, for joint tenants with the right of survivorship, both estates get taxed on the full value?

Ms. LANE. Yes, because it is assumed to belong to the husband. Then the wife's estate is taxed upon her death.

Senator CURTIS. Mrs. Vogel.

Mrs. VOGEL. When we are speaking in terms of the estate being half my husband's and half mine, it is like a marriage. Can you divide it 50–50? You cannot.

Another point that bothers me is that, referring to the loss in revenue, the proven fact is that when estate taxes are taken out of a community, it takes 25 years for that community to recoup that money. You are telling us that that money left in that community to work in that community will not give the Internal Revenue any money back?

Yes, it will. It will supply jobs, and therefore people will be paying taxes. So you must look at it in many different aspects.

Senator CURTIS. And you can't have a great deal of relief with only a little bit of revenue loss. The revenue loss is a measure of how much good you do.

Mrs. Sickinger?

Mrs. SICKINGER. I would like to say that I own a 360-acre farm back in Wisconsin, on which I milk 150 cows. Now, I manage this herd, I contribute to the work of it, I work on the days off that my man does not work, and when I am to inherit my husband's farm, IRS doesn't feel I am capable of doing it.

I am already doing it, and that is a point I would like to make.

Senator CURTIS. Mrs. Furber.

Mrs. FURBER. Thank you. I think our Government should consider our farmers are a natural resource. I do not feel that you can crank a farmer out of a 4-year university. When you get down to the point where you are having 4-year farmers, you are going to be very hungry.

I think farming is a lifetime of learning on the farm. I have two boys, and believe me, I look at those kids and realize what they have learned and what they are capable of, and if there were going to be one man left on earth, I would hope it would be a farmer, because he is the guy who is going to get us through, and I think we have to start realizing that this is a type of training, and I hope that something is done to save our farms before it is too late.

Senator CURTIS. Yes, and I can't escape the idea that I mentioned a while ago just as the illustration. This house had increased in "value" from somewhere in the $20,000 range to $107,000, and yet the house isn't worth any more than it was at the outset.

That increase is due to inflation, and the estate tax says to the surviving spouse that, even though you are not going to sell it, but instead are going to keep it and carry on, the fact that there has been inflation the "value" is now such that a tax should be imposed.

That is all I have.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. I thank Senator Curtis for bringing this fine panel to testify. What you say rings a bell, as Senator Byrd knows, because he has seen how ranch operations work.

My daughter and three of our grandchildren make a very important contribution to the fact that the ranch that we own in Jackson Hole isn't more deeply in the red than it is. They are out there every day. My daughter can do anything on the ranch that anyone else can do, and you certainly strike a sympathetic chord.

The last person on earth may not be a farmer when he awakens in the morning, but he will be by noon when it comes time to eat. You make a very good point.

Senator CURTIS. But he still needs a wife.

The CHAIRMAN. Senator Roth?

Senator ROTH. I would like to congratulate the group, too. I think you make a persuasive case for relief. You all sound very much like the family farmer from Delaware. I have one question.

I notice in your recommendation that you speak about the IRA retirement program. You may not want to answer it currently, but later I would like to have your comments. I have proposed that the so-called IRA program be extended to wives as well as working men. It seems to me that this would give recognition to wives and it would help them develop their own pension programs. Would you care to comment on that?

Mrs. ROYAL. I am not familiar with the IRA, but my husband is involved in the Keogh, and I understand they are quite similar.

The point I am trying to make here is why, when he dies, should his accumulated retirement fund plan go back into the estate when if it were in a corporate retirement, it would not?

Senator ROTH. I understand your recommendation. What I am proposing, however, goes a step further, that housewives, not only the wives of farmers but all housewives, have the same opportunity to obtain an IRA. I would be very much interested in having your comments for the record.

Mrs. ROYAL. Would you just want a written comment later?

Senator ROTH. That would be fine, yes.

[The letter referred to follows:]

SPRINGFIELD, NEBR., *April 12, 1976.*

Senator WILLIAM ROTH,
Senate Office Building,
Washington, D.C.

DEAR SENATOR ROTH: I want to apologize for taking so long to answer your question April 6 when I testified before the Finance Committee. As I told you then much of my time is spent contributing to the farm. It was two days after my return before I had time to unpack my suitcase. My time was devoted to such things as helping castrate pigs, disking, harrowing, etc.

As to your bill S. 2732 on allowing unsalaried women Keough Plan retirement plans. I feel much the same as my first impulse. It would be a tremendous benefit to any widow who could afford to have used it. I will have to say it should be enacted for these people. I still have reservations as to how many family farmers and small businesses will have the available cash to make use of the law. As we stated in various Estate Tax testimony's, we do not have cash assets, our money is spent improving our operation. Most probably the saalried person would be the one most likely to use it. It is for the benefit of the low salaried worker that I say your bill should be enacted. I hope it will not become just another tax dodge bill for the wealthy.

While I was visiting around Washington much concern was voiced about loss of revenue if Estate Tax reform bills were enacted. I hope you will give some thought to taxing skip-generation transfers. Also, large corporation farms will cause much unemployment, thus cutting income tax revenue. They will not use the small town implement dealers, grocers, attorneys etc. These people will not only be paying no income taxes, they will in all probability cost revenue by use of welfare programs. Also, taking the life's savings is putting many elderly on welfare, as well as hurting their pride. This is something no pill can correct. Many who have contacted me state they have no desire to enlarge their businesses

when they know the government will take so much. This again means less employment. Perhaps these other sources of revenue will more than compensate for the loss of Estate Tax revenue.

I certainly hope something can be enacted before too many people die. Every small farm or business lost because of Estate Taxes is lost forever.

Sincerely,

MRS. LLOYD ROYAL.

Mrs. FURBER. I think I have the testimony here of Mr. Brownlie, of Boston, presented to the House Ways and Means Committee on the problem of the individual retirement account or Keogh plans, regarding the fact that they are included in an estate, whereas a corporate retirement plan, or the congressional retirement plans, are not—and I think this is grossly unfair—and I think very definitely this should be changed.

I have a copy of this testimony of Mr. Brownlie, and he goes into this in detail, if you would like it.

Ms. LANE. I have a Keogh plan too, since I am self-employed. The IRS discriminates particularly against me, because I have chosen not to marry.

Senator CURTIS. Maybe we ought to repeal the whole Tax Code.

Mrs. Furber, are you an apple grower? Senator Byrd is active in that, too.

Senator BYRD. May I ask what variety of apples you grow?

Mrs. FURBER. MacIntosh, Rome—just about everything. We have even got Ben Davis left on the farm, which I don't know if you even have in Virginia.

Senator BYRD. We have them, but we don't find them commercially very profitable, the Ben Davis. We find the Rome good. Do you have Red Delicious?

Mrs. FURBER. Yes, and many of the new types, Empire, Spartan, and we are planting dwarf trees.

Senator BYRD. One final question. It is a tough business, don't you find?

Mrs. FURBER. Yes, indeed.

Senator BYRD. Thank you, ladies, very much. You made a fine contribution to this business today, and we appreciate your being here.

[The prepared statements of the preceding panel follow:]

STATEMENT OF MRS. LLOYD ROYAL, SPRINGFIELD, NEBR.

SUMMARY

Present laws are:

1. Grossly discriminatory against the wife.
2. Far outdated in that exemptions and annual exclusions need to be increased to reflect the impact of inflation on agricultural and small business property.
3. Threatening the existence of efficient family farms and small business operations.
4. Forcing undue hardships on family farmers and small businessmen.
5. Discriminatory against the self-employed and others using the KEOGH and IRA retirement plans.

Recommendations:

1. Increase the marital deductions to provide more equitable treatment for spouses.
2. Increase exemptions and annual exclusions to compensate for inflation.

3. Do not move to tax the unrealized capital gains on farm and small business property.
4. Allow users of KEOGH and IRA retirement programs to transfer tax free, the same as those under corporate and congressional retirement programs.

STATEMENT

My name is Mrs. Lloyd Royal of Springfield, Nebraska. My husband, Lloyd and I own 240 acres of farm land and rent another 80 acres in Sarpy County, Nebraska. We are family farmers in the true sense of the word with both of us working in the farming operation. Today I am presenting two petitions containing 160,262 signatures to Chairman Long and members of the committee. These signatures have been gathered in 49 states. I am also presenting copies of letters and quotes from other letters.

It is still hard to believe that a simple campaign by three women to arouse the people in their county could spread across the entire United States without receiving any dissent. This to me is very vivid proof that the law is in need of change.

I am not a women's libber; however, when I found that the IRS did not recognize the contribution of a spouse, it was a feeling of disbelief. To think that spouses can work together for so many years and be told only one of them had earned the estate. It's unreal.

I firmly believe that in middle class families there cannot be much of an estate unless both spouses help. It is easy to spend; difficult to save.

There is no logical reason why work on the family farm or in the family business should not count as a countributiod. I would wonder if the reason spouses were not allowed to show contribution for their labors in the original law might be because the tax was directed at the wealthy who employed domestic help. Their spouses were ladies of leisure.

On the contrary, I, and many others, can and do operate almost every piece of machinery on the farm. Just this last summer, my husband was hospitalized during the cultivating time. This meant one tractor in the field instead of two. My hours went from 4:30 in the morning until 10:30 at night. Even then I almost didn't get finished before the corn became too big.

To us, I made a contribution to our net worth. Why not to IRS? What difference should it make if I drive the tractor or work in town for wages with which to pay a hired hand? Every husband I came in contact with declared emphatically that their estate would not be as large if it had not been for the help of their wife.

This is not just a farm problem. In Springfield almost every business is family owned with the wives helping. A letter from Mr. Dixon Adams, a Sarpy County attorney, states "In my own case, my wife worked both at home and in the office for more than 20 years. During this time I have paid her no salary, so under present law she would not be able to show contribution toward the acquisition of jointly owned property. This is totally unrealistic because her contributions have been substantial and as far as I am personally concerned she has made as much contribution as I have.

I am very pleased to see that bills have been introduced allowing a tax free transfer between spouses in an effort to change this injustice.

I realize there are many identical or similar bills to the ones I will be quoting; however, due to work on the farm and my lack of time, I will use the bills which have been brought to my attention.

It would be hard to devise a more efficient device for systematically snuffing out independent businesses and eliminating continuity of small family farms than the combined effects of federal estate taxes, capital gains, inflated real estate taxes, and incomes taxes which presently exist in this country. These effects are destroying profitable farming, a foul feat that depressions and wars have been unable to do before. Contrary to articles stating there really is no problem, farmers and businesses are having to sell to pay estate taxes.

One of the saddest cases I have heard is a farm that was given to a son by his father many years ago. It was small and when the son died, it was not enough to keep his widow. Her daughter and son-in-law contributed much to her upkeep. The widow died recently. The daughter's husband died shortly after her mother. The doctor bills, funeral bills, etc. drained all of the savings. The daughter had to sell part of the property. She then applied for a loan. Because of her age and health, she was turned down.

This woman had no training for a job. All she knew was farming. Her children mortgaged their property to obtain the necessary money so she could remain on the farm.

It is very obvious, where the children have already mortgaged their property to pay her tax, there will be no way they will be able to pay the tax when she dies. The land that has been in the family 3 generations will never make it to the 4th. Incidentally, she has 7 grandsons who would like to farm. Another farm will go the way of a big farmer taking over.

They say all of this can be avoided by proper estate planning. This family had not one, but two, attorneys. They used the attorneys who handled all of their business matters. The money they gave the attorneys was lost, as even they did not have the knowledge to write the deeds correctly.

It is high time that the estate tax laws be recognized for what they are: not so much a tax on the rich, but more a tax on members of the hard working middle class. People who are truly wealthy are able to hire expert tax advice to keep the bulk of their estates intact.

I wonder what our forefathers, who gave up so much to settle this country, would think if they could return to life and see what is happening. My own grandfather left Germany to escape the two class system. We are rapidly approaching that point in this country. Where will our children and grandchildren have to go to own a business of their own?

It is my hope that the Congress will move rapidly. Making the estate tax law more equitable will encourage the continued existence of small family enterprises.

I can think of no more fitting way to celebrate this year's Bicentennial than to pass estate tax legislation which will save the small and middle class people from becoming dependent on state or federal aid. There are still many of the old school who try to save for their retirement. Why take their savings away just because one happens to die. You pay income tax, land tax, personal tax, sales tax, etc. Can't the government let a person grieving a death alone? Even then it shows an even greater lack of compassion by making the survivor pay within 9 months. Very few are over the shock of the death before the tax man asks them to make major decisions on their property.

A concern has been voiced about loss of revenue. Revenue is very important; however, death is a very cruel time to be gathering money. It always brings many other expenses—funeral, often lengthy hospital and doctor bills, disruption of the business which, if a sale is necessary, means more income tax. Very often the estate tax is the so-called "straw that breaks the camel's back." The crunch is even greater if there are several children, because the one who wants to continue the farm or business must buy out the other heirs at the same time he is paying the taxes.

Revenue could be gained by evaluating some of the current programs to see if they really are doing what they were intended to do and if they really are getting their true dollars worth for what they cost. Mrs. Vernon Clark of Iowa cited the article which appeared in their paper about a project for studying the Love Life of the Guppy. The cost—$50,000. Also, those who stress revenue loss, quote the gross amount. I would like to point out that the cost of administration had not been subtracted from that figure.

If the estate tax is necessary, then repeal the tax evasion laws that allow the wealthy to avoid estate taxes and get back to the original intent of the law. The revenue lost if all estate taxes are abolished would amount to 1.6% of the annual federal budget, according to the Wall Street Journal. Think how much revenue could be raised if they would abolish the "outs" that only the wealthy can afford. At the time the law was enacted it was a good source of revenue, because it was low enough that it was not worth hiring lawyers to avoid. It has now lost its effectiveness because so much of society's resources are spent paying lawyers and accountants to find ways to avoid it.

At an estate planning meeting the speaker told how one millionaire and he named him, paid no estate tax by giving half to his wife and the other half to charity. If my husband or any other middle class man gave half to charity, the spouse might end up living off charity.

A look at your schedule of tax reform bills shows so many that are for tax exempt status. Just giving each of them a little bit less of a tax break would more than take care of the revenue problem.

In answer to the worry of creating tax loopholes which would start the wealthy buying farms: Congressman Floyd J. Fithian of Indiana quoted, "Mr.

Vanik reported the disturbing fact that 240 residents of the District of Columbia—which can hardly be considered a part of the farm belt—claimed farm losses of more than $11,000 each on their IRS returns last year. Put simply, these " 'gentlemen farmers' are not paying their fair share of taxes."

While I strongly support the Curtis bill, I do feel it is lacking in the treatment of spouses. A monetary figure cannot apply to all estates. I, and those who have contacted me, also feel the $200,000 figure is too low.

Many of the letters sent directly to members of the Senate advocate changing the $60,000 to $200,000 and the marital deduction from ½ to ½ plus $100,000. I would not that in my petition, these figures were quoted merely because the Curtis-Burleson bills were the best we had seen at the time the petition was written.

According to "Farm Real Estate Developments", Economic Research Service of USDA, the value per acre of farm land in Nebraska increased 1023.8% from 1942 to 1975. If the specific exempti..n had been raised by the same percentage (the $60,000 would now be $614,285), we would not have an estate tax problem today. Good farm land usually sells for about $1,000 an acre. This makes the $60,000 exemption even worse.

Senator Nelson has a proposal to relieve the estate tax problem through the implementation of a tax credit program. Preliminary evaluation would indicate that it has merit and would be acceptable as a good alternative to raising the exemption, providing the credit has an adequate figure, and that the rates are not changed. It would appear that this might give more recognition to the original intent of the law by giving a greater advantage to the small estate. He also has suggested that efforts be made to combine the Gift Tax and Estate tax exemtpion. I fear in going this route we might stand to lose the annual gift exclusion which is the only one small businesses and farmers might have the assets to use.

The family farmer and small businessman would undoubtedly lose more than would be gained by use of tax on unrealized capital gains transferred at death. It would levy taxes on income which the estate has not received. As in current valuation of the farm, the estates with capital gains liabilities might be forced to liquidate something to provide cash for such taxes. It also might require records which would be hard to obtain because of inadequate records on the part of the deceased. Any legislation on this should be studied very carefully to evaluate the entire impact.

The Wall Street Journal editorial on March 10th states: "The fact is that inflation and the rise in real incomes now means that 11% of estates are now subject to the estate tax against 1% prior to the 1940's which means that more than 75% of all Americans including the children, grandchildren, and great grandchildren of the deceased have a direct interest in estate taxes. Even some retired elderly people who have never earned more than $4,000 or $5,000 a year during their lives have estates worth in excess of $60,000, the point at which the estate tax now begins to bite."

S. 2879

I hope the Senate will consider the ideas presented in Senator Pearson's S. 2879, as he includes all family enterprise as long as they are managed by the heir. He recognizes the contribution of spouses. He also has included a clause which authorizes automatic increases to reflect cost of living raises. This is very important and should be included in legislation so we will never again be caught with an outdated bill. Congressman Bedell quotes Iowa land rose 30.8% from 11-1-1974 to 11-1-1975 and the value per acre in Nebraska increased 19.6% during the same period, which makes the figures of $200,000 already outdated. A 19.6% increase puts the figure at $239,200. He also has a retroactive clause which should be considered. Since this change is so long overdue, some consideration should be given to correcting the injustices which have been done. At the present time we feel that S. 2879 is the best bill that has been brought to our attention.

S. 227

Senator Bayh has introduced S. 227 in an effort "to save the family farm". While this bill sounds like help for the family farm, there is one word which will not let it apply to many bona fide cases; that is, live on the farm. The widow may be afraid to stay on the farm and prefer a house in town, but would still manage or help on the farm. Other instances are the son may move to a farm

which is more specialized and better equipped; such as, confinement feeding versus grain farming, and while he may want to grain farm the home place, he may not want to return to the father's farm to live. If there is only one house on the farm, the heir may elect to live nearby and have a hired man live in the farm home.

All who have contacted me do not feel President Ford's first proposal solves the problem. The estate still pays. His second proposal, a step in the right direction, is not realistic with inflation. All approve his third proposal, estates should be tax free between spouses.

Another gross discrimination which I have not mentioned is between KEOGH or IRA plans and Corporate and Congressional Retirement plans. The Corporate and Congressional Retirement Plan assets are not subject to the Federal Estate Tax when the participant dies, while beneficiaries of KEOGH and IRA participants must include the amount in settling with the government.

I thank you for the opportunity to speak.

Quotes From Letters Received

BY MRS. LLOYD ROYAL ON ESTATE TAXATION

What is Uncle Sam trying to do to our family farms? Give them to big business and put us farmers on welfare.—Calif.

They bought their ranch in 1937 for $37,500. Now the appraised value is $357,660. Who knows what it will be this year? These are just figures. The house is older. The soil is more depleted. John and Mary have worked hard and long hours. Many years with no profit. They have provided jobs for hundreds of people. They simply want to operate their ranch knowing that if one of them passes away the other can still continue with their own expense account intact to operate. Now, in their declining years they are frustrated. They can't afford to sell because of the Capital Gains taxes. Who could afford to buy but big business. Perhaps the Oil Industry or Insurance Company. If John or Mary dies they also lose because of the Estate taxes.—Calif.

My husband passed away after a 6-week illness at the age of 45. Now beside managing the farm, caring for my family I had the additional worry of paying IRS. We worked so hard these past 23 years to make land payments, now the valuation is so high, I'm having to pay for the land again to the IRS.—T-1 Ne. Woman.

Some of my points are: 1. When property is owned jointly—yet wife must pay inheritance tax on both halves, she is denied the right to own property. 2 Taxes are paid by joint return therefore she has already paid the tax on her half of income—how can she inherit what is already hers? 3. If labor is not a contribution then her husbands labor should not count either. If his does, then this constitutes slavery. Slavery was abolished in 1865, therefore the law is illegal.—U-1 Wis. Woman.

We live on a 130 A. farm in Indiana which we bought 12 years ago for $30,000. It had an old rundown brick house (about 80 years old). After we improved it the insurance company would insure it for $5,000. The two barns were in bad shape, the land run down. It has taken all our money and we've both worked hard to improve. If my husband were to die today the IRS would come out and value our property to probably $130,000 or more since land has tripled in the past eight years. I would have to sell the farm, cattle, and everything just to pay the taxes. Where would it leave me and my daughters? Out in an apartment, just getting by.—S-1 Indiana Woman.

I began circulating your petitions and did not become totally involved until a friend of mine told me that when they incorporated their business she had to pay gift tax on the shares that she was to hold on the corporation because she could not give monetary proof of her contribution in building the business. WoW—E Wis. Woman.

Mr. Alfred Pallokat of Connecticut writes: My wife is a beneficiary under a will that caused her five sisters to mortgage the property heavily in order to pay estate taxes and the only persons getting money from this estate are attorneys and the government with no chance if ever to see any benefits till 1984. If the law had been changed to the present bills under consideration they would have had something.—Conn.

I am of a large family who have worked hard to build up an inheritance for our children. Our family have farmed and owned some of the land for four generations and it took that long to accumulate and pay for the property. All the

while each year paying taxes: Property, personal property, self-employment, employee's social security, income, sales, state income, exise. Gad! Thinking of all those taxes, it will be the fifth generation still paying without the IRS.—C-1 Ore. Woman.

The IRS' attorney explanation that "The wife renders all these services as a part of her marriage contract" infuriates me. I surely didn't sign my name to any such paper. The man doesn't work for nothing all his life and my husband certainly doesn't expect me to. I'm not putting in 40 years work just to end up owning the IRS.—C-1 Col. Woman.

My husband and I are in our seventies; we have worked (I without a dollars pay) for 46 years to get our ranch paid for and improved and now we are faced with the unfair widow's tax! I am not a woman's libber but I certainly would like to join the protest, against this situation.—E-1 Tex. Woman.

As a wife of a farmer who drives tractor or anything else that needs to be done on the farm I feel that I help make money to pay for our farms and any other things we need. I think I should be entitled to what is left if my husband should die before me. That is, what you work for in the first place, so the other one can have something when you are gone. The way taxes are now a lot of the younger people can't afford to go into farming, and the country needs all the good farmers we can get.—N Ind. Woman.

Why should any farmer at death leave to his wife a "drummed up" Estate tax and slap it at her with 9 months time limit. Just such is going on in the different states I have canvassed and these widows now on welfare, are living examples of the heavy hand of the law where Tyranny has taken over and taxation without representation has become a lost cause—every deceased husband died, thinking he was leaving his wife, a home and shelter, a roof over her head and a means to make an honorable living.—P Ks.

Mrs. Eunice Baumgard, Rt. 1, Round Lake, Minn. says: When we were making out my husband's will, the lawyer advised him the farm should be in my husband's name only. I asked "Even if I can prove I've earned half the cost of the farm in my lifetime and deposited same to our joint account?" (I work as Ass't Office Manager in town). He said "They would contend that you spent it all on clothes and frivolous things!)—Minn. Woman.

A River Falls, Wisc. woman: I personally think it is grossly discriminating and degrading that a wife is neither legally equal to nor a partner of her husband. We, my husband and I, have farmed for 35 years. Oddly enough, he has not been able to take depreciation on me!

I have worked fourteen hours a day six days a week for the past thirty years raising four children, sewing, cooking, baking, gardening, canning, freezing, etc., and certainly feel that I have made a contribution that should be recognized.—L 403 Tenn. Woman.

NOTE.—This petition, known as the Royal petition, addresses the specific issue of estate tax discrimination against wives. Since it is a public opinion petition, it is proper to add signature pages, as long as they are security attached. Also, additional copies of the petition itself may be made on a good grade copy machine. Most people will want to put their names on both the Royal and the Brooks petitions.—Mrs. Royal

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To: The Honorable ————
(Senate) (House) Office Building
Washington, D.C.

We, the undersigned are concerned citizens of the United States and the State of ————, and are particularly concerned with that portion of the laws of the United States and the State of ————, relative to the taxation of estates which provides that the full value of property which a decedent held at the time of his death, either as a joint tenant or a tenant by the entirety is includable in his estate, unless the surviving tenant can show contribution toward the purchase of the property.

The undersigned strongly believe that the foregoing provision of federal and state law unjustly discriminates against women who work in the home, on the farm or in a family business and make a contribution toward the acquisition of property held in joint tenancy or tenancy by the entirety with right of survivorship with their husbands. Even if both spouses contribute significant physical

efforts to earnings over the years and such earnings are the basis for increase in estate, at the time of death, the entire estate is considered to have been earned by the husband.

Justice and fairness dictate that this palpable inequity and inconsistency be corrected. There is no logical reason why women who make a contribution by working other than for salaries should be discriminated against.

The undersigned petitioners earnestly urged that federal and state law be amended and changed to recognize the contribution of women who work in the home, on the farm or in a family business toward the purchase and acquisition of property.

We respectfully request that you introduce and work diligently for legislation which will allow women to show contribution for work performed which contributes to the acquisition of such property for purposes of federal estate and state inheritance taxes.

Respectfully submitted,

Name ——————————

Address ——————————

NOTE.—This petition, known as the Brooks petition, addresses the issue of correcting the various inequities in present estate tax laws. Since it is a public opinion petition, it is proper to add signature pages, as long as they are securely attached. Also, additional copies of the petition itself may be made on a good grade copy machine. Most people will want to put their names on both the Royal and the Brooks petitions.—Mrs. Royal

To:

We, the undersigned, are citizens of the United States and the State of ———— who are particularly interested in reform and modernization of the Federal Estate Tax laws.

We believe that Congress should correct the inequities in present estate tax laws and should give recognition to the effects of inflation upon these laws. The present $60,000.00 exemption was written into the law in 1942. Currently a widow has to pay such high inheritance tax on her husband's estate (even if the property is in both of their names) that she may find herself virtually destitute.

We believe that existing law creates a severe hardship upon taxpayers and penalizes those citizens who have accumulated property through hard work and the exercise of frugality.

Accordingly, we urge the Congress to enact into law S. 1173 now pending in the Senate and H.R. 1793 now pending in the House which would increase the specific exemption to $200,000.00 and increase the marital deduction by $100,000.00.

Respectfully submitted,

Name ——————————

Address ——————————

KIMBALL, NEBR., *March 10, 1976.*

MRS. LLOYD ROYAL,
Springfield, Nebr.

DEAR MRS. ROYAL: Am very proud of your fortitude in promoting legislation to stop this gigantic "rip off" of farm families in the form of the "widow tax."

My situation of now, a widow of two years this month is, mother of six children and responsible for the management of our 2,640 acre farm. This farm, my husband and I worked for twenty-three years to put together and I plan to do everything possible to keep it together for our family. I still have a debt of $80,750 on the farm.

My mind is on a constant whirl trying to make ends meet with the low cattle and grain prices and the high cost of fuel, fertilizer and labor plus paying 9% interest on money borrowed to pay the "widow tax."

The following information I've sent to Reps. Ullman and V. Smith, also to Senators Hruska and Curtis.

"What could you do with $88,400? I could pay the indebtedness owed on our family farm and have several thousand dollars to spare. This is the amount I had to gather together in order to pay the 'widow tax', $80,100 for the IRS, $2,400 interest on same, $2,200 to the State and $3,700 for county inheritance tax.

Although pending legislation will be of no help to me, I'm requesting you take *immediate action* on pending legislation to increase the estate tax exemption to $200,000. Another important item you should consider is increasing the time on making the estate report to the IRS from 9 months to 18 months for all estates over $100,000. (It took my attorney 14 mo. to gather the necessary data, hence the interest mentioned above.) Some provision should be made to pay the estate tax in quarterly installments.

Your immediate attention and untiring efforts to promote this legislation will be very rewarding to volumes of taxpayers and voters."

Best of luck to you Mrs. Royal, while in Washington!

Sincerely,

MRS. MARY TARKASSEN.

YODER, COLO., *March 5, 1976.*

DEAR MRS. LLOYD ROYAL: Good luck on your trip to D.C. I hope this letter might help you in some small way. Use any part of it.

My dad passed away in 1974 with a sudden heart attack while visiting friends. Since there was a doctor's office just across the street it was no time before he had medical help but "he was dead before he reached the floor", so the doctor said.

My mother had paid almost $50,000 for State, Federal and lawyer fees since. Thank God she had money to pay it with. Many are not that fortunate. However, she has been in a wheel chair six years now and can only feed herself, and that is becoming a task. Due to arthritis everything else must be done for her, getting dressed, comb her hair, bath, taken to bathroom, moved from one chair to another, etc. Thank God for two loving daughters-in-law and two sons-in-law who take care of her. She spends a week with each of us four kids, each month. Since the government has seen fit to take so much tax from her what else could she do. Nursing homes are completely out of reach for elderly people on small incomes.

Three of us live on her land and a sister near us, owes her a large of sum of money for their land. All of us worked very hard before and during our teen years while home. My dad believed if you didn't work them young you would get nothing out of kids. We farmed 2000 acres and never shut two tractors off. One brother and I ran day time and a brother and Dad ran nights. We ran several hundred head of cattle and it was my job in the winter to bring them to the corral on horseback each night or sometimes herd them in fields. It can get cold on a horse.

It was nothing for my mother to have six to nine men to cook for, plus we six during harvest. Yet she always came out after dinner and worked until sun down. She would then hurry home to feed the pigs and chickens, milk the cow and do other chores and still have supper on the table when we all got in after dark. We had no electricity, refrigerators or even water in the house at this time so all meals were made from scratch.

Yet we had to have seven or eight people sign a statement that she helped make her half of the estate.

Anyone knows a farm and ranch wife has worked beside her husband in all kinds of weather. Just yesterday we received six inches of snow and I was out helping my husband feed cattle. We had to bring a new born calf and mother to the barn and this morning I have a half frozen one in my porch, hoping to save it. As cheap as they are I wonder why sometimes. How many urban wives would allow a calf to mess up her lovely home?

I ask you is it right for a woman who has worked so hard and now in a wheel chair and unable to care for herself to be taxed penniless.

Sincerely,

MRS. HARRY GEIST.

CALIF., *March 8, 1976.*

DEAR MRS. ROYAL: The enclosed information concerns our 200 acre ranch, consisting 125 acres of wine grapes and balance in pasture for cattle.

In 1937 my husband bought the ranch for $37,000.00.

I will give a relative rundown over the years. I have no record from 1938–1940, but I'm sure they were in the minus income column.

	Income	Expenses	Profit (+) or loss (−)
1941	$11,317	$11,715	−398
1942	18,510	20,204	−1,694
1943	69,515	37,233	+32,282
1944	64,253	38,940	+25,313
1945	38,502	41,910	−3,408
1946	67,185	50,333	+16,852
1947	10,994	33,113	−22,119
1948	16,639	23,588	−6,949
1949	12,022	17,748	−5,726
1950	25,035	23,036	+1,999
1951	23,953	23,711	+242
1952	16,390	23,099	−6,709
1953	17,532	18,985	−1,453
1954	22,764	19,234	+3,530
1955	29,689	23,363	+6,326
1956	43,273	25,968	+17,305
1957	29,264	25,181	+4,083
1958	37,834	27,654	+10,180
1959	40,566	27,538	+13,028
1960	43,305	30,675	+12,630
1961	41,139	28,051	+13,088
1962	57,113	32,227	+24,886
1963	49,329	35,122	+14,207
1964	52,950	36,300	+16,650
1965	58,081	39,601	+18,480
1966	56,715	35,183	+21,532
1967	63,986	40,046	+23,940
1968	68,835	42,951	+25,884
1969	82,570	43,226	+39,344
1970	73,982	53,337	+20,645
1971	92,595	61,283	+31,312
1972	137,509	59,998	+77,511
1973	192,120	74,520	+117,600
1974	145,461	86,980	+58,481

I must add, the above income balance is before Federal and State Income Taxes.

In 1974, we had enough money in the bank to cover one years expenses if we had a crop failure and for farm equipment replacement.

Then my husband passed away in March 1974.

In one years time this is what I was required to come up with or else.

1973 Income tax	$59,000
1974 Estate tax and relative expenses	60,000
1974 ranch expenses	86,000
1974 Income tax	18,500

My lawyer managed to get me the 4 percent, 10 year Estate Payment Plan but as of July 1974 the Government raised that to 9 percent. So they accomplished their end. I paid up.

I sold the herd of cattle Dec. 1974 when the price was very low. I sold a rental house, my husbands boat, motor, travel trailer and anything else not related to the farm. I did not have the protection of a crop failure and prayed the equipment would hold up as it is old.

I'm back on my feet but only because my husband and I throughout the years were hard working and never really squandered the money.

I guess what I'm trying to say is, if my husband had passed away in 1971, I probably would have had to sell the ranch as the appraised value was almost as high as the $357,660. that was set for the estate.

As an after-thought. Some Agriculture statistician would consider the above figures and say "There's a $17,000. yearly average before Fed. & State taxes, what's wrong with that?" Well plunge one foot in ice cold water & the other in very hot water, average that out and One's supposed to feel comfortable.

It's when that Estate Tax hits.

Sincerely

LOIS NIPKAU.

PORT GIBSON, MISS.,
March 25, 1976.

MS. CHERY TEVIS,
Associate Editor, Farm Wife News,
Milwaukee, Wis.

DEAR MS. TEVIS: I am so sorry to be so late answering your letter. I am making a copy of this for Mrs. Royal so she might understand that I have not accomplished very much.

An illness and death in the family has had me too much preoccupied to do what I would like.

I would like to elaborate on your questionnaire I had no idea of this very unfair inheritance tax law until I was faced with it. My husband died in June, 1974 at the age of 55. We married in 1946 and returned to his home after his 4 years in service—WWII. He and his 3 brothers re-entered the logging business their father had managed to maintain during the war years. As I stated on your

question form, nothing can help me; but if I can in any way help someone else that may be faced with it, I want to.

In 1949 we paid $60,000 for a 400 acre farm. This may not seem high to mid-America farm land, but it was premium here at that time. The IRS valued it at $85,000 on the Estate return.

Incorporation is no solution either. With War Bonds, and help from the Federal Land Bank, the 4 boys and their father purchased about 3,600 acres of land and incorporated. About half was cultivatable land, half-growing timber. The price was $75,000. The IRS valued it at $611,560 and my husband's share at $158,480. I realize that land values have risen everyplace; but the specific exemption under this horrendous law has not.

I have worked as a bookkeeper outside the home all these years, as well as on the farm. We had only one joint bank account and any income was put into this. It was used to pay off indebtedness and improvement of the farm. I received no credit for this, even though I had the W2 forms for proof.

After allowable (according to IRS) expenses and debts, IRS came up with a net taxable estate of $172,531 with an estate tax of $42,459. Plus interest from the original filing of estate tax by my attorney in 1974 to the final assessment by IRS in December, 1975. Except for my 3 wonderful brothers-in-law, I would have had to sell my farm—at a forced sale, of course—to pay the IRS.

I realize all of this detail is probably more than you wanted, but if it can be used in any way to point out the unfairness, please feel free to do so. It all boils down to our 25 years of hard work to pay the IRS more money than we ever had in our lives. This, while big corporations and family owned businesses set up "foundations" and never pay a dime in income or estate taxes.

I have talked personally with all 6 Mississippi Senators and Representatives I shall continue to get signatures on the 2 petitions Mrs. Royal sent me. Incidentally, I just happened to see Mrs. Royal on the Sunday night CBS 60 Minutes program.

Sincerely

______ ______.

St. George, Kans., *March 11, 1976.*

Mrs. Lloyd Royal,
Springfield, Nebr.

Dear Mrs. Royal: Enclosed a few more signatures. You may copy or use our experience in settling two small estates. Would rather this wasn't put in a large magazine like Farm Journal.

My father died Jan. 23, 1962. One pasture was appraised at $70 & 80 acres mostly crop land at $125 per acre.

My mother died Jan. 25, 1976, age 91, 14 years later, (I am the executor) and the same pasture was appraised March 1, 1976 at $300 and the 80 acres at $400. Since the appraisal March 1, two pieces of land have sold for what was a unheard price a year ago, so I'm sure the 80 acres tract will bring $450 to $500 per acre. This 80 is just across the road from a 80 I bought in 1940 for $20 per acre and my 80 is improved and is a lot better soil.

It is hard to explain to an elderly person that because of unjust laws they must give away their life savings at least down to $60,000. Especially when they are living in a rest home which along with the medicine is costing $600 per month.

The satisfaction of financial security, dignity and self respect is about all the elderly have left and shouldn't be taken away. No pill can take the place of that.

In my mother's case we didn't insist so now the FET will take much of her estate 28% on some of it.

Many people in their 60's find they must start making gifts or deeds to their children who are making more money than they ever did.

This can ruin the lives of their children and grandchildren. My wife and I did some estate planning; saw 3 lawyers, 1 certified public accountant and after 6 months decided what we thought was the best way. Now 16 months later due to inflated prices we are back where we started. A $200,000 exemption would stop a lot of worrying.

My wife was administrator of her sister's estate in 1975. She was widowed in 1944 and had accumulated all her estate but 13½ acres of land in Washington State 1½ miles out of Mt. Vernon.

The $60,000 exemption was used up in Kansas so the Federal estate tax was on 13½ acres in Washington appraised at $24,000. This was cut off timber land could be used for housing.

Here are the costs on 13½ acres, 10½ acres isn't sold yet.

Federal estate tax	$1,595.50
Washington Inh tax	1,230.00
Attorney fees (including as administrator)	1,305.00
Filing fees, bond and publications	120.20
Appraises fees	24.00
Pioneer Title Co.:	
Title insurance	90.00
Sales tax	4.50
Recording deed	3.10
State stamps	12.00
Excise stamp	115.09
	224.69
Part of taxes on 3 acres	18.66
Total expense now	4,518.05

4,518.05÷13½ acres =$336.00 per acre.

I had a cousin who was born in Kansas on a farm that we own now. She was the only child so inherited her parents life savings. She owned a plastic factory in LA Calif. and retired to San Juan Islands, Washington State.

We visited her twice in 1974, her health was perfect but her 2d husband had open heart surgery and cancer. Due to his health and most of the estate belonging to her, they had everything in her name.

In June 1975 she found out she had leukemia and only lived a few days.

Hope you can read this.

Sincerely,

P.S. We checked with several farm magazines in 1967 as to when our subscriptions was paid up to. Our Farm Journal was paid up to 2020, 53 years in advance. Guess that is what they call long time subscriber.

If the 60,000 exemption was in use in 1940 when I gave $20.00 per acre for the 80 I mentioned, it would have taken 3,000 acres before $60,000 was used. At $400, only 150 acres.

SARPY COUNTY BOARD OF COMMISSIONERS,
Papillion, Nebr., February 4, 1976.

The Sarpy County Board of Commissioners hereby goes on record in whole-hearted support of revision of existing estate tax laws.

We feel that existing estate tax laws, both State and Federal are destroying the family farm and the family owned small business. The present laws are antiquated because the exemption values are those which were set many decades ago, prior to the inflation which we have known in the past thirty years.

We realize that families can give away part of their property prior to death and that family trusts can be set up. These are tools of the wealthy. The small farm and small business cannot give away any portion of their property and continue to operate. They need the operating capital. We further do not feel that families should be forced to the legal subterfuge of a trust in order to preserve their method of making a living. Family farms and small business are an endangered species on the American scene.

We feel that the present estate tax exemption of $60,000.00 is not in line with todays inflation. This figure was established in 1942 when this was a sizeable amount as related to the value of the home, the business, the farm and to other family savings, with which average families hope to provide for themselves in later years. At that time the $60,000.00 exemption meant that only the wealthy were touched by estate taxes.

We further feel that present estate tax laws do not recognize the contribution that the wife has made in the acquisition of property held in joint ownership and joint tenancy. This should be recognized as inherent in the basic relationship of

husband and wife. Anyone who is familiar with the farm or small business knows that the wife's labor has in many instances meant the survival of the farm business, yet our Federal Tax laws do not recognize this. She still has to pay the "Widow's Tax" or prove monetary contribution. We feel that this downgrades the valuable contribution made by American womanhood and that it is morally wrong.

By Direction of The Sarpy County Board of Commissioners.

W. V. BROOKS, *Chairman.*

BROKEN BOW, NEBR., *March 3, 1976*

MRS. LLOYD ROYAL,
Springfield, Nebr.

DEAR MRS. ROYAL: I received your letter of March 1st, 1976, and am only too happy to let you use my lettter of October 30, 1975, and if you wish you can also use this letter as I am going into detail on two or three estates that my last employer, Attorney M. M. Runyan, administered while I was helping him close out his law business.

One estate consisting of real estate, cattle and machinery owned by a mother and divided among her children and grandchildren was valued at approximately $150,000.00. One son, an invalid in a wheelchair, inherited a portion of the real estate and a portion of the personal property and his proportionate share of the Federal Estate tax was approximately $9,000.00. Because of this man's illness, his son and wife are living on this farm with his father and mother, and continuing with the farming operations. When the mother passed away there was a mortgage on the farm, which, of course, is an obligation of the son. Not only that, they also had a mortgage on their cattle, and to meet the obligation of the Federal Estate tax they had to make an additional loan, putting them in a precarious position. As a mattter of fact, I question they can make it, if things keep on like they are.

In another estate the tax came to $64,000.00 and although they had real estate, they had no cash on hand, to speak of, so they had to mortgage the land, which was clear and today the mother is working by the day to keep herself going and the children are trying to farm and pay off this indebtedness, which was wished on them by this exorbitant taxation. I think I would be safe in saying that this land that they own did not cost what the Federal Estate tax came to.

In an article in the Omaha World Herald I read the administration stated "that increasing the exemption would cost the government $2 billion a year, but in another article I read "Israel would receive $2.2 billion." Why should foreign countries get all this consideration, and not the ones paying taxes and putting food on our table? This does not sound like "common sense."

Now that I have covered two estates as to Federal Estate tax in the office and results of the same, I am going to give the experience that my family and myself have gone through and still are. My mother passed away in August, 1974, and at the start of the probation of her estate it was valued at approximately $138,000.00. Later on, a farm that she had deeded to my sister, subject to a life estate, in 1964 was brought to the attention of the estate attorney, so he checked into the law and decided it was necessary to include the land in the estate. Prior to including the land, the IRS office figured the amount to be approximately $9,000.00 and when the land was included it raised it to $25,713.40. Not only that, the attorney was dilatory in compiling and filing the Federal Estate tax return, and the estate was fined $4,569.74. Knowing what steps to take, I called it to the attention of the Nebraska Bar Association, whereupon the attorney agreed to pay same.

In connection with this estate, I received $11,500.00 in government bonds and since November 14, 1975, I have been corresponding with the Treasury Department at Parkersburg, W. Va. with regard to interest due me and in the meantime they have been sending checks from time to time ranging in the sum of $30.00 up to $180.00 although the interest payments do not conform with the due dates on the bonds. At this time the government owes me interest in the sum of $300.00 and that is not including a bond this month.

It is too bad the farmer and rancher cannot strike like other people, and really let the other half of the world know how important they really are to our well being. I have seen the time, and still do, where the farmer or rancher and his son, or sons, would work together and upon the father's death the sons would carry on, but if this exorbitant taxation keeps on that will be an impossibility.

I only hope that we can get our representatives to see our way of living, and keep it that way, as that is what has made our country so wonderful to live in. I say this in all sincerity.

Sincerely,

MRS. C. W. BUCKNER.

P.S. Grand finale: If Patrick Henry thought his tax was bad, he should see it with representation.

LAKEPORT, CALIF.

FARM JOURNAL,
Philadelphia, Pa.

DEAR SIRS: I've read with great interest your article in the September 1975 by Laura Lane on "Widows Tax." We also recognize this problem of estate taxes as a most serious problem.

Our orchard land has been in the family for over 100 years, and now because of this unfair tax in an inflationary period the resources of the family (never more than provided a living for the family during the past 30 years) is now about to be confiscated by the government for taxes.

Please send us copies and covering letter of Doris Royal. We'd like to get some signers from our area to be sent our California Congressmen.

Yours truly,

BILL (WM. D.) JONES.

WEST CORNWALL, CONN., December 4, 1975.

MRS. LLOYD ROYAL,
Springfield, Nebr.

DEAR MRS. ROYAL: Enclosed are signed petitions that I have to date: My wife and I are in full accord with this movement, as we have experienced the bitter bite that the IRS imposes on an estate under the present laws.

My wife is a beneficiary under a will that caused her and her 5 sisters to mortgage the property heavily in order to pay estate taxes and the only persons getting money from this estate are attorneys and the Government with no chance if ever to see any benefits till 1984.

If the law had been changed to the present "Bills" under consideration they would have had something.

Our 6th district representative to U.S. is Toby Moffett. Our senators are Abraham Ribicoff and Lowell P. Weicker, Jr. These people, we will write letters, too.

Good luck.

ALFRED F. PALLOKAT,

STATEMENT OF MRS. JACQUELINE J. FURBER, WOLCOTT, N.Y.

I am Mrs. Jacqueline J. Furber. I represent Furber Farms and Women for the Survival of Agriculture in New York.

The economic situation of the late 1960s and early 1970s has pressured the little people of our country to get involved and speak out for long overdue reforms in many areas of government as a means of survival, rather than just equity or convenience.

There is concern on the farms of this country, over the estate tax situation, bordering on panic. Farmers, who a short time ago, perhaps had no more than a will, are rushing to their lawyers to try to figure out elaborate estate plans that might allow their farm families to continue farming the family acres. For some, it is not too late to plan effectively. With the low margin of profit in farming, the additional costs involved in estate planning measures to cover liabilities under current law are far beyond the economic reach of most family farmers. Further, there exists discrimination in our estate tax structure against farm families and other self-employed persons, who do not receive the same benefits under the Keogh and IRA Plans, as those who are covered under Corporate Retirement Plans. We are already over-taxed by every level of government and are now required, in effect, to pre-pay our own death taxes if our lifetime's efforts are to survive as a business and a source of income for our surviving families.

My husband and I just narrowly escaped extermination as "family farmers" when my father-in-law died in 1974 and left us his farm. We certainly became painfully aware of the obsolescence of the current estate tax as it applies to family farms.

Our farm's history is typical of most of today's full time "family farms". The original nucleus of Furber Farms was purchased in 1931 by my husband's father, when he was a young farm lad, just starting out during the depression. It was, for many years, a diversified sort of operation, a few cows, chickens, numerous field crops, orchard and so on. My husband was born and brought up on the farm, and as is traditional, at a very early age, became an important part of the farm labor force gradually learning and mastering the multitude of skills necessary to farming. His wages were the privilege of sliding his feet under the family table. Over the years, as some of the neighboring farmers died or moved on, our acreage increased, field by field, to the moderate size of approximately 550 acres. We have a tall stack of deeds and property searches to attest the piecemeal growth. By growing, farms could use technology and improved machinery with more efficiency. As with most of today's farms, the diversified operation gave way to specialization, in our case, fruit growing. Our farm has had its share of hail, freezes, droughts, infestations and other assorted catastrophes that all farm families risk on a year-in-year-out basis. The farm has been mortgaged and re-mortgaged for most of it's 40 odd year history, either to off-set bad crop years, poor price years, or as a means to expanad or make improvements. Some of the trees that were planted by my husband's father will still be bearing fruit when his grandchildren are grown and in charge of the farm. And so the business of producing food and fiber on family farms continues from generation to generation.

My father-in-law had done some estate planning by providing insurance and I know he would have bought more if he could have afforded the premiums. Unfortunately, the insurance benefit, though it was sizeable, was not enough. I really believe that no one, unless he has gone through the experience of a farm estate settlement, can have any realization of the tremendous amount of capital one must raise. Fees abound: Federal Estate Tax, state inheritance tax, funeral costs, administrative costs, income taxes, appraisals, attorney's feeds and on and on and on. The bill gets bigger and your spirits get lower. Remember too, that on a farm, you can't hang a wreath on the door and close up. So the problem becomes not only raising the capital necessary to settle the estate, but also to continue the business of producing food. We happened to be in the middle of apple harvest when my father-in-law died. Believe me, we had little time for grief. Ripe apples will not wait through the proper period of mourning.

The information one must dig up to fill out a Federal 706 form is mind bending and time consuming. It was actually months before we knew the total estate liability and then the question was, could we scrape together the money to cover it and keep the farm intact. There were many times during that anxious period when we hoped that nobody else died and left us anything. In the final analysis, it became clear that keeping the farm depended on finding a buyer and selling a portion of it, keeping in mind that we must retain enough property with which to make a living. Fruit farms are not exactly hot property lately, but fortunately we found a buyer. We were forced to sell 100 acres, buildings and some machinery. We did not get as much as we should have for the property because we did not have the option of time to sell at the best advantage. Our financial stability, because of this sale and the total impact of the estate settlement, is now strung so very tight, that it will be years before we recover, even under the best of conditions.

With this bitter experience still fresh in our minds, my husband and I are well aware of the problem we now face in assuring that our two sons will be able to continue the farm operation when we die. With property values still inflating, and no end in sight, even good estate planning has limitations and the nature of farming further limits the use of the measures now commonly instituted to evade estate taxes. Because farm estates are comprised of land, buildings and machinery, it is difficult to put definite parcels in the form of gifts, and giving such property limits our ability to raise operating capital through mortgages. Adequate insurance coverage would seem a reasonable solution. Frankly, we cannot afford the premiums. While farmers may be thought of, by urbanites and suburbanites, as "wealthy landowners", in truth, farmers usually exist under the "live-poor die-rich" rule. The income from our large investment is not all that great.

Now the question is—Is the "family farm" worth saving? I read recently in a government publication, this statement: "From the strengths of our social heritage, the lifestyles of the family farm are worth maintaining." Lifestyles worth maintaining, in deed! Who do you think feeds them? Phase out the family farm and you have delivered your future food supply into the hands of the same nice folks who have tied up pricing in most all our other American industries and made our agricultural products our last real international trade commodity. Loss of the "family farm" will have snuffed out the last competitive feature of our food supply system.

I believe that family farms should be included on the list of endangered national resources. As a farm wife and mother, who grew up in town, I can see that no urban child has much chance of becoming a farmer. Farmers are born—not cranked out of a university. Farm kids are subject to a lifelong internship, without which, they would never make the grade as farmers. Constant interaction with nature and farm activities, during his growing up years, teaches a farm child practical and common sense that no amount of formal education could ever accomplish or duplicate.

Once lost, a family farm cannot be easily brought back. If forced sales cause farms to be sold to developers, land that is covered with shopping plazas and pavement is not likely to ever again be used for food production. Also, it is a rarity today for a young person to have the capital to start a totally new farming operation. That is why most of the farms now operating are businesses that have passed from father to son.

Whether the government's intention in levying estate taxes is to collect revenue or distribute the wealth, in practice these taxes are destroying productive, competitive and necessary units of our society. If "family farms" are to survive, revisions of the Federal Estate Tax Law should incorpate the following concepts:

1. The outdated $60,000 exemption figure must be raised to fully compensate the effect of inflation. I am no economist, but I believe this would be no less than $200,000, to $210,000;
2. Farm land evaluation for estate tax purposes should be based on the agricultural use value rather than the potential use value;
3. There should be a more liberal marital deduction than the current 50 percent;
4. The farm wife's contribution of labor should be recognized;
5. Private retirement plans should receive the same estate tax consideration that Corporate plans now receive;
6. There is merit in the proposal that the estate tax payment period be lengthened to 20 years at 4 percent interest; and
7. To cover the event of both parents dying in a common accident, provisions should be made for an exemption or tax free transfer of property to minor children.

Thank you for the opportunity to present my views and the views of those I represent. I sincerely hope that realistic and meaningful estate tax reform will result from these hearings and that you will not delay in instituting them.

Statement of Mrs. Harald Branl, Manitowoc County, Wis.

I am Mrs. Harald Brandl (Doris). My husband and I own and operate a 220-acre dairy farm in Manitowoc County, Wisconsin. I am testifying in favor of the Burleson Bill HR 1793. There hasn't been a change in the tax structure for these people for many years. Not since the 1940's. The present personal deduction hasn't been changed since 1942 when it was raised to $60,000. The cost of land has risen as much as 500 percent since that time. In some instances more than that. The cost of keeping the farm up to proper production has also risen tremendously. Like 500 percent also, when we purchase farm machinery and supplies.

The most important part of this Bill to us, will be to enable my husband and I to keep our farm in our own family if it is the desire of one or more of our children to own and operate it. We do not, and what farmer does, have a savings account to adequately cover the price of an estate. By this I mean to have enough money to pay out their other children so one or two sons can own and operate the farm.

To use my own family as an example, we have eight children, ages 4 to 25. Our family farm is valued at about $250,000. Until the debts are paid and the children given a equal share I would have to sell our farm upon the death of my husband to settle the estate.

STATEMENT OF LAURA LANE, PHILADELPHIA, PA.

My name is Laura Lane. I live at 2018 Spruce St., Philadelphia, Pa. 19103. I own a 400-acre farm which I bought on the installment plan in 1940. That took some scrimping, because at the time I was making $150 a month. Two years later the specific Federal exemption applying to all estates was set at $60,000. That was in 1942. I made my final land payment in 1958. Since then the value of my property has multiplied 10-fold, but the exemption has not been increased by a dime.

If this day should happen to be my last, my heirs would have to sell about half of my property to pay Federal estate taxes. The principal reason for that unavoidable forced sale would be the out-dated exemption. Another reason is that the Tax Code discriminates against me and my heirs because I have chosen not to marry.

Settling my affairs to file the return and pay the tax within the space of nine months would be an added hardship.

In addition to being the owner of a farm, I am self-employed—a freelance writer. Among my clients, the principal one is Farm Journal, a national magazine with a circulation in excess of 1½ million. My title is contributing editor.

For a long time I have felt that Section 2040 of the Internal Revenue Code discriminates against women who are widowed while holding the farm in joint tenancy. In effect, you are telling a woman who has worked alongside her husband in the fields, with livestock in confinement or on the range, who has coped with ledger sheets and shared in sticky decisions, that her efforts to pay for the place are not a contribution with money value. Yet the efforts of her husband are viewed in a far more favorable light. The burden of proof of contribution rests unfairly on a woman because she is a woman, according to the usual interpretation of IRS and the courts. The entire value of the property is assumed to belong to the husband. In some states—South Dakota for one—a woman's efforts to document her contribution has been an exercise in futility. With a single provision in a new law, you can change this arbitrary inequity.

Few people outside of agriculture recognize what has happened rather suddenly to women on farms and ranches. Acreages per farm operator has increased rapidly. Farm workers have decreased. I could cite a bushel of statistics but you don't need them. The efficiency and productivity of the American farmer are the marvel and envy of the world. The hired man Robert Frost wrote about is as extinct as the passenger pigeon. Who took his place? Usually the farm wife with help from the children. But she came into the business power structure with a new role; she was forced into full partnership, and she has adapted in an amazing fashion. Her latent talents for management and for speaking out have emerged and blossomed. Farm wife partnership is an economic fact of life; the laws of some states, notably Iowa, have been changed to reflect this new necessity, this actuality. The Federal laws and regulations must also be altered.

Last summer I wrote an article about a woman who publicly has protested this injustice, Mrs. Doris Royal of Nebraska, who is here today with her husband and will present her own views. My story about her was entitled "Let's Get Rid of the Widow's Tax," and in it I explained to farm couples what their situation is with regard to estate taxes. Now that phrase, "the widow's tax," is in wide current use. I have seen it in the Congressional Record, the New York Times and in many country weeklies.

Because of this story, I had received by last Friday 4,800 pieces of mail. I suppose the best word to describe people's immediate reaction is outrage. You have received mail, too—I know, because I've seen copies. But the tone is more polite, more reasoned. People's fury was spilled to me. Since then I have written other articles to tell one readers how legally they can avoid estate taxes * * * pros and cons of incorporating the family farm; how to set up a legal husband/wife partnership with property held as tenants in common—all the devices attorneys can employ to solve their dilemma. Soon I will be writing about different kinds of trusts and private annuities. All of these stories are designed to keep the business within the farm family. Once these family businesses are bought up by corporations there will be no estate tax, for a corporation does not die. Presently the law is forcing a trend to the corporate form of business.

The saddest letters I get come from people who already have been forced to sell farms because of estate taxes. Mostly they come from widows who feel cheated * * * "Like an unpaid servant," in the words of a woman in Arkansas. Other widows say they have worked to pay for the farm twice. Both men and

women say they regard this tax as a form of confiscation. I recall one letter from a man in Capistrano Beach, Calif., who recently had settled his mother's estate. He said: "IRS is killing the goose that laid the golden egg. It's too late for me to save the farm that's been in my family for three generations. But I can do something about up-dating the law and regulations."

Recently the president of Chase Manhattan National Bank told an audience of agribusinessmen: "When the farm is recycled from one generation to another, every 25 years or so, succession taxes take a major bite out of its total value, with a reduction of the farmer's return on investment. As a result there is a disappearance of private capital that will require years to regenerate—if it can be done at all." end of quote.

In the 40 years that I have been a journalist, I have seen billions of tax dollars spent to make farming a self-perpetuating business. But it now seems that what Congress has given with one hand it is taking away with the other.

I urge you to bring estate and gift taxes into the here and now, the economic climate of 1976. Make these laws fair to women as well as to men, to the single and the married, to the farmer and the investor, to those with small family businesses, to all who won't let work and thrift become obsolescent as these laws are. My plea is: Make these laws reasonable. I thank you.

BERESFORD, S. DAK., *December 1, 1975.*

Re Federal Estate Tax Joint Tenancy Property (Records to prove contribution).

DIRECTOR OF INTERNAL REVENUE SERVICE,
Aberdeen, S. Dak.

DEAR SIR: My husband and I have been married since 1966. Since then we have made a down payment on our farm and have substantially increased our net worth. After discovering that I will have to prove my contribution to the farm if my husband precedes me in death, I would like to know just what kind of records I need to keep in order to substantiate my money contribution to the farming operation; and also how do I document my physical and management contribution?

Example 1. I was employed 4½ years as a teacher. The first 2½ years the money was directly absorbed into the farming operation. How do I document this actual money contribution?

Example 2. I am half the farrowing operation—giving shots, clip Inp teeth, docking tails, etc. Do I keep track of my actual hours like doing for hired help?

Example 3. I take care of all farm records and participate in all management decisions. How do I receive credit for this?

Example 4. I contribute countless hours of physical labor to all phases of the farming operation. Again, do I keep record of the actual hours?

I could continue, but it all boils down to the issue of a wife having to prove her contribution to an enterprise she is as much a part of as her husband.

Please answer this with the appropriate way for me to document my services in the coming years. Also, can I estimate hours worked in the past based on a farm daily reminder and other farm records?

Thank you.

Sincerely,

MRS. SHARON L. JENSEN.

INTERNAL REVENUE SERVICE,
DEPARTMENT OF THE TREASURY,
Aberdeen, S. Dak., December 15, 1975.

MRS. SHARON L. JENSEN,
Beresford, S. Dak.

DEAR MRS. JENSEN: This is in response to your letter of December 1, 1975 concerning the records you should maintain to substantiate your contribution to a farming operation for estate tax purposes.

Regarding your first question, the Internal Revenue Service has always recognized a contribution made to a family operation by a surviving wife from earnings unrelated to a farming operation. Copies of your Federal income tax returns and Forms W-2, applicable to each year, will service as adequate documentation for contribution purposes.

Your other three questions relate to how you can document the services you perform in the day-to-day operations of the farm for the purpose of determining your contribution for Federal estate tax purposes.

The value placed on such services which could be used in determining your contribution to the farm operation if your husband precedes you in death would be subject to the laws of the State in which the property is located. This generally accepted principle of law is discussed in Revenue Ruling 72-443, Cumulative Bulletin 1972-2, Page 531. A copy of the ruling is enclosed for your consideration.

Under the existing laws of South Dakota, the services rendered by a farm wife, freely volunteered, are considered as gratuitously given by reason of the marital contract. You could not, therefore, assign a value on your services in computing your contribution for Federal estate tax purposes.

To establish an acceptable contributive value, there must be a legal relationship between the husband and wife other than the marriage license. This could take the form of a written partnership agreement. For additional advice or assistance, you should seek the services of one who is knowledgeable in the field of estate tax planning.

Your comments have highlighted an area of concern which may be of interest to other taxpayers. We plan, therefore, on issuing a news release in the near future to discuss the points covered in your letter.

Hopefully, our response to your questions has been adequate for your purposes. Please feel free to contact us if you should require any additional information.

Sincerely,

JOHN B. LANGER, *District Director.*

Attachment.

WILLIAM G. COX,
Capistrano Beach, Calif., September 21, 1975.

Mr. RICHARD BRAUN,
Managing Editor, Farm Journal,
Philadelphia, Pa.

DEAR MR. BRAUN: You're going to be losing a long time subscriber * * * and not because I don't like your magazine. It's because I've lost the farm land.

I know you have an interest in the problem I'm about to describe because I've read several articles on the subject in Farm Journal (example: Let's Get Rid Of The Widow's Tax by Laura Lane, September 1975).

I've enclosed a copy of a letter that I wrote to the IRS several weeks ago relative to the estate, inheritance, and death taxes that combined with inflation will soon wipe out the small, father-to-son one family farm. That is the type of farm that has always been called "The Backbone of America."

Several months ago my mother passed away and we started the simple process of changing the title from her name to mine. It is no longer simple * * * in fact, it is impossible. I had to sell. For me and my family, it was a financial catastrophe. We have just lost the finest and safest investment in the world. It is the only investment that I really know and understand. Most important, at my age (57), our land has a built-in hedge against inflation. If and when there is any money left from the sale after two or more years of waiting at 10 to 20 percent inflation each year on top of about 50 percent estate taxes, where and how can the remaining 25 percent be invested to assure me and my family a comfortable income, so we will not have to demand upon government assistance?

I have devoted years of time and a great deal of energy to the preservation of my family estate. We had a saying in our family, that if we took good care of the land . . . it would take good care of us during our declining years. It worked too for my grandparents, and my parents, and they were never burdens on society. There was one thing for sure though . . . they kept the land. It's too late for me to save the land. It's gone, but we can do something about updating the laws, rules and regulations, so there is a much larger exemption before taxes. The $60,000.00 exemption should be increased to about $200,000.00 to preserve small (like 320A) family farms. That's all the larger our farm was and I couldn't even save it. If I borrowed the tax money at 9% (Land Bank), I would have been in debt the rest of my life. The farm was not large enough to sell part and save the rest. Paying the taxes, would have been like buying the farm all over again from the Internal Revenue Service, and they didn't have the deed. They had a right. That's wrong.

LET'S GET CRACKIN' ON THIS

The backbone of America is being broken at a time when everyone is talking about "Saving the small farm and farmer."

The IRS is killing the goose that lays the golden egg. The big corporations that are buying up the small farms will never pay another death tax on the land, because a corporation never dies. Forming trusts and corporations within families seems to be the only way to go now, so get set, everybody, and hire yourself a string of corporate attorneys. Wouldn't it be better for the IRS to take less and leave a little for us?

Sincerely,

WILLIAM G. COX.

I am very anxious to do all I can to correct this situation. I have sent letters to my Congressman and Senator. If quoting or re-printing portions of this letter will help, I'm willing.

READERS FIGHTING MAD AT UNFAIR ESTATE TAXES

Shock, anger and determination to do something now about unfair estate tax laws and regulations came through loud and clear in letters we've received in response to the "widow's tax" story in October issue. Fortunately, there's still time for more to get on the bandwagon for estate tax reform.

Response to our September story, "Let's Get Rid of the Widow's Tax," showed 100% support for Doris Royal and her Nebraska campaign. Not a note of dissent in the first 1,000 letters! Reactions:

It was a bombshell to many that if husband and wife hold property in joint tenancy and the husband dies first, IRS assumes the entire value of the property belongs to the husband . . . no matter how hard the wife has worked on the farm to help pay for it. "We are recovering from shock and amazement as to the facts," writes a Michigan woman.

The discrimination is no surprise to women who have lost their husbands: "As a farm widow who found out a wife is just an unpaid servant, I am interested in changing our laws. It is too late for me, but maybe I can help others."—Arkansas.

Letters from men (almost half) often mentioned inflation in land values since the individual exemption was set at $60,000 in 1942. At that time a Congressman's salary was $10,000; it is now 4½ times that—$45,612, a landowner in Washington says, "By that logic, why shouldn't the exemption be multiplied by 4½ and rise to $270,000?"

HOW DO YOU LOBBY, ONCE YOUR DANDER IS UP?

1. Work to get a favorable bill out of committee and on the floor of the House and of the Senate, otherwise we get nowhere," says Doris Royal. This means writing your views to Al Ullman, Chairman, House Ways and Means Committee, Washington, D.C. 20515. Also to Russell B. Long, Chairman, Senate Finance Committee, Washington, D.C. 20510.

2. Use petitions with people who won't bother to write letters. A hardware merchant in western Nebraska paid for newspaper and radio ads to let people know they can sign petitions in his store. Feed dealers, bankers, tax consultants are displaying the petitions for people to read and sign. A Texas woman got our permission to reprint Farm Journal's article and the petitions in her local paper.

If you want copies of Doris Royal's two petitions, send a big stamped, self-addressed envelope to Estate Plan Changes, Farm Journal, 230 W. Washington Square, Philadelphia, Pa. 19105.

UNITE CONGRESS TO HELP END THE WIDOW'S TAX

Farm wives who work alongside their husbands now can press for specific legislation which would end IRS discrimination against them if they were widowed while holding the farm in joint tenancy.

Congressman Charles Thone (R., Neb.) has introduced House Resolution 7521 which would change the Internal Revenue Code of 1954 by providing that "a spouse's services shall be taken into account" in determining if she contributed.

What Congressman Thone calls "sweat equity" would qualify her for exclusion from the Federal estate tax. Wives likely would have to keep work diaries. IRS now assumes in such cases that the entire value of the property belongs to the husband.

An identical bill, H.R. 11657, was introduced Feb. 3 by Congressman Mark Andrews (R., N.D.). Both make it clear that work by a spouse "shall be treated as consideration in money or money's worth." IRS and the courts maintain that wives of farmers and owners of small businesses have worked "for love and affection" only, not for the business.

"Farm Journal" believes it's no accident that this legislation was first drafted by a Congressman from Nebraska where a farm wife, Mrs. Lloyd (Doris) Royal, is rallying support for modernizing estate tax law.

WHAT'S THE NEXT STEP?

"Readers must now put pressure on the House Ways and Means Committee to include the sense and intent of H.R. 7521 in any estate tax bill it reports out of Committee." Doris Royal said in a telephone interview. "Otherwise we'll have to start all over."

The Committee now has 149 separate bills on estate taxes to consider, so it would be easy for relief of widows to get lost. Address your letters to the House Ways and Means chairman, The Honorable Al Ullman (D., Ore.), 1102 Longworth Office Bldg., House of Representatives, Washington, D.C. 20515.

Will Congress act soon? If it is pressured. House Ways and Means hearings are scheduled March 15-19. Doris Royal hopes to testify and present petitions collected by Farm Journal readers.

LAURA LANE.

LET'S GET RID OF THE WIDOW'S TAX

By Laura Lane, Contributing Editor

"A farm wife doesn't know how the government discriminates against her until she is widowed or divorced. My husband and I worked hard these past 23 years to make land payments. One year ago he died at 45. Now I'm having to pay for the farm again—this time to IRS."—Nebraska

Informed couples are eager for a change in estate tax laws, our mail shows. But is Congress? The House Ways and Means Committee has on its calendar at least 15 bills aimed at reform of tax structure, yet that doesn't guarantee action. To get the job done we need more people like Mr. Lloyd Royal of Sarpy County, Neb.

"One day I learned that if something happened to my husband, I'd probably have to mortgage the farm to pay the estate taxes," she told me. That was five years ago. Doris Royal waited for "someone to get up in arms about the injustices." Nobody did. Meanwhile, land values have climbed, making her more vulnerable and endangering the inheritance of the Royal's son and daughter.

Doris has never thought of herself as a leader or political crusader, but she has a high Indigation Quotient. So she began what later became a campaign by enlisting the help of Mrs. Jerry (Annie) Knapp, Mrs. Robert (Sylvia) Wulf, and Mrs. Bill (Evelyn) Clark. Among them they can do just about everything that needs doing on a Nebraska farm . . . spread manure, keep books, operate machinery, type letters. They have become a good team for arousing public sentiment and applying pressure. What they lobby for:

Let's get rid of the Widow's Tax! "That discrimination is enough to turn a farm wife into a libber," acknowledges Phillip A. Henderson, Nebraska Extension economist who fuels the reform movement with information. The situation:

If husband and wife hold property in joint tenancy and the husband dies first, the entire value of the property is assumed to belong to the husband and is subject to estate taxes—unless the wife can prove that she inherited part or held an off-farm job to meet payments or otherwise made a legally recognized contribution of money or "money's worth." Proof means cancelled checks, mortgage releases, etc. Didn't the wife contribute by driving the tractor, sorting cattle, doing bookwork? Not in the eyes of IRS.

"The wife renders all these services as a part of her marriage contract," an IRS attorney explained, when I asked him about this interpretation, I pressed him for an example of when a wife does contribute. "The classic case is a Mom and Pop grocery store where the wife draws a salary and pays Social Security tax."

Earlier Doris Royal had showed me sheaves of letters from widows burdened with this tax. . . . "If there is such a thing as 'his' and 'her' money, it is 'my' school teaching pay that we used to buy this farm in the first place, but I'm having trouble proving it." Another reason for your keeping good records!

Everywhere I travel—not just in Nebraska—I find farm wives hurt, dismayed and angered at the IRS interpretation. . . ."We are contributing greatly to the acquisition of land and machinery with our labor," a woman wrote the Nebraska Commission on the Status of Women. "We, along with our husbands, increased our net worth over the years—the difference being that later we women are told we didn't earn half and when it is 'given' (willed) to us we have to pay tax on it." Convictions like this have led to changes in laws of a few states—Iowa, for instance. Wisconsin Women for Agriculture recently have sought legislative changes, too. In June their Senate voted to alter inheritance laws so the farm wife would not have to "prove her contribution."

"I know we can hire a lawyer to change our legal setup," Doris Royal says, "but I want what I've worked for and am entitled to. We women who have taken the place of hired men deserve fair treatment under the law." So this winter she spent over 40 hours a week working for justice she feels she is denied.

A second disadvantage of holding the farm in joint tenancy: "Upon the wife's subsequent death the same property will be taxed again to the heirs—usually the children—the rate depending on how long she outlives her husband. It's even higher if she survives him by 10 years. Also a widow or widower has no marital deduction. So it's not uncommon for two deaths to take as much as 25 percent to 50 percent of a farm estate," Dr. Henderson told me.

How common is it for farm couples to hold property in joint tenancy? One Nebraska attorney said 50 percent do; the IRS lawyer said 9 of 10 farm estate tax cases he handles. Why? This way of holding property originally meant a saving in probate expense—costs now usually much lower than estate taxes. Also, it's a great convenience to hold a car or bank account in joint tenancy when one partner dies.

A widow often has other problems. Dixon G. Adams, Nebraska attorney who is donating time to the reform movement, gave me this instance: "Some banks are reluctant to lend money to a widow—she hasn't proved she can manage. Just now I'm helping a woman mortgage a farm to pay off estate taxes."

IRS' interpretation of "contribution" isn't limited to farm wives—it applies to other businesses and professions where the wife is receptionist, bookkeeper, secretary and general flunky. For this reason, Doris Royal seeks and gets the support of diverse groups such as Chambers of Commerce, senior citizens' clubs, Shriners, altar societies, the Nebraska Commission on the Status of Women, dentists' wives, livestock feeders associations and Farm Bureaus.

The personal exemption needs a big boost because of inflation since 1942. IRS was ready to propose legislation raising the specific exemption for every estate from $60,000 to $100,000 or maybe $120,000 when Watergate and the enemies' list caused them to seek a low profile, an insider told me.

The increase from $60,000 is a reform everybody can support, believes William V. Brooks, Sarpy County commissioner and oil dealer. He is campaigning for new estate tax legislation through trade journals, business organizations, petitions, and one-to-one politicking. "Many small businesses like mine don't have liquidity to pay a big tax—we need to put everything back just like farmers do," he told me. "And of course the value of our property, too, has increased dramatically in 33 years."

It's time to change the way land is valued for estate tax purposes. As of now, estate taxes often are inflated because the farm or ranch is appraised at its anticipated market price—its "development" value—not on its ability to produce crops or livestock. This inflationary factor often means "when death comes along, land and equipment hit the auction block," writes George R. Baker, Spokane County, Wash.

We need more time to "settle" and estate and file estate tax returns. "The nine months allowed after a person's death aren't sufficient—especially if there has to be a distress sale of land or property," says Doris Royal, Attorney Adams agrees.

Farm people can get the needed legislation if they rally the support of other citizens who care enough to use political muscle. Nebraskans are supporting H.R. 1793 introduced in the House by Rep. Omar Burleson (D., Tex.) and its identical twin, S. 1173, introduced in the senate by Senator Carl T. Curtis (R. Neb.,). This bill has 60 sponsors, and has been endorsed by all the Nebraska delegation.

"It doesn't include everything we might like, but it comes close," Doris Royal says. What it provides:

An increase in the exemption allowed every estate from $60,000 to $200,000.

An increase in the marital deduction by a flat sum of $100,000 beyond the present one half. (Notice this means less financial burden on a wife but does not alter the "discriminatory disregard for her contribution" where property is held jointly.)

A method for valuing real property—farms, woodland—on the basis of current use rather than on any potential use at higher value.

Your Congressman can get you a copy of this bill or some of the others which would change estate tax laws, including House Resolutions 2048, 3871, 3903, 3915, 2417, 3879, 1349 and Senate Bill 277.

Your state inheritance tax laws probably need updating, too. The Nebraska group supports Legislative Bill 585 which specifically provides that if husband and wife hold property in joint tenancy, "it shall be assumed that each spouse contributed equally to the acquisition of the property, unless the surviving spouse shall prove that his or her contribution was greater than one half the cost of such property."

How to lobby for your ideas about changes:

1. Write your Representative and Senators, sending copies to Al Ullman (D., Oreg.), Chairman of the House Ways and Means Committee, Washington, D.C. 20515 and Russell B. Long (D., La.), Chairman of the Senate Finance Committee, Washington, D.C. 20510. Even if you get brush-offs, keep plugging.

"Thoughtful, convincing letters probably do the most good, but we know a lot of people won't go to that trouble, so we use petitions, too," Doris Royal says. Recently copies of petitions in behalf of H.R. 1793 with 3,365 signatures were delivered to key people in Congress—signatures Doris and her co-workers had collected. I saw people interrupt her lunch in a restaurant, eager for a chance to sign!

2. Bone up—then speak out on proposed legislation. That means speaking at legislative hearings, state conventions or to small informal groups, being interviewed by the press and TV. It's especially helpful to have a lawyer on your team. "I don't know where we'd be without the counsel of Dixon Adams," Doris says. Also you need people who type or mimeograph, stuff envelopes, do research, work on posters and other visual aids.

3. Accept every offer of help. "You can't expect to agree on every issue under the sun, but you can capitalize on your mutual dissatisfaction with present estate tax laws."

After an interview appeared in the Omaha World-Herald, Doris had such a voluminous correspondence she had to resort to duplicated form letters. She can't spare a lot more time from the livestock or the tractor, so if you want copies of her petition in support of H.R. 1793 and her covering letter, don't write her—write us. Send a stamped, self-addressed envelope (big) to Estate Plan Changes, Farm Journal, 230 W. Washington Sq., Philadelphia, Pa. 19105.

Here's how proposed changes in estate laws could affect tax arithmetic. Assume wife inherits 100% of estate as a surviving joint tenant. She is unsalaried and has not inherited any of the land:

	As law now stands	As proposed under H.R. 1793
Value of estate	$350,000	$350,000
Less marital deduction	175,000	275,000
Total	175,000	75,000
Less exemption	60,000	200,000
Taxable estate	115,000	0
Estate tax	25,200	0

Statement of Mrs. Jerome Sickinger, Cato, Wis.

My name is Mrs. Jerome Sickinger (Audrey) and I reside at R. 1, Cato, Wisconsin with my husband and family. My family consists of seven children, 5 girls and 2 boys.

We farm 1,800 acres in Manitowoc County growing corn, oats, alfalfa and some vegetable crops. Our Holstein dairy herd consists of 500 head with 275 of these being milk cows.

I am a member of the Outstanding Young Farmer Fraternity which has over 800 members in every state in the United States. We appreciate this opportunity to offer testimony and to be heard on our views of support for the bill H.R. 1793. The estate of these farmers run in excess of a million dollars.

The law passed in 1942 setting the general exemption of an estate at $60,000 is we feel in need of change. The bill H.R. 1793 suggests a $200,000.00 exemption which would be more realistic.

H.R. 1793 states that the marital deduction of ½ the estate be increased over and above this exemption by another $100,000.00. This too would be a realistic figure.

We also would agree with the election methods stated in H.R. 1793 of appraising real estate property according to the use of this land. If the land is sold for another purpose within the five year period, we agree taxes should be paid on the value for which it was sold for.

We further feel that the time allowed (9 months) is not long enough to settle an estate in operations of this size and be able to continue efficient operation of the farm. We therefore suggest an 18-month period in which to pay taxes which are due.

I have been married 23 years to a farmer, starting my day at 4:30 each morning. Heading to the barn to milk and feed the cows and care for the baby calves before breakfast at 7 a.m. Our children must accompany us in order to get the work done and then hurry to be ready for school. Our cattle are housed in 5 different sets of farm buildings. The remainder of our day is spent traveling to each farm to feed and care for our animals. We have worked diligently and daily to increase our farm operation. Today, besides our family we do have hired hands. We like our work and feel we are doing a good job.

Our boys 15 and 14 would like to continue farming after school. At this time should their father die it would create many hardships and the possibility of farming could be negative. Much of the estate would have to be sold to settle the estate taxes.

The possibility of our daughters farming is quite probable, as their interest and knowledge of agriculture is there and instinctive. Sandy, 19, attends the U.W. Manitowoc Center as a sophomore in the Ag & Life Science College majoring in bacteriology. Debby, 17, graduates in June from high school. She plans to enter the Ag Life Science College of the University of Wisconsin majoring in dairy science with a strong interest and desire to be a Veterinarian.

I am a farm owner and operator in Manitowoc County in addition to being a farm wife. To continue the farm operation after my husband's death would not be an unreal situation. Therefore, I support the changes in the Burleson Bill H.R. 1793 on the point that the old law of 1942 discriminates against my ability to efficiently manage a farm operation because I am a woman.

The average Wisconsin farm of 185 acres with 41 cows, and machinery is said to be worth $185,000.00 according to the latest figures of our Wisconsin Department of Agriculture. This is figuring land at a value of $451.00 an acre. Just last week two farms in our area sold for over $800.00 an acre. This rate of inflation plus insurance policies of the average farmer in Wisconsin would put his estate far past the general proposed exemption of $200,000.00.

As a member of American-Agri Women and Vice President of Wisconsin Women for Agriculture I feel a need to support changes in our country's estate exemption laws. I thank you for the opportunity to appear here before you today and ask that you consider some new provisions for our outdated estate tax law.

STATEMENT OF MRS. MARCELLUS VOGEL, MANITOWOC COUNTY, WIS.

My name is Mrs. Marcellus Vogel (Jo Ann). We farm 275 acres in Manitowoc County, Wisconsin. We have 150 head of cattle of which 70 are milk cows. We have 4 children ages 16, 15, 14, and 9.

I am testifying here today representing American Agri-Women a National Organization of 2,000 members concerned about the future of Agriculture. We as women are unjustly discriminated against by a law written in 1942. At that time the Consumer Price Index was 48.8 and in December of 1974 it was 155.4. Which

means the purchasing power of the dollar has been reduced by 68¢. Agricultural land in our area sold for $100.00 an acre, that same land today would sell for $800.00 to $1,000.00 an acre for agriculture.

Something must be done about this law it is archaic and derives from old English law. That looked upon a woman as a servant being owned by her husband. Once a woman signed a marriage certificate she became the property of her husband. In many respects women are still treated by law in this manner. I am not a woman "Libber." Farm women have always been liberated, we've always had the opportunity to do any work along side our husbands we would or could do. Whether we were bearing our children or not. All farm women help their husbands whether it's driving trucks, hauling grain, apples, peaches, etc. or doing the bookwork and many other errands on a farm too numerous to mention.

To give you an idea of why I feel so strongly about changing this law. I would like to tell you about my life since I've been married. Seventeen and ½ years ago my husband and I were married. I have helped my husband every single day all day and many times far into the night. The only exceptions have been 4 or 5 days to have each of our 4 children and 7 other days for business. We have never had a vacation and we work 7 days a week. My day begins at 5:30. I make breakfast for our children and pack lunches, call them for school and then go to the barn. Feed and milk the cows, feed calves and heifers. Go to the house at 9:30 make breakfast, clean the house and start supper. By 11:30 I must go back to the barn to do other chores and if everything goes all right with no breakdowns I will be in the house by 3:30 to finish supper. Supper at 4:30—do dishes and back to the barn at 5:30 until 8:30. Our children help us in the barn every night, every weekend and all summer. During harvesting and planting seasons all chores must be done plus all the field work. I will then help in the field—I must know how to drive every tractor and use every piece of machinery. Besides this I do all the book work and banking for our business. My sister-in-law laughingly ask, "How can you stand each other all day every day?" it ain't easy. Yes. I am indeed a partner in everyway possible—I know and feel all the grief, anxiety and disappointments of being stewards of the land and providing food for the world.

In the eyes of the law we women that work alongside our husbands are considered not contributing to an estate. The only way a contribution is recognized, if we had worked outside the home and could prove it. I am allowed $60,000 plus ½ the Gross Estate—Why? When I've worked all my married life forsaking other employment to help my husband, if I did not we could not farm as efficiently as we do—therefore we would not pay as much in federal and state income taxes. It seems peculiar to me that I must pay estate taxes upon the death of my husband when we've paid for the farm by my labor as well as his besides paying interest, income taxes, state and federal, and property taxes every year. As I see it there is only one advantage to this law—The wife should die first—the husband could collect her Life Insurance, if she had any, and bury her in the manure pile, if he had one and that would be the end of that. If my husband died tomorrow and left a taxable estate of $300,000.00. The taxes would amount to $36,700. Federal, state and other expenses would be another addition of $20,000.00. Beside this daily expenses must be met. Like most farmers we do not have a savings account, everything we make goes into our business. Therefore I would have to dispose of some property. I would have no choice. Estate taxes must be paid in 9 months. We of American Agri-Women believe that it should be extended to 18 months because many crops cannot be harvested and sold in 9 months. We also believe that the exemption should be raised to $250,000. My personal feelings are that there should be no estate taxes between spouses.

The Burleson Bill HR 1793 has many good points. In particular the Elections of Classifying land and raising the marital deduction by 100,000. We think it's an excellent idea. Land used as agricultural land is only worth as much as it produces, it can not be or should not be assessed as land that could be developed. We think it's very important to keep all agricultural land intact and this is one way of helping.

A sincere thank you for your kind attention and for the opportunity to appear here today in behalf of American Agri-Women.

Senator BYRD. The next witness is William C. McCamant, executive vice president, National Association of Wholesaler-Distributors.

We have a substitute, Mr. Lee Gosnell, director of government relations. He will testify.

STATEMENT OF W. LEE GOSNELL, DIRECTOR OF GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. GOSNELL. Thank you, Mr. Chairman. It is going to be a tough act to follow those ladies.

I am Lee Gosnell, director of government relations. I am appearing here today for Mr. William C. McCamant, who is our executive vice president, and who due to last-minute complications coulld not appear.

I would like to express our very sincere appreciation for the opportunity to appear before this distinguished committee, and I commend the members for their recognition of the need for hearings in the area of the estate taxation.

Additionally, we would like to thank members of this committee who also serve on the Select Committee on Small Business, and the members of the Financial Markets Subcommittee, who have for some long period of time dug deep into the taxation problems of smaller businesses.

I will summarize my statement and ask that the full text be placed in the record.

Senator BYRD. Yes; your full text will be placed in the record, and you can summarize your remarks.

Mr. GOSNELL. We are an association which is composed of over 32,000 merchant wholesaler-distributors throughout the United States.

Now, although our industry consists primarily of smaller businesses, we are still one of the Nation's major industries. Sales by merchant wholesaler-distributors are forecast by the Department of Commerce to reach $498 billion in 1976. The association estimates that NAW affiliates account for approximately 60 percent of the total industry sales and 60 percent of over 4 million individuals employed within the wholesale trade.

Our members, consisting preponderantly of smaller, closely held family businesses, have a vital interest in the impact of taxes on smaller business enterprises. We are particularly concerned with the matter of estate taxation, which poses a very serious problem for many wholesale distributing firms.

The President's proposal and other bills have been introduced by members of this panel, Senator Curtis, Senator Nelson, Senator Mondale, and others, which take note of this situation.

The estate tax will have a great effect on whether the closely held business can be perpetuated beyond the life of the present principal owner. We must keep in mind that closely held firms, whether they be farms, manufacturing firms, or distributing firms, all pay a significant role in the productivity and growth of our national economy.

We are here today to urge the Congress to take action to correct the situation that threatens the very existence of a viable smaller business entity in our Nation—the present system of estate taxation. We wish today to present our recommendations for reform in this area which we believe will assist in the continuation of smaller enterprises in the wholesale distribution industry and in the economy as a whole; but before getting into the meat of our recommendations, I would like to briefly explain two of the exhibits attached to our statement.

Both exhibits A and B pertain to a subject which you covered in depth last week; that is, capital formation. We would like to echo the sentiments espoused by many of your witnesses, and many of you gentlemen on the panel, and that is the urgency of the capital formation problem. It cannot be overly emphasized, and failure to solve the problem will have profound implications for the national economy and not just for our industry.

We recognize that Congress needs hardheaded factual information in order to evaluate tax proposals to reach decisions about appropriate changes in the tax law.

Last year Dr. Norman Ture, a recognized expert on capital formation, whom some of you may know, prepared a detailed examination of the capital formation process within our industry and the role played by tax policy in this process. The primary objective of that study was to examine the capital inadequacy, both present and future, in our industry and the type of tax reform which would correct this most effectively.

Exhibit A [1] contains that study. That study determines that an increase of the corporate surtax exemption figure to $100,000—one of our industry's major tax goals—would increase full-time employment by 720,000, and increase total wages and salaries by about $10 billion in 1977.

Exhibit B [1] is also a document by Dr. Ture, which was presented to the Senate Committee on Small Business. It deals with the capital formation adequacy for the overall U.S. economy.

As you are all aware and as we have heard this morning, the first $60,000 of net personal worth of a deceased is exempt from estate tax. The exemption level was established in 1942, and no change has been made in this level, despite the change in the purchasing power of the dollar.

Members of this committee recognized a similar inflation problem last year when you took action to increase the corporate surtax exemption to assist in capital formation. The fact that Congress has made no change in the estate tax laws does not mean that no change has occurred.

Indeed, a very significant change has occurred for the businesses. The effect of inflation on estates has been dramatic, and has resulted in huge tax liabilities which businesses must pay when faced with the death of a principal owner.

The figures indicate that the GNP implicit price deflator has increased 250 percent since 1942. Thus, the value of the $60,000 exemption Congress approved in 1942 would now equal approximately $17,100. Conversely, the purchasing power of $60,000 in 1942 would now equal approximately $210,000.

It should be noted that the current tax on the estate of $210,000 is $35,700. Yet no Federal estate tax would have been due on the same amount of purchasing power in 1942.

We recommend that the Congress remedy this situation by increasing the estate tax exemption figures to $200,000.

Another aspect of estate tax that bears examination is the rate structure. Inflation has, again, distorted the intent of Congress in

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[1] Printed hearings entitled "Small Business Tax Reform," pt. 2, Sept. 23, 24, and 25, and Nov. 13, 1975.

this regard. Table 6, within our statement, which is on page 20, demonstrates the tax rate between 1942 dollar values to 1975 third-quarter dollar values. We suggest that in the interest of return parity to the estate tax structure that the tax brackets be adjusted to reflect present dollar values.

Congress has recognized the tremendous problems encountered by closely held business with regard to payment of estate taxes, and has included within the Internal Revenue Code provisions which allow for an extension of time for payment. However, in practice such provisions are of very little assistance, mainly because of stringent criteria set down in the code.

We firmly believe that the effectiveness of these sections of the code would be greatly enhanced by the adoption of the following recommendations:

1. Increase the time allowed for filing and payment of estate taxes from the present 9 months to at least 1 year.

2. Permit installment payment in any case of hardship by striking the word "undue" from the present hardship section of the code, section 6161.

3. Ease requirements of section 6166 that pertain to the closely held business by increasing the allowable number of shareholders from the present 10 to 15, and reducing percentage requirements for the decedent's interest in the closely-held business from 35 percent of gross estate or 50 percent of taxable estate to 20 percent of gross estate or 35 percent of taxable estate.

We would also ask that there be a 5-year moratorium on estate taxes eligible for installment payment provisions.

One other point: A number of proposals pending before Congress contain provisions imposing a capital gains tax on assets transferred at death. To a typical wholesale-distribution firm a tax of this nature——

Senator BYRD. Your time has expired. Could you wind it up quickly?

Mr. GOSNELL. Yes. This type of tax coupled with estate taxes would most probably preclude the continuation of the business. There is a table on page 9 which shows an actual case study of what happens.

We would like to urge the Congress not to apply the capital gains taxes to an imaginary gain. It is not a realistic basis for taxation.

Mr. Chairman, we are certain you and the members of the committee realize the gravity of these problems, and you share our concern over the continuation of a viable small business sector in our economy. We urge your consideration, therefore, of our considerations. Thank you.

Senator BYRD. Thank you, Mr. Gosnell. Senator Roth?

Senator ROTH. I have only one question, Mr. Chairman.

I am sure you are familiar with the concept of indexing tax rates. Do you think it would be desirable to index the estate tax rates so that they would automatically reflect the increase in cost of living? If so, would you know if that has ever been done?

I know that a number of countries have adopted indexes in other areas, but I am not sure it has been done in the case of the estate tax.

Mr. GOSNELL. I think Great Britain tried to approach this, and I gather there was some long discussion, and I don't believe it worked

out. We have discussed this at length, but at the present time I just don't see that it would be the proper way to go today.

Senator ROTH. Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Gosnell.

[The prepared statement of Mr. McCamant follows:]

STATEMENT OF WILLIAM C. McCAMANT, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

SUMMARY OF STATEMENT

I am William C. McCamant, Executive Vice President of the National Association of Wholesaler-Distributors, in Washington, D.C. The National Association of Wholesaler-Distributors (NAW) is a federation of 98 national commodity line associations which in turn are composed of over 32,000 merchant wholesaler and distributor establishments located throughout the 50 states. Sales by merchant wholesaler-distributors are forecast by the Department of Commerce to reach $498 billion in 1976. The Association estimates that NAW affiliates account for approximately 60% of total industry sales, and 60% of the over 4 million individuals employed in wholesale trade.

Our members, consisting preponderantly of smaller, closely-held, family-owned firms, have a vital interest in the impact of taxes on the continuation of smaller business enterprises. We are particularly concerned with the matter of estate taxation, which already poses a serious problem for many wholesale distribution firms. The President's proposal and many other bills which have been introduced in the Congress take note of this situation. The degree to which estates are taxed will have a great effect on whether the closely-held business can be perpetuated beyond the life of the present principal owner.

Smaller, closely-held firms, whether they be wholesale distribution firms, retail firms, or manufacturing firms—all play a significant role in the productivity and growth of our economy. We are here today to urge the Congress to take action to correct a situation that threatens the very existence of a viable smaller business entity in our nation—the present system of estate taxation. We wish today to present our recommendations for reform in this area, which we believe would assist measurably in the continuation of the smaller business enterprise, both in the wholesale distribution industry and the economy as a whole.

Increase the specific estate tax exemption to $200,000

At the present time, the first $60,000 of net personal worth of a deceased is exempt from the Federal estate tax. That exemption level was established in 1942. No change has been made in this level of exemption despite the change in the purchasing power of the dollar. The members of this Committee recognized a similar inflation problem last year when they took action to increase the corporate surtax exemption to assist in capital formation. The fact that Congress has made no change in the estate tax law does not mean that no change has occurred. Indeed, a very significant change has occurred for the heirs of the deceased and for the future of the business.

The effects of inflation on estates have been dramatic, and have resulted in huge tax liabilities which the business must pay when faced with the death of a principal owner. The figures indicate that the GNP Implicit Price Deflator—one measure of the price level—has increased 250% since 1942. Thus, the value of the $60,000 exemption Congress approved in 1942 would now equal approximately $17.100; conversely, the purchasing power of $60,000 in 1942 would now equal approximately $210,000. It should be noted that the current tax on an estate of $210,000 is $35,700, yet no Federal estate tax would have been due on the same amount of purchasing power in 1942. We recommend the Congress remedy this situation by increasing the estate tax exemption to $200,000.

Revise estate tax structure

Another aspect of estate taxation which requires examination is the rate structure. Inflation has distorted the intent of the Congress in this regard as well. Table 6 (page 20) demonstrates the application of the tax rate in 1942 dollar values to 1975 third quarter dollar values. In the interest of returning parity to the estate tax structure, the tax brackets should be adjusted to reflect present dollar values. For example, the $20,000 to $30,000 1942 tax bracket was taxed at a marginal rate of 14 percent. However, with inflation, that dollar value bracket is now $70,200 to $105,200, taxed at a marginal rate of 28 percent—a 100

percent increase in the marginal tax rate at a relatively low estate value. The impact of inflation has been such that a 1942 estate of $8 million (originally intended to be taxed at a marginal rate of 56 percent) is now equal to approximately $10.5 million, and is taxed at the maximum marginal rate of 77 percent. NAW therefore recommends that the Congress revise the tax brackets to restore parity.

Ease tax payment

Any discussion regarding methods of easing the tax burden on closely-held business must of necessity include consideration of the options available to the heirs of the closely-held business for payment of the estate tax. Remittance of the total amount of estate tax due presents often insurmountable difficulties to the closely-held business. Such a large sum of cash can only be obtained in a very few ways—through the sale of stock, proceeds from a loan, or cash on hand. It must be remembered that stock in a closely-held business is not easily saleable, as there is not a ready market compared to stock traded on an exchange. Banks are not a likely source of additional funds for the closely-held business during this time, as the future of the business is extremely uncertain due to the death of a principal. Payment of the tax with cash on hand—if this is even possible—would so severely hamper the daily operation of the business as to effectively preclude its continued growth and profitability. It must be understood that the closely-held business, faced with the loss of valuable management skill and leadership provided by the principal owner, is in a vulnerable position already, notwithstanding the additional burden of the estate tax obligation of the heirs (see pages 22–24 for an analysis of the financial situation faced by the typical wholesale distribution firm upon the death of the principal owner).

The Congress recognized the tremendous problems encountered by the closely-held business with regard to payment of the estate tax, and included within the Internal Revenue Code provisions which allow for an extension of time for payment. However, in practice, such provisions are of little assistance, mainly because of the stringent criteria set down in the Code. NAW firmly believes the effectiveness of these sections of the Code would be greatly enhanced by the adoption of the following recommendations:

1. Increase the time allowed for filing and payment of estate taxes from the present 9 months to at least one year.
2. Permit installment payment in any case of simple hardship by striking the word "undue" from the present hardship section of the Code (Section 6161).
3. East requirements of Section 6166 (pertaining to an interest in a closely-held business) by increasing the allowable number of shareholders from the present 10 to 15 and reducing percentage requirements for the decedent's interest in the closely-held business from the present 35 percent of gross estate or 50 percent of taxable estate to 20 percent of gross estate or 35 percent of taxable estate.
4. Increase the present 10 year maximum repayment period allowable under both Sections 6161 and 6166 to 15 years.
5. Allow a 5 year moratorium on payment of estate taxes eligible for installment payment provisions.

Capital gains on assets transferred at death

Additionally, we note that some tax proposals pending before the Congress contain provisions imposing a capital gains tax on assets transferred at death. Such a tax would sound the death knell for small businesses such as those engaged in wholesale distribution.

Those who favor such a tax argue that unrealized appreciation of capital assets, regardless of kind, is income which currently escapes taxation when held until death. They maintain that this unrealized capital gain should be taxed as if it had been sold the day before death.

To the typical wholesale distribution firm, a tax of this nature, coupled with existing high estate taxes due, would most probably preclude the perpetuation of the business. Table 9 (see page 33) presents the financial situation which would result with the application of a capital gains tax in addition to estate taxes. The data is derived from an actual case study.

We urge the Congress not to apply a capital gains tax to an imaginary gain. Taxation of a gain founded only on the assumption that it has in fact occurred is not a realistic basis for taxation.

Mr. Chairman, we are certain that you and other members of this Committee recognize the gravity of this problem and share our concern for the continuation of a viable small business sector in our economy. Estate taxation poses a very real problem to the perpetuation of these firms, and we therefore urge your consideration of our recommendations.

Capital formation and the wholesale distribution industry

Mr. Chairman, we are fully aware that last week, this Committee spent considerable time hearing public testimony on the subject of capital formation. We would like to echo the sentiments espoused by many of the witnesses—the urgency of the capital formation problem cannot be overly emphasized. Failure to solve this problem will have profound implications for the national economy, not just for our industry.

This capital shortfall is, in large measure, attributable to existing tax policy. The Congress recognized this in concept in the Tax Reduction Act of 1975 and the Revenue Adjustment Act of 1975, which temporarily increased the corporate surtax exemption to $50,000. We urge a permanent increase in the corporate surtax exemption to $100,000.

We recognize that the Congress needs hard-headed, factual analyses in order to evaluate tax proposals and to reach decisions about appropriate changes in the tax law. Our objective is to provide a factual basis to assist in examining tax reform—not only for the wholesale distribution industry, but for all other businesses as well.

Last year at our request, Dr. Norman B. Ture, a recognized expert on capital formation and tax policy, prepared a detailed examination of the capital formation process within the wholesale distribution industry and the role played by tax policy in this process. A primary objective of this study was to determine whether a capital shortfall was in prospect for our industry, and, if so, the type of tax reform which would correct this deficiency most effectively. A copy of Dr. Ture's study is attached for the Committee's use. (Exhibit A)

Dr. Ture concluded that, in light of the dependence of merchant wholesaler-distribtors on retained earnings to finance their increasing capital requirements and the estimated inadequacy of the growth in retained earnings, the industry is most unlikely to be able to meet its growing demands for capital without significant tax reform. The study also determined that an increase in the corporate surtax exemption to $100,000 would most effectively solve this capital shortfall.

Additionally, Dr. Ture's study examined the revenue impact and overall economic impact of such an increase in the corporate surtax exemption. His analysis determined that the increase in business investment and output resulting from an increase in the corporate surtax exemption ot $100,000 would increase full-time equivalent employment by 720,000 and increase total wages and salaries by about $10 billion by 1977. Total business sector output would be $17.2 billion greater than otherwise. These increases in output, employment, and income would result in additional Federal revenues more than offsetting the "initial impact" revenue loss—by 1977, a net revenue gain of $3 billion would be realized.

In addition to the above-mentioned study by Dr. Ture, we have attached another document by Dr. Ture (Exhibit B) which we believe would be of assistance to this Committee in determining future tax policy. This overview of capital formation was prepared at the invitation of the Senate Select Committee on Small Business in September, 1975, ana deals with the current and future capital formation adequacy for the overall U.S. economy.

ESTATE TAXATION AND THE WHOLESALE DISTRIBUTION INDUSTRY

Structure and economic significance of the wholesale distribution industry

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small, closely-held, family owned businesses. Of the roughly 300,000 merchant wholesaler-distributors, approximately 90 percent had assets of less than $1 million in 1971. These smaller firms accounted for about 40 percent of the industry sales volume. In contrast, in the manufacturing sector, about 12 percent of the firms control about 95 percent of the assets and account for approximately 90 percent of the sales.

In addition, the wholesale distribution industry provides year-round employment for 4.2 million individuals. Average hourly earnings ($5.02) in the wholesale trade in December, 1975, significantly exceeded those for all private industry ($4.68), while average weekly earnings ($193.77) were 14.1 percent above those for all private industry ($169.88). In short, the wholesale distribution industry has generated a steady growth in dependable, well-paying jobs throughout the U.S. economy.

Merchant wholesaler-distributors also perform a nessential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers,

store, break bulk, sell, deliver and extend credit to retailer dealers, and industrial, commercial institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient distribution of our everyday consumer and business needs. Further, by the market coverage which they offer suppliers and the support which they provide customers, they preserve and enhance competition, the critical safeguard in our economic system. According to a recent NAW survey, the typical wholesaler-distributor establishes the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain and nurture markets for their products. Many customers are small businessmen also who look to the merchant wholesaler to provide merchandise availability, credit and other services.

Perpetuation in the wholesale distribution industry

The economic data which has been cited to this point demonstrates much about the structure and composition of our industry. On another level, however, NAW initiated a broad study project to gain precise understanding of the actual ownership and perpetuation status of U.S. wholesaler-distributors. The survey, conducted in 1973–74, involved 38 commodity line associations and was distributed to 18,000 firms. An astounding 5,000 responses were received, of which 4,700 were useable for the computerized analysis. The analysis was conducted by Robert C. Bansik, Ph.D., and Harold Squire, Ph.D., of the Capital University Graduate School of Administration in Columbus, Ohio. Data collected through NAW's Perpetuation Survey revealed much about the individual wholesale distribution business, and its ability to exist in its present form beyond one generation. The following typical ownership profile was determined from the survey results:

(1) The firm has a net worth of between $250,000 and $499,000.

(2) The Chief Executive Officer (CEO) himself owns from 51 to 74 percent of the firm's outstanding stock.

(3) The CEO is between 50 and 59 years of age.

(4) The CEO's personal maximum Federal tax bracket is in the range of 35 to 49 percent.

(5) His ownership in the company represents from 51 to 74 percent of the CEO's personal net worth.

(6) Less than $100,000 in life insurance on the CEO is owned by the corporation, and payable to it upon the death of the CEO.

(7) The most probable successor to the CEO is either a son or a non-relative.

Based upon the determination of the typical ownership profile, the NAW Perpetuation Survey sought to answer the following question: "What is the likelihood that this firm can be perpetuated beyond the life of the present Chief Executive Officer, in its present form?" The researchers concluded that: "In fact, given the present situation of U.S. inheritance/estate taxation and valuation, perpetuation in its present form may be highly unlikely."

The urgency of this problem cannot be emphasized strongly enough. Standard mortality tabes, accurate to within a fraction of a percent, permit a very realistic projection of how many people, in various age groups, will die during any future specified period. Table 1, based on the "Commissioners' Standard Ordinary Table of Mortality," in conjunction with age data provided by the NAW Perpetuation Survey respondents in 1973–74, indicates that at least sixty-one of the almost 4,800 owners replying had died by the end of 1975. Chief Executive Officers of the firms surveyed are dying at the rate of at least one per week.

TABLE 1.—AGE DISTRIBUTION AND MORTALITY

Age reported	Number reporting	Actuarial age	Deaths by 1975	Expected deaths by 1980	Expected deaths by 1985
Under 40	423	40	1.5	9	22.0
40 to 49	1,235	45	6.6	39	147.1
50 to 59	1,817	55	23.6	167	359.1
60 and over	1,266	60	29.6	148	364.4
Total			61.3	363	874.5

Source: NAW perpetuation survey, 1975.

Table 1 also shows that nearly 8 percent—or 363—of the owners responding will have died before 1980; 19 percent, or 875, will have died before 1985. The figures may be morbid, but they are clear: one in every five Chief Executive Officers of wholesaling firms faces death before 1985. The statistical figures shown are for general mortality; we would expect data for stressed businessmen would be higher—accelerating the death rates for the respondents of the survey.

Over the years, the problem of perpetuation has gained in prominence for the owner or chief executive officer of a wholesale distribution concern as he plans for the disposition of his estate upon his death. The tax crunch resulting from present estate taxes becomes a major concern to everyone faced with this problem. The tremendous estate tax liabilities which are certain to come due upon the death of a principal owner of the small wholesale distribution business leave the heirs of the estate with few options—pay up with cash on hand, or sell or merge the business to generate the needed amount of cash.

Payment of the estate tax, regardless of which of the above methods are employed, will adversely affect the economic health of the small business community—by reducing the funds available to the smaller business for continued growth, or by outright extinction of the small business firm through sale or merger.

Statistics clearly demonstrate the economic value of our nation's small business community. Small business provides 52 percent of all private employment, and approximately 1/3 of the Gross National Product. However, the statistics cannot possibly measure the contribution which small business makes to the American way of life.

We have long recognized the tremendous impact of public policy on the preservation of a viable small business community in our nation, and have repeatedly called attention to the unique needs and problems of the small business community. This concern has been shared by the Congress, as is evidenced by the creation of the Small Business Administration, whose sole purpose was the preservation of a viable small business sector in the economy, the establishment of small business committees in both the House and the Senate, and various pieces of legislation, such as the Tax Reduction Act of 1975, which include measures specifically designed to aid small businesses.

Despite this recognition and awareness on the part of the Federal government, nothing can stop small business from dying a gradual death unless reform measures are enacted to equalize the impact of estate taxation on small business. We recognize the fact that the estate tax system was never intended by the Congress to impact in any adverse manner on the small business community. However, the application of the law in today's economy has in fact done so—a consequence completely at variance with the intent of the Congress.

Estate tax specific exemption

The burden of estate taxation has fallen increasingly on small businessmen and other middle-income taxpayers in recent years. The basic cause for this has been the long-term inflationary trend in our economy. No one should need to be reminded of the tremendous erosion which has occurred in the value of the dollar over the years. However, a few examples of price levels in 1942 (the year in which the specific exemption of $60,000 was established) are recalled here for purpose of illustration: in 1942, average weekly earnings of production workers were $36.65, round steak sold for 43 cents per pound, sugar sold for 7 cents a pound, and imported petroleum crude oil sold for 8.2 cents per gallon. Overall, the price level has increased over 250 percent over the past 34 years (measured by the GNP Implicit Price Deflator). See Table 2.

TABLE 2.—IMPLICIT PRICE DEFLATOR FOR GROSS NATIONAL PRODUCT SELECTED YEARS, 1940-75

Year	Implicit price deflator (1958=100)	Annual rate of percentage change from preceding period
1940	43.87	
1942	53.03	10.0
1945	59.66	6.3
1950	80.16	6.1
1955	90.86	2.5
1960	103.29	2.6
1961	104.62	1.3
1962	105.78	1.1
1963	107.17	1.3
1964	108.85	1.6
1965	110.86	1.8
1966	113.94	2.8
1967	117.59	3.2
1968	122.30	4.0
1969	128.20	4.8
1970	135.23	5.5
1971	141.61	4.7
1972	145.88	3.0
1973	154.31	5.8
1974	170.18	10.3
1975	[1] 186.05	9.3
Percent change:		
1940-75	+324.1	
1942-75	+250.8	

[1] 3d quarter figure.

Source: "Economic Report of the President," January 1973 (p. 198); "Survey of Current Business," December 1975.

It is readily apparent that the cost of living has increased at a tremendous rate—from 1971 to 1975 alone, the Consumer Price Index has increased 33 percent, using average annual figures. But too often, the fact is ignored that the cost of dying has also increased. Changes in the income tax exemption have been made numerous times over the years to account for the rising cost of living, but no corresponding changes have been made in the level of the estate tax exemption since 1942. If the estate tax exemption had been "indexed" with the GNP Implicit Price Deflator, the following table indicates what would have been the result:

TABLE 3

Estate tax exemption adjusted for change in implicit price deflator since 1942

Year:	*Exemption equivalent*
1942	$60,000
1950	90,720
1960	116,880
1970	153,000
1974	192,000
1975	210,504

We can see from the following table that, based on the decreased purchasing power of the dollar, the exemption in 1975 would have equalled $210,504, if the same amount of purchasing power was to be exempted from the Federal estate tax. It should be noted that the current estate tax on the $210,000 estate is now $35,700, but no Federal estate tax would have been due on the same amount of purchasing power in 1942.

Therefore, NAW recommends the specific exemption be increased to $200,000.

We fully recognize that, should the exemption figure be increased in accordance with our recommendation, the impact on the revenue derived from estate taxes would be sizeable. However, it must be remembered that total revenues from estate and gift taxation represent only 1.99 percent of total federal revenues. (Table 4) when considering the total economic impact of this proposal, this fact should be kept in mind.

TABLE 4.—REVENUE SIGNIFICANCE OF ESTATE TAX REVENUES TO FEDERAL BUDGET RECEIPTS, SELECTED YEARS 1959–72

Year	Federal budget receipts (millions)	Estate taxes (millions)	Share of Federal budget receipts attributable to estate taxes (percent)
1944	$44,149	$531	1.20
1951	47,568	577	1.20
1959	79,249	1,186	1.50
1961	94,384	1,619	1.72
1963	106,560	1,841	1.73
1966	130,856	2,414	1.84
1970	193,743	3,000	1.55
1972	208,649	4,153	1.99

Source: "Economic Report of the President," January 1973 and January 1976; Internal Revenue Service, "Statistics of Income: Estate Tax Returns, 1969 and 1972."

However, if economic conditions and budget considerations should preclude this immediate increase in the specific exemption, NAW would not be adverse to adoption of a "phased-in" method of increasing the exemption, as has been proposed by the President, as well as by many members of Congress.

Overall, the effects of inflation over the years with regard to estate taxation have been two-fold: 1) to tax estates which never would have been subject to the estate tax in 1942 (i.e., those with less than $60,000 in assets—which today would encompass those with less than $210,504 in assets) and 2) to tax eligible estates, regardless of size, at a greater rate than would have resulted for the same estate value in 1942.

An increasing number of estates have become subject to the estate tax over the years. The effect is demonstrated in Table 5.

TABLE 5.—NUMBER OF ESTATE TAX RETURNS FILED BY CITIZENS AND RESIDENT ALIENS IN RELATION TO TOTAL DEATHS

Year	Total returns filed	Taxable returns filed	Deaths [1]	Ratio of— Total returns to deaths	Taxable returns to deaths
1941	15,977	13,336	1,432,000	1.1	0.9
1951	27,958	18,941	1,468,000	1.9	1.3
1961	64,538	45,439	1,708,000	3.8	2.7
1970	133,944	93,424	1,926,000	7.0	4.9
1973	174,889	120,761	1,962,000	8.9	6.2

[1] In preceding year.

Source: "Statistics of Income: Estate Tax Returns, 1965, 1969 and 1972;" "Statistical Abstract of the United States, 1973."

This indicates that in 1941, there were 1,432,000 deaths with 12,336 taxable returns filed, or less than 1 percent. In 1972, there were 1,962,000 deaths, with 120,761 taxable returns filed, or 6.2 percent. Expressed in other terms, in 1941, less than one estate out of 100 required a Federal estate tax, compared with over 6 out of every 100 estates in 1972.

As stated earlier, the estate tax is dipping down into smaller estates (as measured by purchasing power) than it did in 1941. Had the Congress at that time intended to tax estates at the effective rate at which comparable values are presently taxed, the exemption would have approximated only $17,100, and the 77 percent maximum marginal tax rate would have become effective at roughly $3 million (see Table 6, page 20). Table 4 on page 17 indicates another point in this regard. There has been a 682 percent increase in the revenue collected from estate taxes from approximately $531 million in 1944 to $4.15 billion in 1972.

Rate structure

Another aspect of estate taxation which requires examination is the rate structure of the estate tax itself. This structure is clearly a highly progressive tax, with marginal tax rates spanning from 3 to 77 percent. However, a close examination of the tax rates shows the sharpest rise in progressiveness occurs in the lower rate brackets, while the upper brackets increase only mildly. The marginal rate rises rapidly to 28 percent on $60,000 in taxable income (see Table 6). In contrast, the next progression of 28 percent encompasses a taxable estate range of $2,940,000 (from $60,000 to $3 million). The final progression, applicable to estates from $3 million $10 million, shows only a 21 percent increase in marginal tax rates, even though the progression covers a $7 million range.

TABLE 6.—EQUIVALENT ESTATE TAX STRUCTURES, 1942 AND 1975

RATE TABLE FOR TAXABLE ESTATE

(A) Taxable estate equal to or more than—		(B) Taxable estate less than—		Tax on amount in Col. (A)		Rate of tax on excess over col. A	
1942	1975 equivalent	1942	1975 equivalent	1942	1975 equivalent	1942	1975
0	0	5,000	17,550	0	0	3	..
5,000	17,550	10,000	35,100	150	1,330	7	11
10,000	35,100	20,000	70,200	500	3,918	11	18
20,000	70,200	30,000	105,200	1,600	12,356	14	28
30,000	105,000	40,000	140,300	3,000	22,260	18	30
40,000	140,300	50,000	175,400	4,800	32,790	22	30
50,000	175,400	60,000	210,500	7,000	43,320	25	30
60,000	210,500	100,000	350,800	9,500	53,850	28	30
100,000	350,800	250,000	877,100	20,700	100,260	30	32
250,000	877,100	500,000	1,754,200	65,700	280,227	32	37
500,000	1,754,200	750,000	2,631,300	145,700	642,590	35	45
750,000	2,631,300	1,000,000	3,508,400	233,200	1,067,789	37	53
1,000,000	3,508,400	1,250,000	4,385,5C0	325,700	1,548,156	39	59
1,250,000	4,385,500	1,500,000	5,262,600	423,200	2,081,065	42	63
1,500,000	5 262,600	2,000,000	7,016,800	528,200	2,644,142	45	67
2,000,000	7,016,800	2,500,000	8,771,000	753,200	3,850,464	49	73
2,500,000	8,771,000	3,000,000	10,525,200	998,200	5,154,160	53	76
3,000,000	10,525,200	3,500,000	12,279,400	1,263,200	6,492,604	56	77
3,500,000	12,279,400	4,000,000	14,033,600	1,543,200	7,843,338	59	77
4,000,000	14,033,600	5,000,000	17,542,000	1,838,200	9,194,072	63	77
5,000,000	17,542,000	6,000,000	21,050,400	2,468,200	11,895,540	67	77
6,000,000	21,050,400	7,000,000	24 558,800	3,138,200	14,597,008	70	77
7,000,000	24,558,800	8,000,000	28,067,200	3,838,200	17,298,476	73	77
8,000,000	28,067,200	10,000,000	35,084,000	4,568,200	19,999,944	76	77
10,000,000	35,084,000			6,088,200	25,402,880	77	77

Source: A Guide to Federal Estate and Gift Taxation, Internal Revenue Service, 1972. Equivalents are derived from implicit price deflator.

Clearly, the impact of the estate tax on the lower brackets seems unfairly severe. As stated in the Annual Report of the Senate Select Committee on Small Business (February 19, 1976; page 105), this lack of true progressiveness in the estate tax rates would "appear to constitute still another example of discrimination, as between entrepreneurs who have managed to build up a modest amount of wealth during their lifetimes and those who have acquired larger amounts of wealth." A clear example of this can be seen when one examines the tax rate on $500,000—20.14 percent. Yet, the rate on *twice* that amount—$1 million—is only 32.57 percent.

Inflation has also severely distorted the rate structure. resulting in an effective rate of taxation completely foreign to that originally enacted. Table 6 illustrates the 1975 third-quarter equivalents (i.e., adjusted for inflation) of the tax brackets and tax rates established in 1942. (Calculations based on application of the percent increase in the GNP Implicit Price Deflator, shown in Table 2.) Thus, in practice, the marginal tax rates found in the last column of Table 6 have also been raised due to inflation. For example, the $20,000 to $30,000 tax bracket was intended to be taxed at a marginal rate of 14 percent. However, with inflation, that dollar value bracket is now $70,200 to $105,200, and is taxed at a marginal rate of 28 percent—a 100 percent increase in the marginal tax rate at a relatively low estate value. The span of estate tax values included in the progressive rate structure also has been effectively reduced—since the maximum marginal tax

rate of 77 percent would be applied to the taxable estate in excess of $3 million, as opposed to the $10 million estate value originally established by the Congress.

In the interest of returning parity to the estate tax structure, NAW recommends the Congress revise the tax brackets to reflect present day values.

Tables 7 and 8 present an analysis of the effects of inflation on various sizes of wholesale distribution firms passed on to the next generation.

TABLE 7.—AVERAGE WHOLESALE—DISTRIBUTION FIRM BY ASSET SIZE: ASSETS AND NET INCOME AFTER TAX

Asset size	$100,000 to $250,000	$250,000 to $500,000	$500,000 to $1,000,000	$1,000,000 to $5,000,000
Number of returns	38,718	23,562	14,810	11,082
Total assets (thousands)	$6,352,185	$8,348,339	$10,374,151	$21,189,452
Average asset firm	$164,100	$354,300	$700,500	$1,920,600
Total net income after tax (thousands)	$434,750	$471,491	$517,961	$935,533
Average net income after tax/firm	$11,228	$20,010	$34,975	$84,419

Source: Internal Revenue Service, Corporation Source Book of Statistics of Income, 1971; p. 15.

The heirs of a family-owned distribution firm will naturally look to the business to pay the estate taxes attributable to the business. In our example, we have considered the business asset as representing the entire estate (this allows for the application of the $60,000 exemption and the lowest possible rate of estate taxation. It must be noted that any additional assets in the estate would be taxed at a significantly higher marginal rate.

Table 7 shows the average asset size and net income for wholesale distribution firms in the $100,000 to $250,000, $250,000 to $500,000, $500,000 to $1 million, and $1 to $5 million asset groupings as derived from the Statistics of Income Series, 1971, the latest year for which data is available. The comparable data for 1970 shows essentially the same figures for firm size and net income.

TABLE 8.—IMPACT OF ESTATE TAXES ON TYPICAL WHOLESALE-DISTRIBUTION FIRM BY ASSET SIZE CLASS

Asset size	$100,000 to $250,000	$250,000 to $500,000	$500,000 to $1,000,000	$1,000,000 to $5,000,000
Average asset	$164,100	$354,300	$700,500	$1,920,600
Less exemption	$60,000	$60,000	$60,000	$60,000
Taxable estate	$104,100	$294,300	$640,500	$1,860,600
Estate tax	$21,930	$79,876	$195,050	$691,100
Net income after tax	$11,228	$20,010	$34,975	$84,419
Ratio of estate tax liability to asset earnings	1.95	4.00	5.58	8.18

Source: Derived from table 7 and applicable estate tax rates (Guide to Federal Estate and Gift Taxation).

The typical firms in the four aset classes have assets of $164,100, $354,300 $700,500 and $1,920,600 respectively. Should the Chief Executive Officer and owner die, the heirs would be faced with estate tax burdens on these relatively modest sized firms that ranged from roughly 2 to 8 times the annual net income of the firm. The estate tax burden and the liability of the heirs and the executor of the estate to pay this tax seriously threatens the continued existence of this firm.

The typical firm in the $250,000–$500,000 asset category has $354,300 in assets which would represent a $294,300 taxable estate with estate taxes due of $79,876—and an earning capacity of only $20,010. In the next asset category, $500,000–$1 million, the average firm had $700,500 in assets which represented a taxable estate of $640,500, and an estate tax of $195,050—an amount five and one-half times the annual earnings. Even if the estate tax was to be paid over a ten year period, the taxes in the first year would be $33,158 (calculated on 10 percent of principal plus 7 percent interest), while the earnings of this firm were shown to be only $34,975. No business can survive in a climate in which estate tax payments seize 95 percent of the income.

Clearly, inflation and the rate structure of the estate tax have had a tremendous adverse impact over the years, but most specifically, this impact has been felt to a greater degree by the relatively small estate. In the words of Senator Gaylord

Nelson, "the steep graduation in the estate tax, on top of a completely outdated exemption, is pushing most businesses and farms into a danger zone where estate and inheritance tax brackets make retention of the business or farm impossible." [1]

We have illustrated the tremendous tax liabilities which fall due upon the death of a principal owner of a small, closely-held business. However, this problem is compounded when one considers the nature and liquidity of the assets which comprise the estate consisting mainly of an interest in a closely-held business. Closely-held stock is highly illiquid, as there is not a ready market for the stock and such stock is not easily saleable. In addition, it is highly unlikely that a prospective buyer of closely-held stock would be interested in obtaining only a minority interest in the firm, thereby allowing the heirs of the estate to continue control of the family interest in the business. One must also consider the tremendous problems encountered in valuation of the closely-held stock, as there are no truly objective standards employed in the IRS valuation of the closely-held stock for estate tax purposes.

The preceding discussion clearly demonstrates the problem which face the small, closely held business upon the death of a principal owner. The future of that business can be very directly affected by the ability of the heirs to pay the estate tax. Inability to generate a sufficient amount of cash to satisfy the estate tax liabilities may force the heirs to sell their interest in the closely held business for this purpose.

It must be understood that the closely held business which has lost its principal owner is in a precarious position already, notwithstanding the additional burden of estate taxes. A difficult transition period takes place, during which time the individual(s) charged with directing the business must seek to compensate for the loss of valuable management skill and leadership which the principal owner had furnished over the years. Customers and suppliers must be assured that the business will continue to provide goods and services in an efficient manner, that existing financial obligations will not be neglected for any reason, and that future profitability will not be adversely hampered.

The problems and concerns of the closely held business stated above are by no means all-inclusive. The fact remains that the closely held business will face a period of uncertainty, and remain particularly vulnerable to a variety of situations, when faced with the death of a principal owner, who was most likely the chief executive officer.

At the same time, however, the heirs of the business must also be concerned with the payment of estate taxes. When the estate consists largely of an interest in a closely held business, the heirs have few options open to them with regard to payment of the estate tax: pay with cash on hand (usually not a viable option), pay with cash obtained through a loan, pay on an extended basis in yearly installments, or pay with cash obtained through sale or merger of the firm.

Extension of additional credit at this time is highly questionable. Indeed, the contrary is likely to happen as the principal owner is also the chief executive officer, the one looked to by the bank to manage the business in such a way that the bank will be repaid is already outstanding loans to the closely held business. When the closely held business loses its CEO (usually the president), the bank is very likely to recall a portion of the loan or decline to extend additional credit or renew current loans until the future of the business is more certain.

Liberalization of time allowed for payment of estate taxes

We have repeatedly emphasized the problems which face a closely held business upon the death of a principal owner, including the inability of the closely held business to easily convert assets to cash in order to pay the estate tax due to the illiquidity of those assets. It must be remembered that estate planning—even the most diligent—is difficult. Regardless of the effort spent in prior planning, the most important determinant remains unknown—the time when death will in fact occur. Therefore, the sooner the heirs of the estate are required to pay the estate tax, the more pressing the problem of liquidity—or the lack of liquidity—becomes.

Prior to 1970, the IRS allowed 15 months from the date of death for the filing and payment of the estate tax. This period was reduced to 9 months in 1971, largely to provide a one-shot revenue increase necessary to pump funds into the budget for the next year. At that time, NAW testified in opposition to this reduction, but suggested that if the revenue needs were pressing, the establish-

[1] Remarks of Senator Gaylord Nelson, Congressional Record, Dec. 18, 1975, page S22684.

ment of a 12 month period for filing would appear to be more equitable and realistic. To quote our earlier statement, "Treasury policy need not be tailored to push to the wall these people who inherit ownership of smaller business enterprises during their time of painful transition." [8] We would like to reiterate that position at this time, and recommend the Committee increase the time allowed for filing and payment of estate taxes to at least one year.

Additionally, every effort should be made by the Congress to allow the closely-held business the maximum amount of time possible for full payment of the estate tax. To do otherwise would effectively signal the demise of many of these closely-held businesses.

Section 6166—Extension of time for payment in the case of a closely-held business

In the case of an estate consisting largely of an interest in closely-held business (i.e., where such an interest comprises 35 percent of the value of the gross estate or 50 percent of the taxable estate), the executor of the estate may elect to pay that portion of the estate tax attriutable to the business interest in not more than ten years, with payment on a yearly basis. The Code defines "closely-held business" as: a) a proprietorship; b) a partnership having no more than 10 partners or one in which the business interest is at least 20 percent; or c) a corporation having no more than 10 shareholders or one in which the decedent held at least 20 percent of the voting stock.

This option has been included in the tax code in an effort to provide a measure of relief and protection to the closely-held business. In practice, such provisions which grant an extension of time for payment of taxes are largely ineffective, mainly because of the stringent criteria set down in the Code. NAW firmly believes the effectiveness of Section 6166 would be greatly enhanced if the requirements were eased—by increasing the allowable number of shareholders from the present 10 to 15 and reducing the percentage requirements for the decedent's interest in the closely-held business from the present 35 percent of gross estate or 50 percent of taxable estate to 20 percent of gross estate or 35 percent of taxable estate.

In this regard, one must also consider the impact of Employee Stock Ownership Plans (ESOPs) on the ability of the closely-held firm to elect to pay that portion of the decedent's estate tax attributable to the business interest in installments. The Congress has, on many occasions, endorsed the concept and utilization of ESOPs. However, if the closely-held business determines that an ESOP should be established within that firm, the resulting increase in the closely-held business' number of shareholders (and decrease in the percent of voting stock held by the previous shareholders) could prohibit that firm from paying the tax in installments upon the death of a principal owner. The decision to establish an ESOP within a closely-held business may therefore be tempered by considerations of the estate tax consequences.

Section 6161—Extension of time for undue hardship or reasonable cause

Another section of the Code provides for an extension of time upon determination by the IRS district office of "undue hardship" or "reasonable cause". Such determinations are, in the words of the Code, "discretionary with the appropriate internal revenue officer and his authority will be exercised under such conditions as he may deem advisable". Undue hardship is defined as "more than an inconvenience to the estate". A granting of undue hardship allows the estate to pay the tax over a specified number of years, not to exceed 10 years. If reasonable cause can be shown, the district IRS office may grant an extension of not more than 12 months for payment. Reasonable cause is generally thought to exist when assets necessary for payment of the estate tax are not readily available or will be received in the near future. In both cases, the executor of the estate remains personally liable for the payment of the full amount of the tax.

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[8] "Tax Recommendations of the President", Hearings before the Ways and Means Committee, September 1970, page 285.

Unfortunately, statistics on the number of estates requesting and receiving any type of extension of time for payment of estate taxes are extremely lacking. It has been estimated, however, that only 1 percent of the estate tax returns filed in 1972 requested an undue hardship extension.[3] There is no information available on how many of these requests were granted. Despite the lack of statistics in this area, a review of the literature and testimony available in the estate tax area reveals that little use is made of these provisions for a variety of reasons—mainly, the harsh requirement that the executor of the estate remain personally liable for the full amount of the tax and the discretionary nature of the determination of undue hardship and reasonable cause.

It has been proposed that the existing Section 6161 be liberalized to allow broader use of this option. Senator Walter Mondale, upon introduction of S. 2394 on September 23, 1975, stated:

> Our estate and gift tax laws are intended in part to prevent excessive concentrations of wealth. Yet in their application to small businesses and family farms, they may be inadvertently increasing it . . . making the installment payment provisions easier to use could well ease the liquidity problems faced by many family farms and businesses, and make it unecessary to sell the farm or business to pay the estate tax . . . the present requirement of "undue hardship" can be a difficult one to meet, and permitting installment payments in any case of simple hardship would make the installment payment option more broadly available.[4]

NAW strongly recommends that the Committee adopt this type of provision, by striking out the word "undue" from Section 6161 of the Internal Revenue Code.

We have detailed earlier in our statement (pages 22–24) the impact of estate taxes on a typical closely-held wholesale distribution firm, even with an extension of time for payment of ten years. The example concluded that serious doubts would remain as to whether this typical closely-held wholesale distribution firm could survive in its present form. Accordingly, NAW recommends that the present ten year maximum repayment period allowable under both Section 6161 and Section 6166 of the IRC be increased to fifteen years. In addition, we recommend that estates qualifying for an extension of time be allowed a five year "grace period" before the first payment is required.

The enactment of liberalized provisions for payment of estate taxes attributable to an interest in a closely-held business would do much to enhance the perpetuation prospects of those businesses. Further, the revenue considerations involved in any liberalization of payment of these taxes would be small. Payment in full—plus interest—will be made; we are not advocating a forgiveness of any portion of the tax.

Additionally, we observe that many legislative proposals dealing with estate tax reform also would provide for an increase in the marital deduction. While NAW endorses an increase in the marital deduction, we would like to emphasize the fact that it would in no way solve the long-term problem of perpetuating a family-type, closely-held business from one generation to the next. Our support for an increase in the marital deduction is therefore tempered by reality—the harsh reality that the increased marital deduction, while needed, in no way solves the basic problem of continuing family-type enterprises under a highly progressive estate tax system.

Imposition of capital gains tax on assets transferred at death

We note that some tax reform proposals before the Congress would contemplate an entirely different approach to tax reform—the imposition of a capital gains tax on assets transferred at death. Such a tax would sound the death knell for small businesses such as those engaged in wholesale distribution.

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[3] Remarks of Senator Walter Mondale, Congressional Record, Sept. 23, 1975, page S16468.

[4] Remarks of Senator Walter Mondale, Congressional Record, September 23, 1975, page S16468.

Those who favor such a tax argue that unrealized appreciation of capital assets, regardless of kind, is income which currently escapes taxation when held until death. They maintain that this unrealized capital gain should be taxed as if it had been sold the day before death.

NAW has evaluated the impact of the imposition of a capital gains tax on the many thousands of firms in the wholesale distribution industry and has concluded that such a tax would make the perpetuation of a family-owned or closely-held business almost impossible. Indeed, the consequences are so severe that it is not an overstatement to say that such a tax threatens to snuff out the entrepreneurial spirit and the private enterprise system as we know it.

An example of the impact of this proposed legislation on a typical small wholesaler is presented in Table 9. This firm was founded 25 years ago with invested capital of $13,000. Through diligent work the firm has been continuously profitable, although its profits have never been large either in relation to its sales or net worth. The result of the firm's management and reinvestment programs has led to a net worth of $495,000. This reflects roughly a 15 percent annual growth rate over 25 years, not an unusual pattern given the growth and change in our nation since World War II.

The tax consequences for the owner, the executor of his estate, his heirs and employees are significant. A son, who is active in the business, is the only prospective heir as the spouse of the owner predeceased him. Because the growth of the business has absorbed all of the firm's profits, the firm is presumed to represent virtually all of the owner's estate. In this case, the owner's home would also come under provisions of the capital gains tax, as well as even higher marginal estate tax rates. But, for purposes of this testimony, the estate will be considered to consist entirely of the business interest.

Table 9 shows the net worth of the business at $495,000, less the specific exemption—leaving a taxable estate of $435,000, on which estate taxes of $124,900 are due. This estate tax is over seven times the annual earnings of the last five years. The minimum payment due, assuming a ten year extension, would be $21,233, or over 120 percent of the firm's average net income per year in the last five preceding years. In this case, the estate tax burden makes the continued independent existence of this firm highly questionable.

TABLE 9.—TAX CONSEQUENCES OF OWNERS DEATH

A. Present estate taxes

Net worth of business	$495,000
Less specific exemption	60,000
Taxable estate	435,000
Estate tax	124,900
Average annual net income (last 5 years)	17,600
Minimum annual tax payment due	21,233

Total estate taxes approximate 7 times the average annual earnings, and the minimum annual tax payment in the first year exceeds earnings by $3,633.

B. Capital gains tax imposed upon owner's death in addition to estate taxes

Net worth of business	$495,000
Original investment	13,000
Capital gains subject to tax	482,000
Capital gains tax (at 25 percent)	120,500
Taxable estate after capital gains	374,500
Less specific exemption	60,000
Estate tax	86,340
Total tax liability	206,840
Minimum annual tax payment due	35,162

SOURCE: Actual case study. Interview and analysis of corporate financial records. Tax consequences based on estate tax structure and stated assumptions of capital gains proposals.

The second example reflects the predicament faced by the heirs and the executor of the estate if a capital gains tax is imposed on the assets upon the owner's death. The $13,000 original capital is subtracted from the present net worth of

the business, leaving $482,000 in assets subject to a capital gains tax. The capital gains tax at 25 percent will require payment of $120,500 in taxes, with the remaining $374,500 of the estate subject to an additional estate tax of $86,340. The total capital gains tax and existing estate taxes total $206,840, or 41 percent of the gross estate value and 11.7 times the recent annual average net income of the firm. Even under a ten year deferred payment system, the first year's taxes are *twice* the average annual net income.

There are very few options for heirs and executors in a situation in which the estate tax liability equals 41 percent of the asset value and annual payments far exceed the annual earnings stream of the asset. This example clearly demonstrates the improbability of perpetuating the independent family-owned or closely-held firm. Such a capital gains tax threatens the family-owned business and the jobs of the roughly 50 percent of American workers who earn their livelihood in small businesses.

We are confident that this Committee will recognize the dangers of such a form of taxation to the small, closely-held business enterprise, and urge the Committee not to apply a capital gains tax to an imaginary gain. Taxation of a gain founded only on the assumption that it has in fact occurred is not a realistic basis for taxation.

Senator BYRD. The concluding witness will be Mr. Thomas L. Little, chairman of the board, First National Retirement Systems, Inc.

Senator Roth?

Senator ROTH. I would like to welcome Mr. Little, who is a resident of Delaware and a community leader. Not only is he a young business leader, but he has also served in the State legislature, so he has a diversified background and I want to welcome him.

Mr. LITTLE. Thank you, Senator Roth.

Senator BYRD. Mr. Little.

STATEMENT OF THOMAS L. LITTLE, CHAIRMAN OF THE BOARD, FIRST NATIONAL RETIREMENT SYSTEMS, INC., ACCOMPANIED BY F. JEROME SHEA, PRESIDENT, AND RUFUS S. WATTS, TECHNICAL VICE PRESIDENT

Mr. LITTLE. I am here in the interest of the voluntary plan. I incorporated a summary of voluntary plans as Congress has been kind enough to grant them, reminding you that the first voluntary deferred compensation plan was issued in Senator Long's State in the year 1800, granted by Mr. Washington and Mr. Jefferson, to a man named Gilvany, chief of the Creek Indian tribe. This is the first official record of a voluntary plan in America.

REVIEW OF VOLUNTARY INDIVIDUAL PENSIONS

There has always existed a voluntary employee benefit plan for every working American commonly known as a deferred compensation account. This completely voluntary plan is simply a common law contractual right by which an employer agrees to hold back an individual employee's future earned income until a future date. The employer then further agrees to maintain the ownership of the account until the employee meets certain conditions or event set forth within the contract. The deferred assets remain in the legal ownership of the employer until the employee meets certain conditions in the contract. At that time, the employee takes the assets of the account with the corresponding individual tax liability implied by constructive receipt of the assets. This deferred compensation process will reduce current employee tax liability until a future specified date.

This commonly used technique has been used for decades by highly paid executives, entrepreneurs, professional athletes, entertainers and other high earners as a way of deferring current income until a more convenient future time. This broad concept was first introduced to large groups of salaried workers in Delaware in 1970. Under this theory of deferred compensation, several rulings were requested from the Internal Revenue Service concerning the application to a medium range salaried employee earning approximately $10,000 per year. Repeatedly, the answers were positive and I submit to you a treatise regarding this process authored by both F. Jerome Shea and myself.[1] This treatise details the basic construction of deferred compensation contracts that have been used for decades and is settled law.

VOLUNTARY TAX SHELTERED ACCOUNTS

The first major statutory breakthrough in the order of events of completely voluntary employee benefit plans occurred as an amendment to the Internal Revenue Code in 1954. The amendment provides for individual voluntary tax shelter accounts. This law covered specifically employees of nonprofit institutions which are charitable in nature and was later broadened to include public school teachers. These tax sheltered accounts have subsequently become well known throughout America as tax shelter annuities in public school systems, private school systems, university and hospital systems. These particular tax sheltered accounts originally were limited for investments to a specific insurance product known as an annuity. In the Pension Reform Act, Congress properly and wisely expanded these tax sheltered accounts to include the use of mutual funds as an additional investment vehicle in addition to the insured annuity. However, the real significance of the tax sheltered account is the completely voluntary nature of participation by an individual employee regarding the stabilization of future personal retirement plans. This voluntary salary reduction plan was the first broad based incentive plan for the salaried employee enabling him to voluntarily subsidize future personal retirement benefits.

The next major statutory effort to expand voluntary retirement benefits resulted from the passage of the Keogh-Smathers legislation in the early 1960's. This legislation is now commonly called H.R. 10 and allows the entrepreneur, whether offering services or products, to voluntarily reduce present income—and include certain employees—under conditions set forth in the legislation. This remains an attractive and convenient method for the entrepeneur to voluntarily provide for his and his employees future retirement benefits.

INDIVIDUAL RETIREMENT ACCOUNTS

Congress then decided after long years of study and through an extensive statutory thrust to provide the American public with a completely voluntary personal retirement account known as the IRA or individual retirement account. Individual retirement accounts provide the needed buffer zone between covered employees of industrial corporations and the great masses of employees not covered by company or union sponsored plans. Essentially the individual retirement ac-

[1] "A Treatise on Deferred Compensation," is included at the conclusion of this statement.

count provides an opportunity for each individual—with or without his employer—to voluntarily save or invest funds for future retirement not to exceed 15 percent of income or $1,500 per year. The individual retirement account has been in effect for 1 year and seems to be relatively accepted by those who qualify and need a current tax deduction. However, without employer support through a payroll reduction, it is not likely the IRA will have broad base use throughout the economy by the personnel most in need of this benefit.

INDIVIDUAL PENSION ROLLOVER

Also included in the legislation is an opportunity for an individual pension rollover from a qualified plan into an individual retirement account. This provision in the Pension Reform Act, although well intentioned, fell short of its goal and this current amendment attempts to correct the problem. However, this amendment will only correct the obvious inadequacy in the recent Pension Reform Act by allowing for a rollover from an existing plan without requiring that the employee leave his current job in order to meet the rollover requirements set forth in the act.

It is therefore my purpose today to respectfully remind the committee that it is essential that this legislation recognize the rollover commonly takes two forms; one form is the lump sum provision; the other is a monthly—or periodic—actuarial rollover provision. The necessity for allowing an individual employee to option for the periodic rollover from a currently qualified plan can be explained by the following example:

An employee voluntarily or involuntarily, leaves a corporation at age 51; and therefore, the company pension plan. Under the proposed amendment, he can rollover his lump sum vested assets to an individual retirement account and therefore avoid undesirable tax liability. However, pension plans were designed to provide for periodic payouts and do not anticipate the lump sum payout. Qualified pension plans were certainly not designed to accommodate these lump sum payout provisions on a widely accepted basis; and as a result, they may be counter productive to the total pension reform concept. In turn, the individual employee may be losing a long-term actuarial benefit by being forced to select only the lump sum option in lieu of the planned periodic payout. We suggest this amendment include a provision to merely allow an option for both lump sum rollover and periodic rollovers to the individual retirement account. In either case, the tax consequence is the same and the long-term benefit for both the Government and the public interest will be substantial by providing for both provisions.

We have generally reviewed the recent history of voluntary retirement plan from the common law-deferred compensation contractual right to the highly specialized statutory plans created by Congress.

LIMITED EMPLOYEE RETIREMENT ACCOUNTS

Individual retirement accounts are now available to approximately 30 million employees who are not covered by company pension benefits. The proposed limited employee retirement account soon to be

known as LERA will adjust the air and equitable position of individuals who are now covered by qualified company pensions and therefore not entitled to participate in the individual retirement account. This amendment will remedy a basic unfairness inadvertently caused by the Pension Reform Act by allowing further expansion of the voluntary plan concept. We fully support this effort.

SUMMARY

It becomes glaringly obvious that the voluntary plan is the only realistic approach to reducing current economic tension on Government and corporate pension plans including the Social Security System. In that spirit, let me respectfully alert the committee that there is one significant portion of the work force not yet considered for a voluntary pension plan. These workers choose a career objective that is the backbone of American society.

If the accumulated numbers of these specialists were expressed as a single unit, it would certainly dwarf all employment categories yet recorded. These workers are fundamentally general practitioners in their trade; however, they must by the very nature of their job develop specific skills in the following areas:

Basic accounting.
Nursing and first aid.
Care, cleaning and maintenance of children.
Preschool education.
Primary and secondary education.
Budgetary management and control.
Consumer advocacy and investigative procedures.
Real and personal property management.
Culinary arts.
Fashion design and interior decoration.
Landscaping.
General home repair and maintenance.
Psychological and physical therapeutic techniques.
Judicial review of minor disputes.
Other skills just to numerous to mention.

Of course, all of this expertise is taken for granted in the overall scheme of our free enterprise system and to make matters even more ludicrous * * * these workers have no employer from whom to draw a paycheck * * * nor a pension plan.

I am speaking, of course, of our American Homemakers who also double as our wives and mothers. She is entrusted with the motivation and morale of literally millions of governmental officials, service industry professionals and manufacturers of goods throughout our land. Other adult Americans have some source of employment income or at least some type of government subsidy. These critically important specialists, who are the backbone of the family unit and the economy, have no identifiable source of personal income unless it is in the form of a gratuitous transfer.

This is not only downright injust—it's just downright impractical!

The real compensable worth of a homemaker has been estimated by economists and financial planning experts to range between $5,000 to

$15,000 per year. No matter what the figure, no one of us would seriously suggest that it would be adequate. Yet in spite of our common agreement, no serious proposal for compensation has yet come forth from government or the private sector.

Therefore, as a mere start and as an effective compromise, we strongly suggest that the committee consider passage of Senator William V. Roth's amendment to the Tax Reform Act of 1975. His amendment provides for a completely voluntary tax deferred retirement account for the homemakers of America. We would not be so presumptuous as to suggest the actual amount to be considered by the committee—that is for wiser men than us to determine considering the overall economic scheme of things. It is, however, essential that the committee consider this amendment at this time in light of your sincere effort to round out the whole voluntary pension system. This rounding out process should make provisions for all homemakers now totally dependent on the one income source earned by their spouse.

Let's face the facts, when the sole income earner is disabled or dies, the surviving homemaker is fully expected to immediately take over the breadwinner role. This occurs under extremely trying circumstances and at best during a period of extreme emotional stress when she is usually unfamiliar or unskilled for participation in the economic world outside the home.

We believe the same equitable principles that motivated the Congress to grant voluntary plans to all earned income categories in the work force will compel the addition of this amendment resulting in the Homemaker's personal retirement account.

Thank you.

Senator ROTH. Thank you, Mr. Little.

I want to express my appreciation for your support of my legislation. I wonder as chairman of First National Retirement Systems Inc. do you believe there would be fairly broad participation by the housewives?

Mr. LITTLE. Yes, I brought along with me two gentlemen. These associates have helped put together the system which has existed for several years, and now accommodates the IRA program through payroll deduction. Housewives are primarily dependent on the filing of a joint return and this, of course, could be implemented to allow any working American who is fortunate enough to have a homemaker to ask for an employer deduction similar to an LERA or the IRA and very easily implement the homemaker account.

Senator ROTH. It is a fact, of course, that on the average women outlive men. It is also a fact that the Social Security System does not really provide the relief that—or help that—was originally anticipated, even though it was never intended to be the sole basis of retirement.

Do you see this pension proposal being helpful in easing the burden on the family, on the social security program?

Mr. LITTLE. Yes, sir. The issue very simply is that the earner is removed from the scene through disability or death, and the surviving spouse is not prepared for work and cannot easily fit into the work economy, and she is extremely dependent on the "cookie jar" mentality that has existed for generations, that she only has what

she has been able to save from the regular family budget. This would not only encourage spouses to accumulate money, but would encourage the earning spouse to allow for this accumulation because of the tax deductible advantage. I think it would allow man and wife to legitimately accumulate capital or capital formations, for the surviving individual, during a crisis situation such as disability or the death of a spouse.

Senator ROTH. I also believe this bill would have a dual impact that would increase savings for the homemaker and family, but, of course, it would also provide additional funds that are needed by our economy as a whole.

Mr. LITTLE. Yes, sir. The funds are stored up for future use, and if we follow the same rules as in the IRA, they will be immediately invested in the economy through insurance companies, banks, and the investment media.

Senator ROTH. Do you see any administrative problems or obstacles in this kind of proposal?

Mr. LITTLE. No, sir. In fact, it would be as easy to implement as the IRA.

Senator ROTH. I want to thank you very much for coming here. It has been most helpful, and I appreciate the assistance you have given me.

[The attachment to Mr. Little's statement follows:]

A TREATISE ON DEFERRED COMPENSATION

(January 2, 1976)

Formerly "an exclusively private corporate-executive privilege . . . now gone public".

Written by: T. L. Little and F. J. Shea, board chairman and president of First National Retirement Systems, Inc.

INTRODUCTION

Mr. Little and Mr. Shea are students in the Extended Division at Delaware Law School. They are founders and organizers of First National Retirement Systems, Inc., sponsor of "The National Retirement Plan".

The National Retirement Plan is a national computer recordkeeping payroll reduction system offered exclusively through statewide and regional banking, administrative and marketing facilities to both large and small employers for convenient monthly payroll reduction pension systems. Each regional administration and banking facility is serviced by a computer system through the Wilmington, Delaware, administrative office and the Delaware Trust Company which serves as the National Retirement Plan Custodian Bank. The Wilmington office produces the "computer bookkeeping" and "investment traffic management" for each individual savings, insurance and investment selection through the national bank custodianship system.

Although the system is defined and promoted as a "Bank Plan", clients may select from a wide range of investment options for each employee participant in the plan. The "Bank Plan" efficiently accomodates the wide selection of individual investment options for pension, profit sharing, Keogh, Individual Retirement Accounts and other payroll reduction employee benefit plans.

Since 1969, executive officers of First National Retirement Systems have negotiated extensively with both Federal and State agencies and officials in the research, development and organization of the National Retirement Plan. Prior to the passage of the Pension Reform Act (ERISA 1974), Company executives worked closely with Treasury Department personnel, White House officials and were invited to testify before the U.S. Senate Sub-Committee on Pension Reform co-chaired by Senator Harrison Williams D-N.J. and Senator Jacob Javits R-N.Y.

As a result of this background and experience, executives of First National Retirement Systems, Inc., have an intimate working knowledge of the New Pension Reform Law and the various mechanics of implementation on industrial and governmental employee benefit plans.

DEFERRED COMPENSATION

This writing is a Treatise on only one particular and singular aspect of the employee benefit industry which is not covered by the new law; and yet, as an employee benefit, is older than the pension industry itself. As a result of the Pension Reform Act, members of the legal profession have once again come to the fore in the pension field and predictably will ultimately replace the "actuary" in expertise and necessity in designing the mechanics of implementing employee benefit plans.

At the outset, it is extremely important for all parties to reach a common agreement regarding the definition of the term "deferred compensation." In the past, the term has been a "catch all" phrase to include all types of employee benefit plans.

In this treatise the term "deferred compensation" will be specifically defined as a mere contractual agreement between an employee, unfunded by the employer and nonqualified in federal statute and containing one or more of the following considerations:

Voluntarily reduce an employee's current salary level.

Voluntarily forgo an anticipated employee's raise in salary.

Voluntarily forgo certain anticipated future employee's proceeds not yet earned such as commissions, bonus, director's fees, etc.;

and justified to the Internal Revenue Service for any one or more of the following reasons:

To voluntarily stabilize an employee's future retirement benefits.

To voluntarily restrict an employee from competitive activities after severence of employment.

To voluntarily assure the provision of an additional consulting services to an employer after the retirement of a career employee.

There are certainly other reasons to justify deferred compensation but most of the standard contracts contain a combination of the above conditions. It must be stressed that the Internal Revenue Service will strenuously object to the use of deferred compensation for strictly tax avoidance and for that reason it is important to include even further conditions such as:

The contract must be irrevocable by either party for specific twelve month periods (automatically renewable at the end of each year).

The employer must maintain exclusive ownership of the assets in the account with a mere promise to pay the employee at a future date (no employee vested rights).

It should be contractually agreed that the assets may not pass to an employee until he meets one of the following criteria:

1. Death (to a preselected beneficiary);
2. Severance of employment (voluntarily or involuntarily); or
3. Disability (by rules of the employer).

EMPLOYEE TAXATION

At termination of employment and disbursement of assets, the employee is then liable for personal ordinary income tax at the current taxable year. At the same time, and only then, the corporation is entitled to take the corporate tax deduction on the exact amount that changes hands between the employee and employer. (The American Institute of Certified Public Accountants in 1956 has stated "you pay as you go" regarding deferred compensation tax treatment.)

Of course, it is extremely important to keep prominent in the mind that any institution qualifying under Section 501 of the Internal Revenue Code as a Federal tax exempt organization has no federal tax liability on amounts withheld for employees through deferred compensation contracts.

The above criteria are the most essential and commonly known ingredients in a standard deferred compensation contract. It is also interesting to note that the 1954 Internal Revenue Code recognized "deferred compensation" plans under Section 404. This fact gives Treasury Department credibility to the doctrine presented in this treatise. Contractual arrangements to defer compensation of corporate executives during a period of years subsequent to the completion of a

career is deeply rooted in the corporate executive employee benefit practices of American business. (Oates, 207 F2d 711, Weathers 22 TC Memo 314 (1953); Veit, 8 TC 809 (1947); Fleming, 241 F2d 78 5th Cir. (1957).)

EMPLOYER TAXATION

It is vividly clear to even the casual researcher that there is no corporate federal tax deduction to the employer for any contribution in kind or in promise to an unfunded, nonqualified corporate deferred compensation agreement on behalf of an employee. In fact, the price consideration assuring the employee the tax deferment is the employer must maintain exclusive ownership of the assets in the plan and the employee must forfeit all vested rights to the assets and defer to the business risk of the employer creditors.

More simply stated, the employer credits to the employee a specific dollar amount of deferred compensation . . . the employee becomes a general creditor of the employer for the specific amount credited. The amount credited remains an asset of the employer and subject to the risk of business until the employee receives it as earned income. (Revenue Ruling 69–650)

GENERAL TAXATION PROCEDURES AND CAVEATS

Eventually, the employee will meet the mutually agreed upon criteria (i.e. death, disability, severance) the employee then "earns out" a specific amount each year (or lump sum) plus any growth or accumulations on the contributions made to the account by the employer while the employee was in active career service.

At the exact moment the employee "receives" . . . the received amount becomes taxable to him at ordinary income rates during the current taxable year. Concurrently the employer is entitled to take the corporate tax deduction of the exact amount "received" as a regular business expense against corporate earnings during the same current taxable year. Employee benefit professionals refer to this type of deduction as a corporate "deferred tax allowance". Again, a reminder, if the institution has no federal tax liability, all the same rules apply except the "corporate tax liability and deferred tax allowance." This is because there is no corporate tax liability whatsoever to a federal tax exempt organization for deferring compensation of employees.

NEW LOOK AT OLD IDEA

The 1969 tax revision and the 1974 Pension Reform Law have brought about a complete reexamination of this executive employee benefit. In 1970, it was discovered that this unique tax advantage could be safely and conveniently offered to federally tax except 501 organizations and governmental employees as an additional voluntary employee fringe benefit. In 1971, executives of First National Retirement Systems, Inc., requested Mr. Joseph H. Geoghegan Esq., of the Wilmington law firm of Potter, Anderson & Corroon, to apply to the International Revenue Service for specific ruling for a custodian bank, an administrator and a public employee regarding a deferred compensation plan for the State of Delaware and City of Wilmington employees. The Internal Revenue Service's answer to both requests confirmed the favorable tax position, the custodian-administrator team idea subsequently became wide spread and is currently being considered in more than two dozen states, hundreds of municipalities, hospitals and educational institutions throughout the country. However, private and publicly owned corporations are currently looking very closely to this type of voluntary payroll reduction deferred compensation benefit to reward career personnel for longevity and valuable service. In this situation certain caveats should be noted:

A. Without careful construction, a nonqualified corporate deferred compensation plan that reduces current salary levels may irrevocably adversely affect anticipated pension or profit sharing benefits for an employee after retirement.

B. The employee's receipt of assets from a deferred compensation account are surely taxable after retirement and may adversely affect the tax planning of anticipated integrated pension and social security benefits.

C. Economic inflation may render a mere "unsecured" promise to pay to an inadequate economic level after an employee reaches retirement age.

D. Careful selection in "securing" the investment of current yearly contributions in life insurance contracts, annuities or equities may overcome the above objections, but a careful agreement should be written to be sure there is no "vested interest", "constructive receipt" or "cash equivalent" received by the employee when the employer has "secured" deferred compensation contributions.

In spite of the above caveats, current heavy tax burdens have motivated many valuable employees who wish to maintain a consistent standard of living after retirement, commensurate with his working years, to increase their demand on employers to provide deferred compensation benefits. Each deferred compensation contract must be negotiated on an individual basis by each individual employee. (8700.2 Institute for Business Planning, Executive Compensation)

For generations this benefit was reserved solely for Board Chairman and chief executive types. The new reforms in employee benefits and the elimination of capital gains treatment for pensioners in 1969 has caused many executives to look to their corporate management for this unique tax break and individual payroll reduction deferred pay contracts. (Annual statements and proxy statements: Coca-Cola Company, duPont Company and Corning Glass Works)

Sensible tax planning for deferred compensation should meet the following tests:

A. The employee needs assurance that he will not be currently taxed each year.

B. The corporation needs assurance it is not committing itself to a plan that can deprive it of its eventual business deduction (deferred tax allowance).

C. Future payments to the employee in retirement should be reasonably "secured" in spite of the business risk of the corporation.

D. The funds contributed should have a guaranteed growth potential to assure the corporation of full recovery of the deferred tax allowance and in turn assure the employee of a potential hedge against economic inflation.

E. There should be no attempt to defer compensation already earned and due the employee.

F. There should be no trust or annuity document in which the employee has any nonforfeitable right.

The Internal Revenue Service steadfastly maintains that each case will be judged upon its own merits and the nearest to a general rule is: "there is no constructive receipt where the employer has executed a mere 'secured or unsecured' promise to pay at some future date; however, there is constructive receipt where the taxpayer has gained vested rights to the promised funds even though not physically in his possession." (Revenue Ruling 60–31: Revenue Ruling 70–435; Revenue Ruling 69–650)

THE "SECURED" ACCOUNT CONCEPT

Recent developments have revealed that deferred compensation contracts can be "secured" with relative ease, safety and confidence through a bank custodian type agreement (or trust) provided the employee's vested rights to the "secured" assets are completely forfeitable to the business risk of the employer. (Drysdale, 177 F2d 413, Rev. 32 TC 378; Bechtold and Johnson private letter rulings, regarding the National Retirement Plan, State of Delaware, City of Wilmington, 1972)

Of course with forfeitable rights, we are back to the nondeductibility problem for the employer, the employer is not entitled to an immediate deduction for contributions to a custodian or trust plan as stated above and must wait until the account "earns out" to the employee before being entitled to the deferred tax allowance.

One solution to a reasonably "secured" account is to have the employer make current payments to an individual custodian account on behalf of each employee, with the custodian making subsequent payments to the employee at a future date. Even though the employer pays the currently deferred compensation to a custodian on behalf of the employee, the employer gets no current business tax deduction because the employee's rights are forfeitable and at the business risk of the corporation. (Again an important reminder that the tax exempt organizations have no tax liability for employees deferrals.) As the employee's rights become nonforfeitable, the employee will at that time be taxed of the full value of interest

received. The exact amount of value received by the employee will then be deductable from the corporation; hence, the "deferred tax allowance" as a business expense, including all growth of assets in a "secured" account since the contributions were made by the corporation.

The Internal Revenue Service has never succeeded in attempts to tax employees where the consideration received in the deferred compensation contract is a mere "secured or unsecured" promise to pay. Revenue Rulings 60–31 and 60–650 clear the way and promise taxpayers relative freedom from the application of constructive receipt or cash equivalent theories to simple unfunded, secured or unsecured deferred compensation agreements. Most of these type contracts are secured by life insurance, annuities or equities and they remain assets of the corporation and subject to corporation creditors.

However, it is possible under unusual circumstances to guarantee a deferred compensation arrangement if there is an unusual fear by the employee that the employers assets are not especially solvent. Medium sized and smaller corporations can have an additional signature on the contract to guarantee payment (Wolfe, 8 TC 689 (1947) aff'd 170 F2d 73 (9th Cir. 1948)).

INFLATION SAFEGUARDS

It is possible to inflation proof a deferred pay contract and maintain flexible investment options for secured employee contracts, one popular method utilizes the individual bank custodian account system.

The employer agrees to contribute a regular dollar amount each year out of future earned proceeds of the employee to an individual bank custodianship. The employer then allows the employee the discretion of directing the future investment of the secured assets at the custodian bank into various investment options such as:

Savings Accounts.
Mutual Funds.
Insured Annuities.
Life Insurance Contracts.
Government Bonds.
New York Stock Exchange Listed Securities.

The actual selection of the secured investment portfolio combinations is the employee's individual discretion and as long as the assets are kept at the business risk of the employer, there is no constructive receipt or cash equivalent taxpayer theory. The custodian then pays out the secured account assets to the employee at the contractual specification selected at the time of retirement, such as:

Lump sum (payout can be income averaged).
Period certain (paid out over a specific numbers of years).
Life expectancy (paid out according to the American Annuitants Table).
Life time annuity (paid out over actual lifetime by an annuity).

ECONOMIC ADVANTAGES FOR EMPLOYERS

It is entirely possible for an employer to increase corporate earnings by the liberal and consistant use of a secured deferred compensation plan:

In an Over-Simplified Example Between Employee and X.Y.Z. Corporation:

E.M.P. defers $1,000 per year into a secured custodian account for 10 years total deferred compensation by E.M.P. equals $1,000.

X.Y.Z. pays 48% federal tax on each $1,000 contribution, but carries the secured asset in the corporation surplus (usually in Stockholders Equity as a footnote). Total 10 year tax paid by X.Y.Z. equals $4,800. Total 10-year asset carried by X.Y.Z. equals $10,000.

E.M.P. requests that the $1,000 secured proceeds each year be directed to: $250 life insurance ($20,000 level mortality risk), and $750 mutual fund (equity investment).

E.M.P. dies before retirement, X.Y.Z. takes minimum corporate business tax deduction of $20,000 plus all accumulated secured cash assets upon liquidation of the account to E.M.P. beneficiary. Minimum deferred tax allowance for X.Y.Z. equals $20,000.

E.M.P. lives until retirement, the equity investment with average 9% annual growth yields $14,250 (plus cash value of insurance, if any). E.M.P. receives assets and pays current ordinary income tax on $14,250 averaged over a 5 year period after retirement.

X.Y.Z. takes minimum deferred tax allowance of $14,250.

X.Y.Z. recovers previous corporate tax paid	$4,800
X.Y.Z. net gain in retained earnings	9,450
Total	14,250

SUMMARY

The secured custodian account system allows each employee to personally select insurance and investments to meet his personal and family goals and at the same time insures the full recovery of the deferred tax allowance paid by the corporation. (Again an important reminder, this is not applicable in a federally tax exempt institution . . . there is no federal tax liability; therefore, no necessity of recovery.) The special tax advantages become quite clear with a simple example and when coupled with other investment mix possibilities both the employee and the employer are well served if they are both willing to share the joint burden of nondeductibility for the corporation and the business risk for the employee.

The prudent use of life insurance in each secured account can help the employee meet a possible mortality liability and at the same time relieve the company of an extensive executive mortality risk by providing:

By Annuity Benefit—an increased standard of living during the retirement life of the employee and dependents.

By Mortality Benefit—the corporation can reduce its mortality risk to employee beneficiaries and dependents.

It is important at this point to stress that each individual deferred pay contract must be negotiated and stand on its own merits—No group benefits should exist that can be construed by the Internal Revenue Service to create the implication of a pension trust, a vested right or implied constructive receipt.

One final caveat should be noted: Generally, most hospitals meet the requirements under Internal Revenue Service Code, Section 501, federal tax exemption, but there is an additional hurdle to overcome with a deferred compensation plan for hispitals receiving provider reimbursement for salaries of employees of the hospital. A special clearance must be requested through the Department of Health, Education and Welfare for the plan should it be decided to use deferred compensation for hospital employees; otherwise, the hospital may not be reimbursed for portions of salary deferred and this could become quite costly and unexplainable to hospital directors and management. (Bureau of Health Insurance Regulations: Costs related to patient care § 2140. Deferred compensation 2140.3B Custodian)

It is increasingly likely that non-profit and profit making institutions will investigate this employee benefit opportunity in the face of increased prospects of rising taxes and economic inflation. The institutional legal counsel should carefully review all the above aspects of a deferred compensation plan and should be fully prepared and current in order to adequately advise corporate and individual clients in the event of Internal Revenue Service opposition. If the rules set forth above regarding construction are followed with reasonable care, there will be no challenge of adverse taxability for the Plan.

Senator ROTH. This committee will now adjourn until 10 o'clock tomorrow morning.

[Whereupon, at 12:55 p.m. the committee recessed, to reconvene at 10 a.m., Wednesday, April 7, 1976.]